

TENTH EDITION

BUSINESS LAW

TEXT & EXERCISES

Roger LeRoy Miller



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Business Law

Text & Exercises

Tenth Edition

Roger LeRoy Miller

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Arlington, Texas



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Contents in Brief

Unit 1

The Law and Our Legal System 1

- Chapter 1 Introduction to the Law 2
- Chapter 2 Ethics in Business 13
- Chapter 3 The Courts and Our Legal System 27
- Chapter 4 Constitutional Law 43
- Chapter 5 Business Torts 55
- Chapter 6 Intellectual Property 67
- Chapter 7 Business Crimes 81

Unit 2

Contracts 95

- Chapter 8 Introduction to Contracts 96
- Chapter 9 Offer and Acceptance 107
- Chapter 10 Consideration 119
- Chapter 11 Capacity 129
- Chapter 12 The Legality of Agreements 139
- Chapter 13 Voluntary Consent 151
- Chapter 14 Contracts That Must Be in Writing 163
- Chapter 15 Third Party Rights 177
- Chapter 16 Termination and Remedies 189

Unit 3

Sales and Leases 203

- Chapter 17 Introduction to Sales and Lease Contracts 204
- Chapter 18 Title and Risk of Loss 217
- Chapter 19 Performance and Breach 231
- Chapter 20 Warranties and Product Liability 245
- Chapter 21 Consumer Protection 259

Unit 4

Negotiable Instruments 273

- Chapter 22 The Essentials of Negotiability 274

- Chapter 23 Negotiable Instruments: Transfer and Liability 287
- Chapter 24 Banking 301

Unit 5

Agency and Employment 317

- Chapter 25 Agency Relationships 318
- Chapter 26 Employment, Immigration, and Labor Law 333
- Chapter 27 Employment Discrimination 347

Unit 6

Business Organizations 361

- Chapter 28 Types of Business Organizations 362
- Chapter 29 Formation and Ownership of a Corporation 377
- Chapter 30 Management of a Corporation 393
- Chapter 31 Combining and Dissolving Corporations 403

Unit 7

Credit and Risk 415

- Chapter 32 Security Interests and Creditors' Remedies 416
- Chapter 33 Mortgages 431
- Chapter 34 Bankruptcy 441
- Chapter 35 Insurance 453

Unit 8

Property 465

- Chapter 36 Personal Property 466
- Chapter 37 Bailments 477
- Chapter 38 Real Property 489
- Chapter 39 Landlord and Tenant Law 501
- Chapter 40 Wills and Trusts 511

Unit 9

Special Topics 525

- Chapter 41 Administrative Law 526
- Chapter 42 Antitrust Law 539
- Chapter 43 International and Space Law 551

Appendix

A Answers to the Issue Spotters A-1

Glossary G-1

Table of Cases TC-1

Index I-1

Contents

Unit 1

The Law and Our Legal System 1

Chapter 1

Introduction to the Law 2

What Is Law? 2

Business Activities and the
Legal Environment 2

Highlighting the Point 3

Sources of American Law 3

Real Case 5

Highlighting the Point 6

Civil Law Versus Criminal Law 7

National Law Around the World 7

International Law 7

Linking Business Law to Your Career:
Consulting an Expert for Advice 8

Chapter 1—Work Set 11

Chapter 2

Ethics in Business 13

The Importance of Business Ethics 13

Setting the Right Ethical Tone 14

Real Case 15

Highlighting the Point 15

The Sarbanes-Oxley Act 16

Business Ethics and the Law 16

Highlighting the Point 17

Approaches to Ethical Reasoning 18

Highlighting the Point 19

Business Ethics and Social Media 20

Highlighting the Point 21

Business Ethics on a Global Level 21

Highlighting the Point 22

Linking Business Law to Your Career:
Managing a Company's Reputation 22

Chapter 2—Work Set 25

Chapter 3

The Courts and Our Legal System 27

Jurisdiction 27

The State Court System 28

The Federal Court System 29

The State Court Case Process 32

Highlighting the Point 32

Real Case 33

Alternative Dispute Resolution 36

Chapter 3—Work Set 41

Chapter 4

Constitutional Law 43

The Constitutional Powers of Government 43

Real Case 44

Highlighting the Point 45

Business and the Bill of Rights 46

Highlighting the Point 48

Due Process and Equal Protection 49

Privacy Rights 50

Linking Business Law to Your Career:
Pretexting and Marketing 51

Chapter 4—Work Set 53

Chapter 5

Business Torts 55

The Basis of Tort Law 55

Intentional Torts Against Persons 55

Real Case 57

Intentional Torts Against Property 58

Highlighting the Point 59

Negligence 60

Highlighting the Point 60

Highlighting the Point 61

Strict Liability 62

Chapter 5—Work Set 65

Chapter 6**Intellectual Property 67**

Trademarks and Related Property 67

Highlighting the Point 68

Highlighting the Point 70

Patents 70

Copyrights 71

Real Case 72

Highlighting the Point 73

Highlighting the Point 73

Trade Secrets 74

Highlighting the Point 75

International Protection for Intellectual Property 75

Linking Business Law to Your Career:

Trademarks and Service Marks 76

Chapter 6—Work Set 79**Chapter 7****Business Crimes 81**

Civil Law and Criminal Law 81

Constitutional Safeguards 82

Highlighting the Point 84

Crimes Affecting Business 84

Highlighting the Point 85

Highlighting the Point 85

Defenses to Criminal Liability 86

Cybercrime 87

Real Case 88

Linking Business Law to Your Career:

Protect Your Company Against Hacking 90

Chapter 7—Work Set 93**Unit 2****Contracts 95****Chapter 8****Introduction to Contracts 96**

The Definition of a Contract 96

Real Case 97

Types of Contracts 98

Highlighting the Point 99

Highlighting the Point 100

Interpretation of Contracts 102

Chapter 8—Work Set 105**Chapter 9****Offer and Acceptance 107**

Requirements of the Offer 107

Highlighting the Point 108

Termination of the Offer 109

Highlighting the Point 109

Acceptance 111

Highlighting the Point 111

E-Contracts—Offer and Acceptance 112

Real Case 113

Chapter 9—Work Set 117**Chapter 10****Consideration 119**

Elements of Consideration 119

Highlighting the Point 120

Real Case 121

The Lack of Consideration 121

Highlighting the Point 121

Settlement of Claims 123

Highlighting the Point 123

Promissory Estoppel 124

Chapter 10—Work Set 127**Chapter 11****Capacity 129**

Minors 129

Real Case 130

Highlighting the Point 131

Highlighting the Point 132

Intoxicated Persons 133

Mentally Incompetent Persons 133

Highlighting the Point 134

Linking Business Law to Your Career:

Contracts With Minors 134

Chapter 11—Work Set 137**Chapter 12****The Legality of Agreements 139**

Contracts Contrary to Statute 139

Highlighting the Point 141

Highlighting the Point 141

Contracts Contrary to Public Policy 142

Real Case 142

Highlighting the Point 143
 Highlighting the Point 144
 The Effect of Illegality 144
 Highlighting the Point 144
 Highlighting the Point 145

Chapter 12—Work Set 149

Chapter 13

Voluntary Consent 151

Mistakes 151
 Real Case 152
 Fraudulent Misrepresentation 153
 Highlighting the Point 154
 Highlighting the Point 156
 Undue Influence and Duress 156
 Highlighting the Point 157

Chapter 13—Work Set 161

Chapter 14

Contracts That Must Be in Writing 163

The Statute of Frauds—
 Writing Requirement 163
 Highlighting the Point 165
 Highlighting the Point 166
 Highlighting the Point 167
 The Sufficiency of the Writing 168
 The Parol Evidence Rule 169
 Real Case 169
 Highlighting the Point 170
 Linking Business Law to Your Career:
 Enforceable E-Mail and Text Contracts 172

Chapter 14—Work Set 175

Chapter 15

Third Party Rights 177

Assignments and Delegations 177
 Highlighting the Point 179
 Highlighting the Point 180
 Highlighting the Point 181
 Third Party Beneficiaries 181
 Real Case 182
 Highlighting the Point 184
 Linking Business Law to Your Career:
 Assignment and Delegation 184

Chapter 15—Work Set 187

Chapter 16

Termination and Remedies 189

Contract Termination 189
 Real Case 190
 Highlighting the Point 191
 Highlighting the Point 192
 Contract Remedies 194
 Highlighting the Point 195
 Highlighting the Point 195
 Highlighting the Point 196
 Linking Business Law to Your Career:
 Performance and Compromise 198

Chapter 16—Work Set 201

Unit 3

Sales and Leases 203

Chapter 17

Introduction to Sales and Lease Contracts 204

Sales and Leases of Goods 204
 Highlighting the Point 205
 Sales and Lease Contracts 206
 Highlighting the Point 207
 Highlighting the Point 208
 Highlighting the Point 209
 Highlighting the Point 209
 Real Case 210
 Highlighting the Point 211

Chapter 17—Work Set 215

Chapter 18

Title and Risk of Loss 217

Identification 217
 Passage of Title 218
 Highlighting the Point 219
 Highlighting the Point 220
 Risk of Loss 221
 Highlighting the Point 222
 Highlighting the Point 223
 Real Case 224
 Insurable Interest 225
 Highlighting the Point 225

Linking Business Law to Your Career:
Risk Management 226

Chapter 18—Work Set 229

Chapter 19

Performance and Breach 231

Obligations of the Seller or Lessor 231

Highlighting the Point 232

Highlighting the Point 234

Highlighting the Point 235

Obligations of the Buyer or Lessee 235

Real Case 236

Remedies of the Seller or Lessor 237

Highlighting the Point 238

Remedies of the Buyer or Lessee 238

Highlighting the Point 239

Chapter 19—Work Set 243

Chapter 20

Warranties and Product Liability 245

Warranties of Title 245

Highlighting the Point 246

Express Warranties 246

Real Case 247

Implied Warranties 248

Highlighting the Point 248

Warranty Disclaimers and
Limitations on Liability 249

Highlighting the Point 250

Product Liability 251

Highlighting the Point 251

Highlighting the Point 253

Highlighting the Point 254

Linking Business Law to Your Career:
Quality Control Management 254

Chapter 20—Work Set 257

Chapter 21

Consumer Protection 259

Deceptive Advertising 259

Highlighting the Point 260

Highlighting the Point 261

Labeling Laws and Consumer Sales 262

Credit Protection 263

Real Case 264

Highlighting the Point 266

Protection of Health and Safety 267

Chapter 21—Work Set 271

Unit 4

Negotiable Instruments 273

Chapter 22

The Essentials of Negotiability 274

Types of Instruments 274

Real Case 277

What Is a Negotiable Instrument? 278

Highlighting the Point 280

Transfer of Instruments 281

Highlighting the Point 281

Highlighting the Point 282

Chapter 22—Work Set 285

Chapter 23

Negotiable Instruments: Transfer and Liability 287

Requirements for HDC Status 287

Highlighting the Point 288

Signature Liability 290

Real Case 290

Highlighting the Point 292

Warranty Liability 293

Highlighting the Point 294

Defenses 294

Discharge 296

Chapter 23—Work Set 299

Chapter 24

Banking 301

Checks and the Bank—Customer Relationship 301

Real Case 302

Honoring Checks 303

Highlighting the Point 305

Accepting Deposits 306

Highlighting the Point 307

Electronic Fund Transfers 309

Banking in the Digital Age 310

Chapter 24—Work Set 315

Unit 5

Agency and Employment 317

Chapter 25

Agency Relationships 318

Principal–Agent Relationships 318

Highlighting the Point 319

Agency Formation 319

Real Case 320

Duties of Agents and Principals 321

Agent’s Authority 322

Highlighting the Point 323

Highlighting the Point 324

Liability in Agency Relationships 324

Highlighting the Point 325

Termination of Agency Relationships 326

Highlighting the Point 326

Linking Business Law to Your Career:
Independent Contractors 327

Chapter 25—Work Set 331

Chapter 26

Employment, Immigration, and Labor Law 333

Employment at Will 333

Highlighting the Point 333

Worker Protections 334

Highlighting the Point 335

Highlighting the Point 336

Retirement Income and Security 337

Highlighting the Point 339

Immigration Law 339

Labor Law 340

Real Case 340

Chapter 26—Work Set 345

Chapter 27

Employment Discrimination 347

Title VII of the Civil Rights Act 347

Highlighting the Point 348

Discrimination Based on Age 351

Highlighting the Point 352

Discrimination Based on Disability 352

Highlighting the Point 353

Defenses to Employment Discrimination 354

Real Case 354

Linking Business Law to Your Career:
Human Resources Management 355

Chapter 27—Work Set 359

Unit 6

Business Organizations 361

Chapter 28

Types of Business Organizations 362

Sole Proprietorships 362

Partnerships 363

Real Case 364

Highlighting the Point 365

Highlighting the Point 365

Highlighting the Point 367

Highlighting the Point 368

Highlighting the Point 368

Highlighting the Point 369

Highlighting the Point 370

Limited Liability Companies 370

Linking Business Law to Your Career:
“Doing Business As” a Sole Proprietor 371

Chapter 28—Work Set 375

Chapter 29

Formation and Ownership of a Corporation 377

Formation of a Corporation 377

Real Case 379

Corporate Classifications, Powers,
and Liability 380

Corporate Financing 381

Sales of Securities 383

Highlighting the Point 383

Corporate Ownership—Shareholders 384

Highlighting the Point 385

Highlighting the Point 387

Chapter 29—Work Set 391

Chapter 30

Management of a Corporation 393

Corporate Management—Directors 393

Highlighting the Point 395

Highlighting the Point 395

Corporate Management—Officers 396

Duties of Directors and Officers 396

Real Case 397

Liability of Directors and Officers 398

Chapter 30—Work Set 401

Chapter 31

Combining and Dissolving Corporations 403

Mergers, Consolidations, and Share Exchanges 403

Highlighting the Point 404

Real Case 405

Purchase of Assets 406

Purchase of Stock 406

Termination of a Corporation 408

Highlighting the Point 408

Chapter 31—Work Set 413

Unit 7

Credit and Risk 415

Chapter 32

Security Interests and Creditors' Remedies 416

Secured Transactions 416

Highlighting the Point 418

Highlighting the Point 419

Laws Assisting Creditors 420

Highlighting the Point 422

Highlighting the Point 423

Real Case 423

Highlighting the Point 425

Chapter 32—Work Set 429

Chapter 33

Mortgages 431

Types of Mortgages 431

Highlighting the Point 432

Lender Protections 432

Borrower Protections 433

Foreclosures 434

Real Case 435

Highlighting the Point 436

Chapter 33—Work Set 439

Chapter 34

Bankruptcy 441

Types of Bankruptcy Relief 441

Highlighting the Point 443

Chapter 7—Liquidation 443

Chapter 11—Reorganization 446

Chapter 13—Adjustment 447

Real Case 447

Chapter 34—Work Set 451

Chapter 35

Insurance 453

Insurance Terminology and Concepts 453

The Insurance Contract 455

Highlighting the Point 456

Real Case 457

Highlighting the Point 457

Linking Business Law to Your Career:

Risk Management in Cyberspace 459

Chapter 35—Work Set 463

Unit 8

Property 465

Chapter 36

Personal Property 466

The Nature of Personal Property 466

Property Ownership—Rights of Possession 467

Acquiring Ownership of Personal Property 467

Misplaced, Lost, and Abandoned Property 469

Real Case 469

Highlighting the Point 470

Chapter 36—Work Set 475

Chapter 37

Bailments 477

The Elements of a Bailment 477

Highlighting the Point 478

The Rights of the Bailee 479

Highlighting the Point 480

The Duties of the Bailee 480

Real Case 481

Highlighting the Point 481

The Duties of the Bailor 482

Special Bailments 483

Chapter 37—Work Set 487

Chapter 38**Real Property 489**

The Nature of Real Property 489

Ownership Interests 491

Highlighting the Point 491

Real Case 493

Highlighting the Point 493

Transfer of Ownership 493

Highlighting the Point 494

Chapter 38—Work Set 499**Chapter 39****Landlord and Tenant Law 501**

Types of Tenancy 501

The Lease Agreement 502

Rights and Duties of Landlords and Tenants 503

Highlighting the Point 504

Real Case 505

Transferring Rights to Leased Property 505

Terminating the Lease 506

Highlighting the Point 506

Chapter 39—Work Set 509**Chapter 40****Wills and Trusts 511**

Wills 511

Highlighting the Point 514

Intestacy Laws 516

Highlighting the Point 516

Trusts 517

Real Case 519

Chapter 40—Work Set 523**Unit 9****Special Topics 525****Chapter 41****Administrative Law 526**

Agency Creation 526

The Administrative Process 527

Highlighting the Point 528

Controls on Agency Powers 530

Real Case 531

Public Accountability 532

Chapter 41—Work Set 537**Chapter 42****Antitrust Law 539**

The Sherman Act 539

Highlighting the Point 540

Highlighting the Point 542

Real Case 543

Highlighting the Point 544

The Clayton Act 544

Enforcement of Antitrust Laws 545

U.S. Antitrust Laws in the
Global Context 546

Highlighting the Point 546

Chapter 42—Work Set 549**Chapter 43****International and Space Law 551**

International Principles and Doctrines 551

Real Case 552

Doing Business Internationally 553

International Contract Provisions 554

Highlighting the Point 554

Regulation of International
Business Activities 555

Space Law 556

Chapter 43—Work Set 561**Appendix**

A Answers to the Issue Spotters A-1

Glossary G-1

Table of Cases TC-1

Index I-1

Preface to the Instructor

The study of business law and the legal environment has universal applicability. Any student entering any field of business must have at least a passing understanding of business law in order to function in the real world. Students going on to a business career must have an awareness of the legal and regulatory environment today. Even for those students who do not pursue a business career, legal problems will arise.

In *Business Law: Text & Exercises*, Tenth Edition, I present business law in a straightforward, practical manner. The essential aspects of every important topic are covered without overburdening the reader with numerous details and explanations of arcane exceptions. This new edition helps students master key legal concepts and doctrines while providing practical experience in applying basic legal principles to common business situations. Written in user-friendly, layperson language, I have taken special care to provide straightforward descriptions, everyday examples, and varied exercises to help students apply what they are reading and learning to real-life situations.

Developed specifically for the business law survey course, this new edition's short, concise chapters are punctuated with illustrative and timely features, including Highlighting the Point and Real Case summaries. Each chapter's learning tools clarify contemporary legal principles in a practical presentation that ensures students gain a solid understanding of business law.

What's New in the Tenth Edition

Instructors have come to rely on the coverage, accuracy, and applicability of *Business Law: Text & Exercises*. That is why in the tenth edition I continue to focus on engaging student interest and providing a basic understanding of business law. In every chapter, I have incorporated significant new details, timely examples, helpful exhibits, and recent cases.

This edition aims to provide a text that fully integrates diversity and inclusivity so that all students (and instructors) can feel comfortable at all times while reading it.

New Chapter Content

Where appropriate, I have added new or fully revised sections. These include:

- In Chapter 5, new explanation of **why the common language use of “assault” is incorrect**
- In Chapter 6, new section extension on **selling counterfeit items on the internet, in particular, involving a lawsuit by Chanel against Amazon**
- In Chapter 9, new section on **click-on agreements that includes forum-selection clauses**
- In Chapter 11, new section on **whether minors can avoid their obligations under smart contracts**
- In Chapter 11, new section on **minors' rights and digital assets**
- In Chapter 13, new section on **reformation of contracts as an alternative to judicially canceling contracts**

- In Chapter 13, new section on **innocent misrepresentation**
- In Chapter 14, new section on **text messaging and the enforceability of e-mail and text contracts**
- In Chapter 17, new section on **rules of construction given the order of priority of expressed terms**
- In Chapter 19, new section on **when a repudiation may be retracted**
- In Chapter 21, new section on the TCPA and TRACED Acts, with the latter **dealing specifically with prohibited robocalls**
- In Chapter 22, new section on **acceleration clauses**
- In Chapter 23, new section on FTC Rule 433, which effectively eliminates **holder in due course status for those holding notes pursuant to consumer credit transactions**
- In Chapter 24, new section on **online and mobile banking**
- In Chapter 24, new section on **electronic payment systems, including eBills**
- In Chapter 24, new section on **artificial intelligence (AI) and its use in financial technology (fintech)**
- In Chapter 24, new section on **digital lending using artificial intelligence**
- In Chapter 26, new section on the Family and Medical Leave Act with respect to **families of those in the armed forces**
- In Chapter 26, new section on the Affordable Care Act
- In Chapter 27, new section on the 2020 Supreme Court case *Bostock v. Clayton County* concerning the inclusion of gender identity and sexual orientation within the meaning of Title VII of the Civil Rights Act
- In Chapter 27, new section on **discrimination against transgender persons**
- In Chapter 27, new section on **seniority systems**
- In Chapter 29, new section on Reg. A+, which increased the exemption under Reg. A from \$5 million to \$50 million for security offerings
- In Chapter 29, new section on the **decreased use of physical stock certificates**
- In Chapter 30, new section on **disclosure of conflicts of interest**
- In Chapter 37, new section on a **bailor's duty to reveal defects**
- In Chapter 37, new section on **warranty liability for defective goods**
- In Chapter 38, new section on **creation of an easement or profit by necessity**
- In Chapter 38, new section on **creation of an easement or profit by implication**
- In Chapter 38, new section on **creation of an easement or profit by prescription**
- In Chapter 39, new section on **commercial lease terms**
- In Chapter 40, new section on **transfer of digital assets upon death**
- In Chapter 40, new section on the **eight categories of digital assets that should be of concern to students**
- In Chapter 40, new section on **digital executors**
- In Chapter 40, new section on **adding digital heirs to your accounts**
- In Chapter 40, new section on **using a password manager**

Effective Pedagogy

The tenth edition complements its new content coverage with varied and updated pedagogical content. To provide students with a variety of study tools for retaining and reviewing chapter materials, I have revised the following:

- **Every chapter presents all-new Real Cases, which are based on actual cases.** Eighteen are real cases from 2020 and 2021. Students can quickly read

through the Real Cases to see how courts apply legal principles to everyday business scenarios.

- I have **added Highlighting the Point features**. These features help students understand how business law can apply to common situations. There are over a dozen new features of this type.
- I have **added new Conflict Presented/Conflict Resolved features**. Each chapter opens with a brief legal Conflict Presented scenario and question. The Conflict Resolved feature answers the Conflict Presented question. These Conflict Resolved features are placed after the concept demonstrated is presented within each chapter. Students can therefore more easily see the relationship between the conflict and the legal principle that explains how it is resolved.
- Examples are very helpful for students because they illustrate and clarify legal principles. I have **added numerous new numbered examples** throughout the text.
- This edition also includes **forty-three new Real Law case problems** in the chapter-ending material. Thirty of these cases are from 2020 and 2021.

Additional Practical Learning Tools

To help students review chapter materials and prepare for testing, this text provides additional effective, practical features:

- **Learning Outcomes.** Every chapter starts with four to six Learning Outcomes. Each Learning Outcome is repeated in the margin at the point where it is discussed in the text. Additionally, each **Chapter Summary** includes that chapter's Learning Outcomes with a succinct review of the major points students need to remember. In this edition, the end-of-chapter exercises are also tied to the corresponding Learning Outcome.
- **Linking Business Law to Your Career.** Written in an easy-to-understand style, these features emphasize tips, pitfalls, and effective strategies for students to remember once they are working and applying their knowledge of basic business law to real-life workplace scenarios. In selected chapters, these features often reflect new business developments and examples.
- **Glossary.** For students' convenient reference, each key term throughout the text is defined in the Glossary.

Pedagogical Basis for the End-of-Chapter Questions and Problems

There is a logical progression of questions and problems at the end of each chapter.

1. **Straight to the Point.** After the chapter summary, this section of questions represents, as the title suggests, straightforward questions that students should be able to answer without much effort. In a sense, these questions get the student "warmed up" for more difficult questions.
2. **Issue Spotters.** These two questions are designed to make the student think about hypothetical situations while applying the concepts learned in each chapter. As always, the suggested answers are provided in Appendix A so that students can recognize where their weaknesses are.
3. **Real Law.** Now we get into more difficult questions based on actual cases. The cases are presented in a highly summarized manner, but they still require more analytical reasoning than previous questions. The suggested answers to these questions are presented in the Answers Manual for instructors.

4. **Ethical Questions.** The first Ethical Question is relatively simple, and most students should be able to answer it. The second Ethical Question, in contrast, is similar to the difficulty incurred in the Real Law questions above. Again, the suggested answers are provided in the Answers Manual.
5. **Work Sets.** As always, each chapter ends with a Work Set, an in-text study guide designed to help students review the material covered in the chapter. The Work Set is divided into three sections:
 - a. **True-False Questions.** If this is a homework assignment, most students should be able to answer the true-false questions correctly. In a sense, the Work Set starts with questions that are about the same level of difficulty as those found in the Straight to the Point questions.
 - b. **Multiple-Choice Questions.** These questions attempt to see if students have fine-tuned their understanding of the chapter concepts. While some are relatively easy, others are not.
 - c. **Answering More Legal Problems.** My goal in presenting these problems is to see how well students could be “teased” into filling in the correct answers to hypotheticals that have multiple facets.

Teaching Materials

Business Law: Text & Exercises, Tenth Edition, provides a comprehensive supplements package. The supplements were created with a single goal in mind: to make the tasks of teaching and learning more enjoyable and efficient. The following supplements are available for instructors.

MindTap

Today’s leading digital platform, *MindTap* for *Business Law: Text & Exercises*, Tenth Edition, gives you complete control of your course to create unique learning experiences that challenge students, build confidence, and elevate performance.

MindTap introduces students to core concepts from the beginning of your course using a simplified learning path that progresses from understanding to application. *MindTap* presents concepts using a blend of engaging narrative and media while minimizing distraction with assignments that pair learning content with assessments in a visually appealing side-by-side format. A distinctive, personalized study plan, based on individual performance, helps students stay focused and enables them to easily pinpoint areas for further study and practice.

Exclusive Instructor Tools allow you to modify the wording of questions, answer choices, and feedback in assessments to match the specific objectives and style of your course. New Instructor Reports provide actionable insights into student performance and present opportunities for just-in-time intervention.

Use *MindTap* for *Business Law: Text & Exercises*, Tenth Edition, as-is, or customize it to meet your specific course needs. You can also easily integrate *MindTap* into your Learning Management System (LMS).

Product Features The outcomes-based learning design within *MindTap* propels students from memorization to mastery. It’s the only platform today that gives you complete ownership of your course. With *MindTap*, you can challenge every student, build confidence, and empower today’s learners to be unstoppable.

Boost Comprehension with Improved Learning Design. Students can focus and better comprehend key learnings through a Learning Path divided into groups of short activities, all anchored to a single concept. Built upon proven learning

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I know I am not perfect. If you find something you don't like or want me to change, write to me via e-mail, using the text's website. That is how I can make *Business Law: Text & Exercises* an even better book in the future.

R.L.M.

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Roger LeRoy Miller is currently Director of the Institute for University Studies in Arlington, Texas. He has served on the faculty of several universities, including the University of Washington, Clemson University, and the University of Miami School of Law. As a professor, he has taught intellectual property law and entertainment law, among other subjects. A widely published and respected author, his work has appeared in the *Insurance Counsel Journal*, *Defense Research*, *California Trial Lawyers Journal*, *Antitrust Bulletin*, *Wisconsin Law Review*, and *Connecticut Law Review*. He has authored or co-authored numerous authoritative textbooks on law, including *Business Law: Text & Cases*; *Business Law Today: Text & Summarized Cases*; and *The Legal Environment Today*. Professor Miller completed his studies at the University of California at Berkeley and the University of Chicago.

DEDICATION

*To Johnny Hagenbach,
Your athletic accomplishments will
be followed closely by
your academic excellence.*

—R.L.M.

Unit 1

The Law and Our Legal System

Unit Contents

Chapter 1

Introduction to the Law

Chapter 2

Ethics in Business

Chapter 3

The Courts and Our Legal System

Chapter 4

Constitutional Law

Chapter 5

Business Torts

Chapter 6

Intellectual Property

Chapter 7

Business Crimes

1

Introduction to the Law

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Define *law*.
- 2 List the major sources of law.
- 3 Identify the supreme law of the land.
- 4 Distinguish different global legal systems.

Learning Outcome 1

Define *law*.

law

Enforceable rules governing individuals and their society.

Conflict Presented

Krista created, designed, produces, and sells an antivirus facemask. Each of these masks has a distinctive image of the singer Ariana Grande. Krista never asked permission to use the singer's likeness. Ariana Grande's lawyers file a suit against Krista.

Q Can Ariana Grande obtain a court order to stop Krista's use of her likeness and recover payment for lost profits due to that use?

Persons entering the world of business today will find themselves subject to numerous laws and government regulations. An acquaintance with these laws and regulations is beneficial—if not essential—to anyone contemplating a successful career in business.

In this introductory chapter, we look at the nature of law in general. We also examine the history and sources—both domestic and international—of American law in particular.

1–1 What Is Law?

The British jurist William Blackstone (1723–80) described law as “a rule of civil conduct, . . . commanding what is right, and prohibiting what is wrong.” There are many sets of rules that declare what is right and what is wrong. These may come from religion, philosophy, and other scholarly sources, or arise from peer pressure, customs, and social conventions.

Only rules enacted by the government apply with equal force to all of the individuals in a society, however. Of course, to be effective, these rules must be enforced with penalties when they are broken. Thus, the **law** consists of enforceable rules governing relationships among individuals and between individuals and their society.

1–2 Business Activities and the Legal Environment

To make good business decisions, knowledge of the laws and regulations governing business is essential. Businesspersons must also develop critical thinking and reasoning skills to evaluate how the law might apply in a given situation and to determine the best course of action. Businesspersons are also pressured to make ethical decisions. Thus, the study of business law involves an ethical dimension.

1–2a Many Different Laws May Affect a Single Business Transaction

As you will see, each chapter in this textbook covers a specific area of the law and shows how the legal rules in that area affect business activities. It is important to remember, however, that many different laws may apply to just one transaction.

Businesspersons should be aware of this and understand enough about the law to know when to hire an expert for advice. See the Linking Business Law to Your Career feature later in this chapter for more on this topic.

If a dispute cannot be resolved amicably, then a **lawsuit** may become necessary. At that point, it is also important to know about the laws and the rules concerning courts and court procedures.

lawsuit

A judicial proceeding for the resolution of a dispute.

Highlighting the Point



Suppose that Molortron, Inc., plans to introduce a driverless car equipped with Lidar, a radar system that relies on lasers, and with artificially intelligent cameras. Even if its technicians put the vehicle through two million miles of testing on closed courses and then deem this vehicle low risk, Molortron cannot simply start selling rides to consumers.

What are some of the legal issues that Molortron could face? The company must first test the cars on public roads, which requires permission from state governments. It must also establish safety rules in conjunction with federal regulators, and it must negotiate sustainable insurance rates. At each step, Molortron will have to adjust its bottom line to take account of the legal costs of introducing cutting-edge, but potentially dangerous technology, into the marketplace.

1–2b The Role of the Law in a Small Business

Some of you may end up working in, or owning and operating, a small business. The small-business owner is the most general of managers. When you seek additional financing, you become a finance manager. As you go over the expenses and revenues, you become an accountant. When you direct an advertising campaign, you are the marketing manager. When you have employees and determine salaries and benefits, you become a human resources (HR) manager. Each of these roles has a link to the law. Exhibit 1.1 shows some of the legal issues that can arise in managing a small—or large—business.

1–3 Sources of American Law

To understand the law, you need to have some understanding of its origins. One major source is the common law tradition that originated in medieval England. Another is constitutional law, which includes the U.S. Constitution and the constitutions of the states. Statutes—the laws enacted by Congress and the state legislatures—comprise an additional source of American law. Finally, yet another source of American law is administrative law, which consists of the regulations created by administrative agencies.

Learning Outcome 2

List the major sources of law.

1–3a The Common Law

In medieval England, the courts established a uniform set of rules from the customs and traditions that had been in force in various regions of the nation. These rules—and the principles behind them—were applied to resolve similar disputes in a consistent way. Each application served as a guide for future decisions—a legal **precedent**.

precedent

A court decision that guides subsequent decisions.

Exhibit 1.1 Linking Business Law to the Management of a Small Business**common law**

A body of law developed from court decisions.

case law

Rules of law announced in court decisions.

stare decisis

A doctrine under which judges follow established precedents.

jurisdiction

The authority of a court to decide a specific dispute.

action

A court proceeding to enforce or protect a right, or redress or prevent a wrong.

Over several centuries, these decisions developed into a body of **common law**. The English colonists brought this law to America and set up legal systems based on the common-law method of deciding disputes. When the United States was formed, these legal systems were the model for the new nation's courts.

Today, the common law is still a significant source of legal authority. This body of law—sometimes referred to as **case law**—includes court interpretations of constitutional provisions, statutes enacted by legislatures, and regulations issued by administrative agencies.

The Doctrine of Precedent—Stare Decisis The practice of deciding new cases with reference to previous decisions, or precedents, forms a doctrine called **stare decisis** (pronounced *ster-ay dih-si-ses*), which means “to stand on decided cases.” According to this doctrine, a judge is obligated to follow the precedents established within the judge's **jurisdiction**.

This practice is a cornerstone of the U.S. judicial system. The doctrine helps courts to be more efficient and makes the law more stable and predictable. Someone bringing an **action** in a court can expect a result based on how the law has been applied in cases with similar facts.

Departures From Precedent A court may decide that a precedent is incorrect or that a change in society or technology has rendered it inapplicable. In that case, the court may rule contrary to the precedent.

Sometimes, there is no precedent, or there are conflicting precedents. In these situations, a court may base a decision on the principles announced in other court decisions. The court may also consider public policy, social values, or concepts and data from other fields of knowledge.

Equity A person brings a case to a court of law seeking a **remedy**, or relief from a wrong. Usually, that remedy is **damages**—the payment of money.

Example 1.1 Elena is injured because of Ning’s wrongdoing. If Elena files a lawsuit and is successful, a court can order Ning to compensate Elena for the harm by paying her a certain amount of money (damages). The compensation is Elena’s remedy.

Money may not always be enough to make a situation right, however. **Equity** is a branch of the law that seeks to supply a fairer and more adequate remedy in such a case. ■

For instance, a court might issue an **injunction** to order a party to do specifically what the party promised. Or a contract might be cancelled, and the contracting parties returned to the positions they held before the deal.

Historically, two distinct systems of courts were created to grant the different types of remedies. A court of law could award only damages. A court of equity could provide other relief. Today, however, in most states, the courts of law and equity are merged. A court may now grant either a legal or an equitable remedy, or both, in the same action.

remedy

The means to enforce a right or compensate for a wrong.

damages

Money sought as a remedy for a harm suffered.

equity

Equity here means fairness. Within the law, it refers to types of relief, such as injunctions (as opposed to legal remedies).

injunction

A court order to do or not do a certain act.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Krista created, designed, produces, and sells an antivirus facemask. Each of these masks has a distinctive image of the singer Ariana Grande. Krista never asked permission to use the singer’s likeness. Ariana Grande’s lawyers file a suit against Krista.

A Can Ariana Grande obtain a court order to stop Krista’s use of her likeness and recover payment for lost profits due to that use? Yes. A court can grant both types of remedies in a single case. Krista used Ariana’s likeness without her permission. The court can issue an injunction to stop Krista from continuing this action. If Ariana can also show that she lost sales of her own merchandise that uses her likeness, a court may order Krista to pay for Ariana’s lost profits.

1–3b Constitutional Law

The federal government and the states have separate constitutions that set forth the general organization, powers, and limits of their governments. The U.S. Constitution is the supreme law of the land. A law in violation of the Constitution, no matter what its source, will not be enforced.

Learning Outcome 3

Identify the supreme law of the land.

Real Case

The state of Maine provides by statute that all students shall benefit from a secondary school, whether private or public. Maine’s private schools, in order to be approved for tuition assistance, must be nonsectarian. That is to say, they do not support any specific religious beliefs. Certain parents challenged this requirement as violating the First Amendment of the Constitution.



(Continues)

Does the requirement that private schools not support specific religious beliefs in order to receive tuition-assistance payments infringe on the plaintiff's constitutional rights? No, in *Carson v. Makin*, the U.S. Court of Appeals for the First Circuit ruled that this requirement did not violate the First Amendment free exercise clause and did not violate the establishment clause. Rather, the limitation related to how the state's funds could be used. Maine did not place any limitations on religious teachings in general.

—979 F.3d 21 (1st Cir.)

Each state has its own constitution. Unless it conflicts with the U.S. Constitution, a state constitution is supreme within the state's borders.



Highlighting the Point

The U.S. Constitution gives Congress the authority to regulate businesses involved in interstate commerce. Under this authority, Congress enacts a law prohibiting businesses from refusing to deal with the members of socially disadvantaged groups. Later, a state legislature enacts a law allowing businesses in the state to refuse to deal with members of the groups. Jill, a member of a specific socially disadvantaged group, brings an action against the state to stop the enforcement of the new state law.

Is the state law valid? No. The law violates the U.S. Constitution because it attempts to regulate an area over which the Constitution gives authority to the federal government. The law also violates the constitutional rights of the members of any group against which it discriminates. The court can order the state to stop its enforcement of the law.

statutory law

Laws enacted by a legislative body.

1–3c Statutory Law

Statutes enacted by Congress and the state legislative bodies make up another source of law, generally referred to as **statutory law**. Statutory law also includes the ordinances passed by cities and counties. None of these can violate the U.S. Constitution or the relevant state constitution.

Today, regulatory agencies assume an ever-increasing share of lawmaking. Much of the work of modern courts consists of interpreting the intent of legislation and then the appropriateness of the consequent regulatory rules that were declared after statutes are passed.

Uniform Laws State laws differ from state to state. During the 1800s, the differences among state laws made trade and commerce among the states difficult. To counter these problems, a group of legal scholars and lawyers formed the National Conference of Commissioners on Uniform State Laws (NCCUSL). This organization began to draft uniform laws for the states to adopt.

Each state has the option of adopting or rejecting a uniform law. A state legislature may choose to adopt only part of a uniform law or to rewrite the sections that are adopted. Hence, even though many states may adopt a uniform law, the law may not be “uniform” across all these states. Once adopted by a state, a uniform act becomes a part of the statutory law of that state.

The Uniform Commercial Code (UCC) In 1932, the Uniform Commercial Code (UCC) was created through the joint efforts of the NCCUSL and the American Law Institute. The UCC has been adopted in forty-nine states, the District of Columbia,

and the Virgin Islands. Louisiana has adopted Articles 1, 3, 4, 5, 7, 8, and 9. The UCC facilitates commerce among the states by providing a uniform, yet flexible, set of rules governing commercial transactions.

1–3d Administrative Law

Administrative law consists of the rules, orders, and decisions of administrative agencies. An administrative agency is a federal, state, or local government body established to perform a specific function. Congress or a state legislature charges these departments, commissions, and boards with carrying out the terms of particular laws.

Rules issued by administrative agencies affect almost every aspect of a business's operations. Regulations govern a business's capital structure and financing, hiring and firing procedures, relations with employees and unions, and the making and selling of products.

administrative law

The rules, orders, and decisions created by administrative agencies.

1–4 Civil Law Versus Criminal Law

The huge body of the law is broken down into several classifications. One important classification divides law into civil law and criminal law.

Civil law spells out the rights and duties that exist between persons and between citizens and their governments. In a civil case, one party tries to make the other party comply with a duty or pay for the damage caused by a failure to do so. Contract law is part of civil law.

Example 1.2 If Elijah fails to perform a contract with Mary, she may bring a lawsuit against Craig. The purpose of the lawsuit will be either to compel Elijah to perform as promised or, more commonly, to obtain monetary damages for Elijah's failure to perform. ■

Criminal law has to do with a wrong committed against the public as a whole. Criminal acts are prohibited by local, state, or federal government statutes. In a criminal case, the government seeks to impose a penalty (a monetary penalty and/or imprisonment) on an allegedly guilty person.

civil law

Law that defines and enforces all private and public rights, as opposed to criminal matters.

criminal law

Law that defines crimes and subjects criminals to punishment.

1–5 National Law Around the World

The common law system practiced in the United States is one of the major legal systems of the world. Other countries that were once colonies of Great Britain—such as Australia, Canada, and India—generally also use common law systems.

Many nations employ a **civil law system**, however. The basis of the system is codified law—a set of legal principles enacted into law by a legislature. The primary source of law is a statutory code. Precedents do not bind courts, although previous decisions may serve as guidance for judges. Most European nations, along with many countries that were once their colonies, use civil law systems. In the United States, Louisiana has a civil law system, due to the state's historical ties to France.

Learning Outcome 4

Distinguish different global legal systems.

civil law system

A legal system based on a statutory code.

1–6 International Law

International law can be defined as a body of written and unwritten laws observed by independent nations in their relations with other nations. It governs the acts of individuals as well as governments. International customs and treaties are generally considered to be two of the most important sources of international law.

The key difference between international law and national law (the law of a particular nation) is that national law can be enforced by government authorities.

international law

The law that governs relations among nations.

No such authority exists to enforce international law. The only methods to obtain compliance are persuasive tactics, such as sanctions, by other countries or international organizations.

International law must accommodate two conflicting goals of individual nations. Every nation desires to benefit economically from its dealings with individuals and other nations. At the same time, each nation is motivated by a need to be the final authority over its own affairs. International law attempts to balance these national desires and needs. And individual nations agree to be governed by international law in some respects in order to benefit from international trade.



Linking Business Law to Your Career

Consulting an Expert for Advice

Whether you own a business or work for one, you will face many issues that touch on subjects about which you know little. Not every manager is aware of all the information needed to manage a business. It is therefore necessary for you to know when to ask for advice from experts.

With respect to the law, you may know enough about the law to prevent a potential legal dispute simply by taking the appropriate action. In other circumstances, however, the best alternative will be to seek outside counsel.

Why Consult a Legal Expert?

It is not possible to keep up with the variety of statutes, rules, and regulations that affect the conduct of business in the United States. This problem only gets worse with laws that concern doing business on a global scale. It is possible to break a law without knowing that a law has been broken.

The general standard for compliance with the law is “good faith,” but at any time, an issue may arise that can only be resolved with special expertise. When your business’s reputation and profits are on the line, there is no substitute for the right advice.

How Can You Find an Attorney?

To choose an attorney for an issue that affects your employer’s business, first ask for your employer’s recommendations. There may be an advocate who works for your organization or with whom your employer consults on a regular basis.

To find an attorney for a question that concerns your own business, obtain the recommendations of your friends, relatives, or business associates. Ask for endorsements from those who have had long-standing relationships with their attorneys.

Other sources of referrals include your local or state bar association and online directories.

Chapter Summary—Introduction to the Law

Learning Outcome 1: Define *law*.

Law consists of enforceable rules governing relationships among individuals and between individuals and their society.

Learning Outcome 2: List the major sources of law.

The common law consists of past judicial decisions. According to the doctrine of *stare decisis*, these decisions are normally applied to resolve current disputes.

Constitutional law is the law expressed in the U.S. Constitution and the various state constitutions. Statutory law consists of laws or ordinances created by federal, state, or local legislatures and governing bodies.

Learning Outcome 3: Identify the supreme law of the land.

The U.S. Constitution is the supreme law of the land. State constitutions are supreme within state borders to the extent that they do not violate the U.S. Constitution or a federal law. No federal, state, or local statute or ordinance can violate the U.S. Constitution or the relevant state constitution.

Learning Outcome 4: Distinguish different global legal systems.

The common law system involves the practice of deciding new cases with reference to previous decisions, or precedents. A judge is obligated to follow the precedents established within the judge's jurisdiction.

The civil law system is a legal system in which the primary source of law is a statutory code—a set of legal principles enacted into law by a legislature or governing body. Precedents are not binding in a civil law system.

Straight to the Point

1. Why is knowledge of business law essential for any businessperson? (See Learning Outcome 1.)
2. What is the common law? (See Learning Outcome 2.)
3. When and why does a court apply the decision of another court to determine the result in a case? (See Learning Outcome 2.)
4. What are some of the remedies that a party can obtain from a court to make a wrong situation right? (See Learning Outcome 2.)
5. Which aspects of a business's operation do the rules, orders, and decisions of administrative agencies affect? (See Learning Outcome 2.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Under what circumstances might a judge rely on case law to determine the intent and purpose of a statute? (See Learning Outcome 2.)
2. The First Amendment of the U.S. Constitution protects the free exercise of religion. A state legislature enacts a law that outlaws all religions that do not derive from the Judeo-Christian tradition. Is this state law valid? Why or why not? (See Learning Outcome 2.)

Real Law

1–1. *Stare Decisis.* A patent is an exclusive right granted to the creator of an invention. Under U.S. law, a patent owner possesses that right for twenty years. The owner can allow another party to make and market a product based on the invention in exchange for a payment of royalties on the sales. According to the United States Supreme Court in a case known as the *Brulotte* decision, a contract to pay royalties after a patent has expired is unenforceable. Stephen Kimble owned the patent to a toy glove that could shoot foam intended to look like the web of Marvel Comics' Spider-Man. Kimble agreed to allow Marvel Entertainment, LLC, to sell its version of the toy. Marvel agreed to pay Kimble a royalty of 3 percent on the sales. Their contract did not specify an end date. After the patent expired, Marvel sued to stop the payments. What is the doctrine of *stare decisis*? What are the arguments for and against applying it in this case? Discuss. [*Kimble v. Marvel Entertainment,*

LLC, 135 S.Ct. 2401, 192 L.Ed.2d 463 (2015)] (See Learning Outcome 2.)

1–2. *Role of Law.* Otto May, Jr., a pipefitter for Chrysler Group, LLC, was the target of racist, homophobic, and anti-Semitic remarks. He received death threats, his bike and car tires were punctured, and someone poured sugar into the gas tank of his car. A dead bird was placed at his workstation wrapped in toilet paper to look like a member of the Ku Klux Klan. Chrysler documented and investigated the incidents. Records were checked to determine who was in the building when the incidents occurred, the graffiti handwriting was examined, and employees were reminded that harassment was not acceptable. What role might the law play in these circumstances? Discuss. [*May v. Chrysler Group, LLC*, 716 F.3d 963 (7th Cir. 2013)] (See Learning Outcome 1.)

1–3. Constitutional Law. Under a Massachusetts statute, large wineries could sell their products through wholesalers or to consumers directly, but not both. Small wineries could use both methods. Family Winemakers of California filed a suit against the state, arguing that this restriction gave

small wineries a competitive advantage in violation of the U.S. Constitution. Which source of law takes priority, and why? [*Family Winemakers of California v. Jenkins*, 592 F.3d 1 (1st Cir. 2010)] (See Learning Outcome 3.)

Ethical Questions

1–4. Anticipation of Legal Problems. Should legal problems be anticipated? Why and why not? (See Learning Outcome 1.)

1–5. The Doctrine of Precedent. Sandra White operated a travel agency. To obtain lower airline fares for her non-military clients, she booked military-rate travel by forwarding fake military identification cards to the airlines. The U.S. government charged White with identity theft, which requires the “use” of another’s identification. As background, the court in the *White* case had two cases that represented precedents.

In the first case, David Miller obtained a loan to buy land by representing that certain investors had approved the loan when, in fact, they had not. Miller’s conviction for

identity theft was overturned because he had merely said that the investors had done something when they had not. According to the court, this was not the “use” of another’s identification.

In the second case, Kathy Medlock, an ambulance service operator, had transported patients for whom there was no medical necessity to do so. To obtain payment, Medlock had forged a physician’s signature. The court concluded that this was “use” of another person’s identity. Which precedent—the *Miller* case or the *Medlock* case—is similar to White’s situation, and why? How would you describe the parties’ ethics in all of these cases? Discuss. [*United States of America v. Sandra Maxine White*, 846 F.3d 170 (6th Cir. 2017)] (See Learning Outcome 2.)

Chapter 1—Work Set

True-False Questions

- _____ 1. Law consists of enforceable rules governing relationships among individuals and between individuals and their society.
- _____ 2. *Stare decisis* refers to the practice of deciding new cases with reference to previous decisions.
- _____ 3. The doctrine of *stare decisis* illustrates how unpredictable the law can be.
- _____ 4. *Common law* is a term that normally refers to the body of law consisting of rules of law announced in court decisions.
- _____ 5. Statutes are a primary source of law.
- _____ 6. Administrative rules and regulations have virtually no effect on the operation of a business.
- _____ 7. Each state's constitution is supreme within that state's borders even if it conflicts with the U.S. Constitution.
- _____ 8. The Uniform Commercial Code was enacted by Congress for adoption by the states.
- _____ 9. In most states, the same courts can grant both legal and equitable remedies.

Multiple-Choice Questions

- _____ 1. The doctrine of *stare decisis* performs many useful functions, including
 - a. efficiency.
 - b. uniformity.
 - c. stability.
 - d. all of the above.
- _____ 2. In addition to case law, when making decisions, courts sometimes consider other sources of law, including
 - a. the U.S. Constitution.
 - b. state constitutions.
 - c. administrative agency rules and regulations.
 - d. all of the above.
- _____ 3. Which of the following is a CORRECT statement about the distinction between law and equity?
 - a. Equity involves remedies different from those available at law.
 - b. Most states maintain separate courts of law and equity.
 - c. Damages may be awarded only in actions in equity.
 - d. None of the above.
- _____ 4. Under the doctrine of *stare decisis*, a judge compares the facts in a case with facts in
 - a. another case.
 - b. a hypothetical case.
 - c. the arguments of the parties involved in the case.
 - d. none of the above.
- _____ 5. To learn about the coverage of a statute and how the statute is applied, a person must
 - a. only read the statute.
 - b. only see how courts in their jurisdiction have interpreted the statute.
 - c. read the statute and see how courts in their jurisdiction have interpreted it.
 - d. none of the above.

- _____ 6. Our common law system involves the application of legal principles applied in earlier cases
- a. with different facts.
 - b. with similar facts.
 - c. whether or not the facts are similar.
 - d. none of the above.
- _____ 7. The statutory law of the United States includes
- a. the statutes enacted by Congress and state legislatures.
 - b. the rules, orders, and decisions of administrative agencies.
 - c. both the statutes enacted by Congress and state legislatures and the rules, orders, and decisions of administrative agencies.
 - d. none of the above.
- _____ 8. The U.S. Constitution takes precedence over
- a. a provision in a state constitution or statute only.
 - b. a state supreme court decision only.
 - c. a state constitution, statute, or court decision.
 - d. none of the above.
- _____ 9. Civil law concerns
- a. duties that exist between persons or between citizens and governments.
 - b. wrongs committed against the public as a whole.
 - c. both a and b.
 - d. none of the above.
- _____ 10. In a civil law system, the primary source of law is
- a. case law.
 - b. the decisions of administrative agencies.
 - c. a statutory code.
 - d. none of the above.

Answering More Legal Problems

1. Dark Brew and Sparkling Ale are competitors in the microbrewing industry. To market their competing wares, they use Facebook, Twitter, and other social media. A dispute arises between these parties over the statements each makes about the other through these sites. Dark Brew files a suit against Sparkling Ale. The parties argue their respective sides of the dispute, each citing earlier cases that appear to favor their contentions. Each party asks the court to consider the principles of law established in these cases to decide this case.

What is the term for these former decisions? Which decisions, if any, is the court obligated to follow? The earlier cases are known as _____. Later cases that involve similar principles or facts are decided with reference to those _____. Courts are normally obligated to follow the _____ established within their _____. The doctrine attempts to harmonize the

results in cases with _____ facts. In other words, the objective is to decide similar cases in a similar way.

2. In Dark Brew and Sparkling Ale's case, the court follows a doctrine that requires it to review the rules of law established by other courts.

What is the term for the doctrine under which a court reviews the principles suggested by the decisions of other courts in earlier cases? What are the advantages of this practice? The practice of deciding new cases by referring to earlier court decisions is known as the doctrine of _____. This practice is a _____ of the U.S. judicial system. The reasoning in the other courts' opinions can serve as a guide, allowing a court reviewing the cases to be more _____. When the law on a subject is well settled, the application of this doctrine makes the law more _____.



2 Ethics in Business

Conflict Presented

BMI Food Enterprise makes Chuck Wagon, a plastic-wrapped meal, for children. Chuck Wagon meals consist of food such as bologna, chips, candy, and sugary soda. These combinations provide an unhealthful mix of fat, sugar, and salt. BMI sells Chuck Wagon meals by sponsoring television shows directed at children.

Q Is BMI's making and marketing of Chuck Wagon meals unethical?

One of the most complex issues that businesspersons and corporations face is ethics. Ethics is not as well defined as the law, and yet it can have a tremendous impact on a firm's finances and reputation. Consider what happened to Wells Fargo Bank when it imposed sales quotas on employees requiring them to unrealistically open at least ten new accounts a day. Bank managers companywide berated and threatened employees, who were told to do whatever it took to reach these quotas. As a result, many employees resorted to opening more than 2 million "new" accounts by transferring funds from customers' existing accounts without their consent. These unauthorized accounts incurred an estimated \$2.5 million in bank fees.

Once this systematic unethical practice was uncovered, Wells Fargo fired thousands of employees and paid \$185 million in fines. Despite this fallout, the scandal continues to affect Wells Fargo's reputation and its bottom line.

Wells Fargo's conduct raised several legal questions, but it clearly also raised questions about ethics in business. Business ethics cannot be taken lightly. This chapter examines its definitions, its philosophical bases, and its application to today's global business situations.

2-1 The Importance of Business Ethics

Ethics can be defined as the study of what constitutes right or wrong behavior. It is the branch of philosophy that focuses on morality and the way in which moral principles are derived or the way in which a given set of moral principles applies to conduct in daily life.

Ethics has to do with questions relating to the fairness, justness, rightness, or wrongness of an action. What is fair? What is just? What is the right thing to do in any particular situation? These are essentially ethical questions.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Discuss how businesses can discourage unethical behavior.
- 2 Explain the relationship between law and ethics.
- 3 Compare duty-based ethics and utilitarian ethics.
- 4 Identify ethical problems in the global context.

ethics

A set of moral principles and values applied to social behavior.

business ethics

A consensus of what constitutes right or wrong behavior in the world of business.

2–1a What Is Business Ethics?

Business ethics focuses on what constitutes right or wrong behavior in the business world. It has to do with how moral and ethical principles are applied by businesspersons to situations that arise in their daily activities in the workplace. Business ethics is not a separate kind of ethics. The ethical standards that guide our behavior as students apply equally well to our activities as businesspersons.

2–1b Why Is Business Ethics Important?

Making ethical business decisions is vitally important to the long-run viability of any company. A thorough knowledge of business ethics is also important to the well-being of the company's management and employees. Certainly, company decisions and activities can also significantly affect such groups as suppliers, the community, and society as a whole.

2–2 Setting the Right Ethical Tone

Learning Outcome 1

Discuss how businesses can discourage unethical behavior.

Many unethical business decisions are made simply because they can be made. In other words, the decision makers have the opportunity to make such decisions and are not too concerned about being seriously sanctioned for their unethical actions. Perhaps one of the most difficult challenges for business leaders today is to create the right “ethical tone” in their workplaces.

2–2a The Importance of Ethical Leadership

Talking about ethical business decision making means little if management does not set standards. Moreover, managers must apply those standards not only to the employees of the company, but also to themselves.

One of the most important factors in creating and maintaining an ethical workplace is the attitude of top management. Managers who are not totally committed to maintaining an ethical workplace will rarely succeed in creating one. Employees take their cues from management. If a firm's managers do not violate obvious ethical norms in their business dealings, employees will be likely to follow that example.

In contrast, if managers act unethically, employees consequently will see little reason to act ethically themselves. **Example 2.1** Noura works at Granite Software. If Noura observes her manager cheating on his expense account, Noura quickly understands that such behavior is acceptable. ■

2–2b Ethical Codes of Conduct

One of the most effective ways of setting the tone of ethical behavior within an organization is to create an ethical code of conduct. A well-written code of ethics explicitly states a company's ethical priorities. Its provisions must be clearly communicated to employees.

Most large companies and organizations have implemented ethics training programs, seminars, and face-to-face meetings to communicate the importance of ethical conduct to employees. Managers find that applying clear codes of ethics can deter unethical behavior in the workplace, as well as in other settings, including university campuses.

Real Case



Soccer is the most popular sport on the planet. It is governed by a world soccer organization (officially referred to as FIFA). Country-member associations are grouped into six continental confederations. Each geographic confederation has its own code of ethics, modeled on FIFA's code of ethics. Basically, all officials must act "with absolute loyalty." They cannot accept any improper personal or economic benefit. Nonetheless, numerous soccer organization officials accepted millions of dollars in bribes from sports media and marketing companies for decades. Some of these officials were tried and convicted in the United States, even though their unethical and illegal activities occurred elsewhere.

Did the United States' federal courts have the legal ability to fine and incarcerate accused soccer officials? Yes, in *U.S. v. Napout*, the U.S. Court of Appeals for the Second Circuit ruled that because the corrupt soccer officials had a relationship with both the world and regional soccer federations, they had a fiduciary [one of trust] duty not to accept bribes or kickbacks. This duty was explicitly presented within the international soccer association's code of conduct as well as within each regional association's official code of conduct.

—963 F.3d 163 (2nd Cir.)

2–2c Corporate Compliance Programs

In large corporations, ethical codes of conduct are usually just one part of a comprehensive corporate compliance program. Other components of such a program include a corporation's ethics committee, ethical training programs, and internal audits to monitor compliance with applicable laws and the company's standards of ethical conduct.

To be effective, especially in major corporations, a compliance program must be integrated throughout the firm. Ethical policies and programs need to be coordinated and monitored by a committee that is separate from other corporate departments. Otherwise, unethical behavior in one department could easily escape the attention of those in control of the business.

2–2d Conflicts and Trade-offs

Firms have implied ethical (and legal) duties to a number of groups, including shareholders and employees. Because these duties may conflict, management is constantly faced with ethical trade-offs.

Highlighting the Point



Mooseback Outfitters, Inc., a national retailer of outdoor gear and apparel, decides to reduce costs by downsizing and restructuring its business model. While this decision may benefit the company's shareholders, it will have a direct impact on those employees who are laid off. Mooseback's president suggests laying off the most senior

(Continues)

employees, while other managers recommend making the cuts in jobs with younger employees. It is not illegal to fire senior employees, but ethical issues arise when making such decisions.

Which group of employees should Mooseback management downsize first? The answer depends on how management weighs the trade-offs involved. If the company lays off the most senior employees, it can cut costs more quickly because they earn higher salaries. The positive trade-off in keeping these employees is their loyalty and experience, which could help the company adjust to the downsizing more easily. A negative trade-off is that Mooseback would have to lay off twice as many of the younger employees to make up the dollar difference in salaries because they do not earn as much. By downsizing the younger employees, Mooseback also loses most of its expertise in new product technology and online sales strategies.

2–3 The Sarbanes-Oxley Act

Congress enacted the Sarbanes-Oxley Act to help reduce corporate fraud and unethical management decisions. Among other things, the act calls for a greater degree of government oversight of public accounting practices.

2–3a The Public Company Accounting Oversight Board

To this end, the act created the Public Company Accounting Oversight Board. Generally, the duties of the board are as follows:

1. To oversee the audit of companies, or issuers, whose securities are sold to public investors in order to protect the interests of investors and the public.
2. To register public accounting firms that prepare audit reports for issuers.

The board also establishes standards relating to the preparation of audit reports for issuers.

2–3b Enforcement and Penalties

To enforce compliance, the board can inspect registered public accounting firms, investigate firms that violate the act, and discipline those firms by imposing sanctions. Sanctions range from temporary or permanent suspension to civil penalties that can be as high as \$15 million for intentional violations.

The Sarbanes-Oxley Act prohibits destroying or falsifying records with the intent to obstruct or influence a federal investigation or in relation to bankruptcy proceedings. Violation of this provision can result in a fine, imprisonment for up to twenty years, or both.

2–4 Business Ethics and the Law

moral minimum

The minimum degree of ethical behavior expected of a firm.

Learning Outcome 2

Explain the relationship between law and ethics.

Today, legal compliance is regarded as a **moral minimum**—the minimum acceptable standard for ethical business behavior. Simply obeying the law does not fulfill all business ethics obligations, however. In the interests of preserving personal freedom, as well as for practical reasons, the law does not—and cannot—codify all ethical requirements. No law says, for instance, that it is illegal to tell a lie, but it may be unethical to do so.

In contrast, it may seem that answering a question concerning the legality of a given action should be simple. Either something is legal or it is not. In fact, one of the major challenges businesspersons face is that the legality of a particular action is not always clear. In part, this is because there are so many laws regulating business that it is possible to violate one of them without realizing it.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, BMI Food Enterprise makes Chuck Wagon, a plastic-wrapped meal, for children. Chuck Wagon meals consist of foods that provide an unhealthful mix of fat, sugar, and salt. BMI sells Chuck Wagon through advertising directed at children.

A **Is BMI's making and marketing of Chuck Wagon meals unethical?** Yes. Consumers generally prefer the taste of fat, sugar, and salt. Consequently, many food products are processed to contain a tasty but unhealthful mix of these three. Adults can decide for themselves what to eat. But children may be especially susceptible to advertising. BMI has an ethical obligation to its targeted audience—children—to make and market its products responsibly.

2-4a Laws Regulating Business

Today's business firms are subject to extensive government regulation. Nearly every action a firm undertakes—from going into business, to hiring and firing personnel, to selling products in the marketplace—is subject to statutory law as well as regulations issued by administrative agencies.

Determining whether a planned action is legal thus requires that decision makers keep abreast of the law. Ignorance of the law will not excuse a business owner or manager from liability for violating a statute or regulation. Normally, large business firms have attorneys on their staffs to assist them in making key decisions. Small firms must also seek legal advice before making important business decisions because the consequences of just one violation may be costly.

2-4b "Gray Areas" in the Law

In many situations, business firms can predict with a fair amount of certainty whether a given action would be legal. In some situations, though, the legality of a particular action may be less clear. These "gray areas" in the law make it difficult to predict with certainty how a court may apply a given law to a particular action.

Uncertainties concerning how particular laws may apply to specific factual situations have been compounded in the cyber age. The widespread use of the internet has given rise to legal and ethical questions in circumstances that never existed before.

In short, business decision makers need to proceed with caution and evaluate an action and its consequences from an ethical perspective. Generally, if a company can demonstrate that it acted in good faith and responsibly in the circumstances, it has a better chance of successfully defending its action.

Highlighting the Point



Airway Airlines makes an online forum available to its pilots so that they can exchange ideas and information. Some Airway pilots publish on the forum a series of harassing, gender-based, false messages about Anita Valdez, one of Airway's female pilots.

Could Airway be liable to Valdez for any harm caused by these messages? Yes. An online forum can be considered similar to a company bulletin board, which is part of
(Continues)

a workplace. If Airway knows about the messages and does nothing to stop them, the airline can be perceived as sending Valdez the statement that the harassment is acceptable. If the airline does not know about the postings or if it does attempt to stop them, however, it can argue that it is acting in good faith.

2–5 Approaches to Ethical Reasoning

Each individual, when faced with an ethical dilemma, engages in ethical reasoning. In this process, the individual links their moral convictions or ethical standards to the particular situation at hand. Businesspersons do likewise when making decisions with ethical implications.

Learning Outcome 3

Compare duty-based ethics and utilitarian ethics.

Ethical reasoning relating to business traditionally has been characterized by two fundamental approaches. One approach defines ethical behavior in terms of duty, which also implies certain rights. The other approach determines what is ethical in terms of the consequences, or outcomes, of any given action.

2–5a Duty-Based Ethics

Duty-based ethical standards often are derived from revealed truths, such as religious precepts. They can also be derived through philosophical reasoning.

Religion In the Judeo-Christian tradition, the Ten Commandments of the Old Testament establish fundamental rules for moral action. Other religions have their own sources of revealed truth. Religious rules generally are absolute with respect to the behavior of their adherents.

For instance, the commandment “Thou shalt not steal” is an absolute mandate for a person who believes that the Ten Commandments reflect revealed truth. Even a benevolent motive for stealing (such as Robin Hood’s) cannot justify the act, because the act itself is inherently immoral and thus wrong.

Ethical standards based on religious teachings also involve an element of compassion. ■ **Example 2.2** It might be profitable for Sun Valley Farms to lay off Lee, who is a less productive employee. Lee would find it difficult to get employment elsewhere and his family would suffer as a result, however. This potential suffering would be given substantial weight by decision makers whose ethical standards were based on religion. ■ Compassionate treatment of others is also mandated by the Golden Rule—Do unto others as you would have done unto you—which has been adopted by most religions.

Philosophy Duty-based ethical standards may also be derived solely from philosophical reasoning. The German philosopher Immanuel Kant (1724–1804), for instance, identified principles for moral behavior based on what he believed to be the fundamental nature of human beings.

Kant held that it is rational to assume that human beings are qualitatively different from other physical objects in our world. Persons are endowed with moral integrity and the capacity to reason and conduct their affairs rationally. Therefore, their thoughts and actions should be respected. When human beings are treated merely as a means to an end, they are being regarded as the equivalent of objects and are being denied their basic humanity.

Kant believed that individuals should evaluate their actions in light of the consequences that would follow if everyone in society acted in the same way. This **categorical imperative** can be applied to any action. ■ **Example 2.3** Lars is deciding whether to cheat on an examination. If he adopts Kant’s categorical imperative, he will decide not to cheat, because if everyone cheated, the examination would be meaningless. ■

categorical imperative

An evaluation based on the effect if everyone acted in the same way.

The Principle of Rights Another view of duty-based ethics focuses on basic rights. The principle that human beings have fundamental rights, such as the rights to life, freedom, and the pursuit of happiness, is embedded in many of the world's cultures.

Those who adhere to this **principle of rights** believe that a key factor in determining whether a business decision is ethical is how that decision affects the rights of others. These others include the firm's owners, its employees, its customers, its suppliers, the community in which it does business, and society as a whole.

In general, rights theorists believe that the right with the highest value in a particular circumstance takes precedence. **Example 2.4** Murray Chemical has to decide whether to keep its Utah plant open—thereby saving the jobs of one hundred workers—or shut it down. Closing the plant will avoid contaminating a nearby river with pollutants that could endanger the health of tens of thousands of people. A rights theorist could easily choose which group to favor because the value of the right to health and well-being is obviously stronger than the basic right to work. ■

principle of rights

The principle that human beings have certain fundamental rights.

2–5b Outcome-Based Ethics: Utilitarianism

Utilitarianism is a philosophical theory developed by Jeremy Bentham (1748–1832) and modified by John Stuart Mill (1806–73)—both British philosophers. In contrast to duty-based ethics, utilitarianism is outcome oriented. It focuses on the consequences of an action, not on the nature of the action itself or on a set of moral values or religious beliefs.

Those who apply utilitarian ethics believe that an action is morally correct when it produces the greatest amount of good for the greatest number. When an action affects the majority adversely, it is morally wrong. Applying the utilitarian theory requires three steps:

1. A determination of which individuals will be affected by the action in question.
2. A **cost-benefit analysis**—a comparison of the negative and positive effects of alternative actions on these individuals.
3. A choice among alternative actions that will produce the greatest positive benefits for the greatest number of individuals.

utilitarianism

An evaluation of an action based on its “good” consequences.

cost-benefit analysis

Weighing the costs of a given action against the benefits.

Highlighting the Point



International Foods Corporation (IFC) markets baby formula in developing countries. IFC learns that mothers in those countries often mix the formula with impure water, to make the formula go further. As a result, babies are suffering from malnutrition, diarrhea, and in some instances, even death.

Is IFC in violation of the law? No. **What is IFC's ethical responsibility in this situation?** If IFC's decision makers feel that they have an absolute duty not to harm others, then their response will be to withdraw the product from those markets.

If they approach the problem from a utilitarian perspective, they will engage in a cost-benefit analysis. The cost of the action (the suffering and death of babies) will be weighed against its benefit (the availability of the formula to mothers).

Having the formula available frees mothers from the task of breastfeeding and thus allows them to work to help raise their incomes and standards of living. The question in a utilitarian analysis focuses on whether the benefit outweighs the cost.

corporate social responsibility
The idea that corporations should act ethically and be accountable for their actions.

2–5c Corporate Social Responsibility

Groups concerned with employee safety, consumer protection, environmental preservation, and other causes often pressure corporations to behave responsibly with respect to these causes. That corporations have such an obligation is the concept of **corporate social responsibility**. (See this chapter's Linking Business Law to Your Career feature for more details on this topic.)

The Stakeholder Approach One view of corporate social responsibility stresses that corporations have a duty not just to shareholders but also to other groups affected by corporate decisions, called stakeholders. These groups include employees, customers, creditors, suppliers, and the community. Sometimes, one of these groups may have a greater stake in a company decision than shareholders do.

Example 2.5 During a global virus epidemic, Delightful Salads, Inc., is forced to operate at 50 percent capacity. In response, it implements half-time work for some employees, unpaid vacations, voluntary wage freezes, and other cost-cutting measures. These options can be in the best interest of some of Delightful Salads' stakeholders, which obviously include its employees and the community in which it does business. ■

Corporate Citizenship Another theory of social responsibility argues that corporations should promote goals that society deems worthwhile and take steps toward solving social problems. The idea is that business controls so much of a country's wealth and power that it should use that wealth and power in socially beneficial ways.

Example 2.6 The Hitachi Group annually releases its Hitachi Sustainability Report that outlines its environmental strategy (including its attempts to reduce carbon dioxide emissions). The report also discusses its commitment to human rights awareness. ■

A Way of Doing Business Corporate social responsibility attains its maximum effectiveness if it is treated as a way of doing business rather than as a special program. The most successful activities are relevant and significant to the corporation's stakeholders.

Example 2.7 Derrek Corporation is one of the world's largest diversified metals and mining companies. As a part of its business decision making, it invested more than \$150 million in social projects involving health care, infrastructure, and education around the world. At the same time, it invested more than \$300 million in environmental projects, including the rehabilitation of native species in the Amazon River Valley. ■

2–6 Business Ethics and Social Media

Today, social media affect many areas of daily life, including the business world. As a result, businesses now face unique ethical issues with respect to all social media platforms. In particular, social media raise ethical questions in business hiring decisions.

To gain better insight into a job candidate, managers ask for professional references from former employers, as well as character references from others who know the candidate. Employers are likely to also conduct internet searches to discover more about job candidates. Often, an online search can lead managers to several links regarding a candidate. With relative ease, managers can often view the prospective candidate's postings, photos, videos, blogs, and tweets.

In addition, some employers may decide that a candidate with no social media presence is behind the times and is not a good employee choice. Some would consider this type of employer behavior to be unethical as well.

Highlighting the Point



Penny applies for a salesclerk position at Fair City Market, a convenience store in rural Wyoming. Ali, Fair City's owner, interviews Penny and is seriously considering her for the position. After the interview, Ali does an online search on Penny. The search results reveal that Penny is politically active in an effort to ban off-road vehicles in local wilderness areas. Ali is an off-road enthusiast.

Should Ali consider Penny's activism when deciding to hire her? No. Many people believe that judging a job candidate based on what they do outside of the workplace is unethical. Penny's personal opinions and activities should not factor into Ali's hiring decision.

2-7 Business Ethics on a Global Level

Frequent conflicts in ethics arise between foreign and U.S. businesspersons. In certain countries, the consumption of alcohol and specific foods is forbidden for religious reasons. Under such circumstances, it would be thoughtless and imprudent for a visiting U.S. businessperson to invite a local business contact out for a drink.

2-7a Monitoring the Practices of Foreign Suppliers

Many U.S. businesses contract with companies in developing nations to produce goods, because the wage rates are significantly lower than in the United States. Yet what if a foreign company exploits its workers—by hiring children at below minimum wage? What if the company's workplace is full of health hazards? What if the company's supervisors routinely engage in workplace conduct that is offensive to women?

Given today's global communications network, few companies can assume that their actions in other nations will go unnoticed by "corporate watch" groups that publicize unethical corporate behavior. As a result, U.S. businesses take steps to avoid such adverse publicity. They may refuse to deal with certain suppliers or arrange to monitor their suppliers' workplaces to make sure that the workers are not being mistreated.

Learning Outcome 4

Identify ethical problems in the global context.

2-7b The Foreign Corrupt Practices Act

Another ethical problem in international business dealings has to do with the legitimacy of certain side payments to government officials. In the United States, most contracts are formed within the private sector. In many foreign countries, however, decisions on major construction and manufacturing contracts are made by government officials who control local trade and industry.

Side payments (bribes) to government officials in exchange for favorable business contracts are not unusual in such countries, nor are they considered unethical. U.S. companies, however, are prohibited from making such payments to foreign officials by the Foreign Corrupt Practices Act (FCPA).

Bribery of Foreign Officials The first part of the FCPA applies to all U.S. companies and their directors, officers, shareholders, employees, and agents. This part prohibits payments intended to encourage foreign officials to act in their official capacities to provide business opportunities.

The FCPA does not prohibit payments made to minor officials whose duties are ministerial. (A ministerial action is a routine activity, such as the processing of paperwork with little or no discretion involved in the action.) These payments

are often referred to as “grease,” or facilitating payments. They are meant to speed up administrative services that might otherwise be performed at a slow pace. The act also does not prohibit payments to private foreign parties unless the U.S. firm knows that the payments will be passed on in violation of the FCPA.



Highlighting the Point

Azra, who is a representative for American Exports, Inc., makes a payment on American's behalf to a minor official in Nigeria to speed up an import licensing process.

Has either Azra or her firm violated the Foreign Corrupt Practices Act? No if the payment does not violate Nigerian law. Generally, the Foreign Corrupt Practices Act permits “grease” payments to foreign officials if such payments are lawful within the foreign country.



Linking Business Law to Your Career

Managing a Company's Reputation

Accounting is typically associated with developing balance sheets and profit-and-loss statements, but it can also provide information that helps managers do their jobs. The provision of accounting information for a company's internal use, called managerial accounting, helps in planning and decision making.

Managerial accountants also use their skills to manage corporate reputations. More than 2,500 multinational companies now release large quantities of accounting information to the public.

Internal Reports Designed for External Scrutiny

Some large companies refer to the managerial accounting information that they release to the public as corporate sustainability reports. Dow Chemical Company, for example, issues a sustainability report annually.

Other corporations call their published documents social responsibility reports. Symantec Corporation issues corporate responsibility reports to demonstrate its focus on environmental, social, and governance issues.

Why Use Managerial Accounting to Manage Reputations?

We live in an age of information. Such sources as cable and online news networks, social media, and smartphones guarantee that any news, positive or negative, will be known throughout the world almost immediately after it happens.

Consequently, corporations want to manage their reputations by preparing and releasing company news themselves. In a world in which corporations are often blamed for anything bad that happens, managerial accounting information can be a useful counterweight.

Chapter Summary—Ethics in Business

Learning Outcome 1: Discuss how businesses can discourage unethical behavior.

Managers must set and apply ethical standards to which they are committed. Employees will likely follow their example. Components of a comprehensive corporate compliance program include an ethical code of conduct, an ethics committee, training programs, and internal audits to monitor compliance. These components should be integrated throughout the firm. In making ethical trade-offs, a firm's management must consider which of the firm's constituent groups has a greater stake in the decision to be made.

Learning Outcome 2: Explain the relationship between law and ethics.

The minimum acceptable standard for ethical business behavior is compliance with the law. The law has its limits, though, and some actions may be legal, yet not ethical.

Learning Outcome 3: Compare duty-based ethics and utilitarian ethics.

Duty-based ethical standards are based on religious precepts or derived through philosophical reasoning. Duty-based standards imply that human beings have basic rights. A key factor in determining whether a business decision is ethical is how it affects these rights.

Utilitarian ethics are outcome oriented, focusing on the consequences of an action. Under this standard, an action is “right” when it produces the greatest amount of good for the greatest number of people.

Learning Outcome 4: Identify ethical problems in the global context.

Ethical conflicts between foreign and U.S. businesses may arise because of inherent differences between nations. Notable differences relate to workplace conditions and the practice of giving side payments to foreign officials to secure favorable contracts.

Straight to the Point

1. Why is the study of business ethics important? (See Learning Outcome 1.)
2. How can businesspersons encourage ethical conduct in their workplaces? (See Learning Outcome 1.)
3. How does the Sarbanes-Oxley Act help to prevent unethical management decisions? (See Learning Outcome 2.)
4. How should business decision makers proceed when the legality of a particular action is not clear? (See Learning Outcome 2.)
5. What are the two fundamental approaches by which ethical business reasoning has traditionally been characterized? (See Learning Outcome 3.)
6. What is the concept of corporate social responsibility? (See Learning Outcome 3.)
7. How might social media raise ethical questions with respect to business hiring decisions? (See Learning Outcome 3.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Mac Tools, Inc., markets a product that under some circumstances is capable of seriously injuring consumers. Does Mac have an ethical duty to remove this product from the market, even if the injuries result only from misuse? (See Learning Outcome 3.)
2. Acme Corporation decides to respond to what it sees as a moral obligation to correct for past discrimination by adjusting pay differences among its employees. Does this raise an ethical conflict among Acme’s employees? Between Acme and its employees? Between Acme and its shareholders? (See Learning Outcome 3.)

Real Law

2–1. Business Ethics. Volkswagen corporate executives were accused of cheating on the pollution emissions test on millions of its vehicles that were sold in the United States. Volkswagen (VW) eventually admitted that it had installed

“defeat device” software in its diesel models. The software detected when the car was being tested and changed its performance to improve the test outcome. As a result, the diesel cars showed low emissions—a feature that made the

cars more attractive to today's consumers and also allowed Volkswagen to pass strict pollution tests in the United States and in other countries. What do you think the various courts ruled in response to VW's fraudulent behavior? Do you think that VW's top executives should have been guilty of any crimes? Why do you think those top executives did what they did? [*In re Volkswagen "Cleaned Diesel" Marketing, Sales Practices, and Product Liability Litigation*, 229 F.Supp.3d 1052 (N.D.Cal. 2017)] (See Learning Outcome 2.)

2-2. Business Ethics. Priscilla Dickman worked as a medical technologist at the University of Connecticut Health Center. Dickman's supervisor received complaints she was getting personal phone calls and was frequently absent from her work area. Based on e-mails and other documents found on her work computer, the state investigated her for violations of state law. She was convicted of conducting "personal business for financial gain on state time utilizing state resources." Separate investigations resulted in convictions for forgery and the filing of an unrelated fraudulent insurance claim. Dickman "retired" from her job and filed a claim

with the state of Connecticut against the health center, alleging that her former employer had initiated the investigations to harass her and force her to quit. For lack of "credible evidence or legal support," Dickman's claim was dismissed. Were any of Dickman's actions unethical? If so, identify the actions, and explain why they were unethical. [*Dickman v. University of Connecticut Health Center*, 162 Conn.App. 441, 132 A.3d 739 (2016)] (See Learning Outcome 1.)

2-3. Business Ethics. Stephen Glass made himself infamous as a dishonest journalist by fabricating material for more than forty articles for *The New Republic* and other publications. At the time, he was a law student at Georgetown University. Once suspicions were aroused, Glass tried to avoid detection. Later, Glass applied for admission to the California bar. The California Supreme Court denied his application, citing "numerous instances of dishonesty" during his "rehabilitation" following the exposure of his misdeeds. How do these circumstances underscore the importance of ethics? [*In re Glass*, 58 Cal.4th 500, 316 P.3d 1199 (2014)] (See Learning Outcome 1.)

Ethical Questions

2-4. Ethical Workplace. What factors help to create an ethical workplace? (See Learning Outcome 1.)

2-5. Ethical Leadership. Mark Clapp and Albert DiBrito worked for the Public Safety Department (PSD) in St. Joseph, Michigan. Clapp was the director, and DiBrito was the deputy director. One day, Clapp told Tom Vaught, a PSD employee, that the previous city manager had only hired DiBrito because DiBrito had been investigating the city manager for possible wrongdoing. Clapp said that DiBrito

had dropped his investigation in exchange for the deputy director position. Richard Lewis, the current city manager, concluded that Clapp's remarks were "inappropriate statements for a commanding officer to make." In the meantime, though, DiBrito made his own "inappropriate statements" about Clapp to other PSD employees. How do a manager's attitudes and actions affect a workplace? What steps do you think Lewis could take to prevent future conflicts? Discuss. [*DiBrito v. City of St. Joseph*, 2017 WL 129033 (6th Cir. 2017)] (See Learning Outcome 1.)

Chapter 2—Work Set

True-False Questions

- _____ 1. Ethics is the study of what constitutes right and wrong behaviors.
- _____ 2. A background in business ethics is as important as knowledge of specific laws.
- _____ 3. The minimum acceptable standard for ethical behavior is compliance with the law.
- _____ 4. According to utilitarianism, it does not matter how many people benefit from an act.
- _____ 5. The best course for accomplishing legal and ethical behaviors is to act responsibly and in good faith.
- _____ 6. The ethics of a particular act is always clear.
- _____ 7. To foster ethical behavior among employees, managers should apply ethical standards to which they are committed.
- _____ 8. If an act is legal, it is ethical.
- _____ 9. Bribery of public officials is strictly an ethical issue.

Multiple-Choice Questions

- _____ 1. Beth is a marketing executive for Consumer Goods Company. Compared with Beth's personal actions, her business actions require the application of ethical standards that are
 - a. more complex.
 - b. simpler.
 - c. the same.
 - d. none of the above.
- _____ 2. Raphael, an employee of Quality Products, Inc., takes a duty-based approach to ethics. Raphael believes that regardless of the consequences, he must
 - a. avoid unethical behavior.
 - b. conform to society's standards.
 - c. place his employer's interests first.
 - d. produce the greatest good for the most people.
- _____ 3. Mila adopts religious ethical standards. These involve an element of
 - a. compassion.
 - b. cost-benefit analysis.
 - c. discretion.
 - d. utilitarianism.
- _____ 4. Astrid, an employee of Fine Sales Company, takes an outcome-based approach to ethics. Astrid believes that she must
 - a. avoid unethical behavior.
 - b. conform to society's standards.
 - c. place her employer's interests first.
 - d. produce the greatest good for the most people.
- _____ 5. In a debate, Ed's best criticism of utilitarianism is that it
 - a. encourages unethical behavior.
 - b. fosters conformance with society's standards.
 - c. mandates acting in an employer's best interests.
 - d. results in human costs many persons find unacceptable.

- _____ 6. Acme Services, Inc., represents to Best Production Company that certain services can be performed for a stated fee. This representation would be unethical if Acme knew at the time that
- Acme could not perform the services alone.
 - the actual charge would be substantially higher.
 - the actual charge would be substantially lower.
 - the fee was a competitive bid.
- _____ 7. Leah, the president of United Sales, Inc., tries to ensure that United's actions are legal and ethical. To achieve this result, the best course for Leah and United is to act in
- good faith.
 - ignorance of the law.
 - regard for the firm's shareholders only.
 - their own self-interest.
- _____ 8. Alan, an executive with Beta Corporation, follows the "principle of rights" theory. Under this theory, whether an action is ethical depends on how it affects
- the right determination under a cost-benefit analysis.
 - the right of Alan to maintain his dignity.
 - the right of Beta to make a profit.
 - the rights of others.
- _____ 9. Gamma, Inc., a U.S. corporation, makes a side payment to the minister of commerce of another country for a favorable business contract. In the United States, this payment would be considered
- illegal only.
 - unethical only.
 - illegal and unethical.
 - none of the above.

Answering More Legal Problems

1. Carney & Deb, an accounting firm, performs a variety of tasks for its clients, including completing financial statements and tax returns. To accomplish these tasks, Carney & Deb collects personal and financial information from the clients.
2. Carney & Deb can store the personal and financial information of its clients on any electronic device, including an iPhone, a flash drive, and a laptop. When Carney & Deb upgrades its storage media, the information is transferred between devices.

Does Carney & Deb have an ethical obligation to its clients with respect to this information? Ethics is the study of what constitutes right and wrong _____, focusing on morality and the way in which _____ principles are derived or the way in which such principles apply to conduct in daily life. Sometimes, the issues that arise concern fairness, justice, and "the right thing to do." To answer the question of the firm's ethical obligation, you should note that the confidentiality of its clients' sensitive personal and business information is at stake. The accountants have a(n) _____ duty to ensure that reasonable security precautions are taken to preserve this confidentiality and protect this information.

What are the ethical concerns in this situation?
Discuss. The _____ concerns in this situation relate to fairness, justice, "the right thing to do," personal honesty and integrity, and the duty to maintain the _____ of the clients' information. The accountants need to understand where they are putting the information, assess what the risks are of that location, and consider whether it is appropriate to put the _____ there. For example, putting sensitive information on an unencrypted flash drive would be a bad idea. When the storage media are upgraded, client confidentiality needs to be maintained. Any storage device should be sanitized, or wiped clean, of sensitive data before it is discarded.



3 | The Courts and Our Legal System

Conflict Presented

Rugga slips and falls in Tia's Restaurant, and as a result, he hurts his back. Rugga then files a claim with Tia's insurer, Secure Insurance Company, to recover damages for this injury. Rugga contends that the injury prevents him from working or engaging in any strenuous activity. Secure denies the claim. Rugga files a lawsuit against the insurer. As part of the discovery process before trial, Secure asks Rugga to supply all of his Twitter and Facebook postings since the accident. Rugga objects to this request.

Q Is Secure's request appropriate? Why or why not?

Every society needs to have an established method for resolving disputes. This is particularly true in the business world. Nearly every businessperson will face a lawsuit at some time in their career. For this reason, anyone involved in business needs to understand court systems in the United States, as well as other methods of dispute resolution that can be pursued outside the courts.

American law has many sources. They include the cases that form the common law, the federal and state constitutions, and the statutes passed by Congress and the state legislatures. With respect to the common law, the role of the courts is to declare judicial precedents. Courts are also called upon to interpret the language of constitutions and statutes. In all cases, it is the duty of the courts to apply the law—whatever its source—to a given set of facts. Thus, the function of the courts is to interpret and apply the law.

Even though there are fifty-two court systems—one for each of the fifty states, one for the District of Columbia, plus a federal system—similarities abound. Keep in mind that the federal courts are not superior to the state courts. They are simply an independent system of courts.

3-1 Jurisdiction

Jurisdiction refers either to the geographical area within which a court has the right and power to decide cases or to the right and power of a court to decide matters concerning certain persons, property, or subject matter. Before any court can hear a case, it must have jurisdiction over the person against whom the lawsuit is brought or over the property involved in the lawsuit, as well as jurisdiction over the subject matter.

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Outline the organization of a state court system.
- 2 Define federal court jurisdiction.
- 3 Discuss trial procedure.
- 4 Summarize the steps in a lawsuit.
- 5 Identify methods for resolving disputes outside of litigation.

jurisdiction

Authority to decide a case.

long arm statute

A state statute that permits jurisdiction over nonresident defendants.

3–1a Jurisdiction Over Persons or Property

Generally, a court's power is limited to the territorial boundaries of the state in which it is located. Thus, a court can exercise personal jurisdiction (*in personam* jurisdiction) over residents of the state and anyone else within its boundaries. A court can also exercise jurisdiction over property (*in rem* jurisdiction) located within its boundaries.

Under a state **long arm statute**, a court can exercise jurisdiction over out-of-state defendants based on activities that took place within the state. The defendant must have had enough of a connection with the state for the court to conclude that it is fair to exercise its power over the defendant.

Courts apply a minimum-contacts test to determine if they can exercise jurisdiction over out-of-state corporations. The test is usually met if a corporation advertises or sells its products within the state. The test can also be met if the corporation has an ongoing business relationship with a party within the state, as shown by frequent transactions.

Example 3.1 Allison, a Texas resident, is injured when the PowerFlex exercise machine she is using collapses. Allison files a lawsuit against PowerFlex in a Texas court. PowerFlex, which is headquartered in Chicago, argues that the state court lacks jurisdiction over it. Because PowerFlex sells its exercise products at many retail outlets in Texas, however, there is enough minimum contact within the state for the case to proceed. ■

3–1b Jurisdiction in Cyberspace

The internet's capacity to bypass boundaries undercuts the traditional basis for jurisdiction. Generally, if a defendant's only connection to a state is through dealings with citizens of the state over the internet, a "sliding-scale" standard determines when the exercise of jurisdiction is proper.

Jurisdiction is proper when substantial business is done over the internet. Some interactivity through a website may or may not establish an appropriate basis for jurisdiction. A website with no interactivity—such as passive advertising—does not provide any ground for jurisdiction.

3–2 The State Court System

Learning Outcome 1

Outline the organization of a state court system.

The typical state court system is made up of trial courts and appellate courts. Trial courts are courts in which trials are held and testimony is taken. Appellate courts are courts of appeal and review. Exhibit 3.1 shows how state court systems, as well as the federal court system, are structured.

Persons who are parties to a lawsuit typically have the opportunity to plead the case before a trial court and then, if they lose, before at least one level of appellate courts. If a federal statute or constitutional issue is involved in the decision of the state supreme court, that decision may be further appealed to the United States Supreme Court.

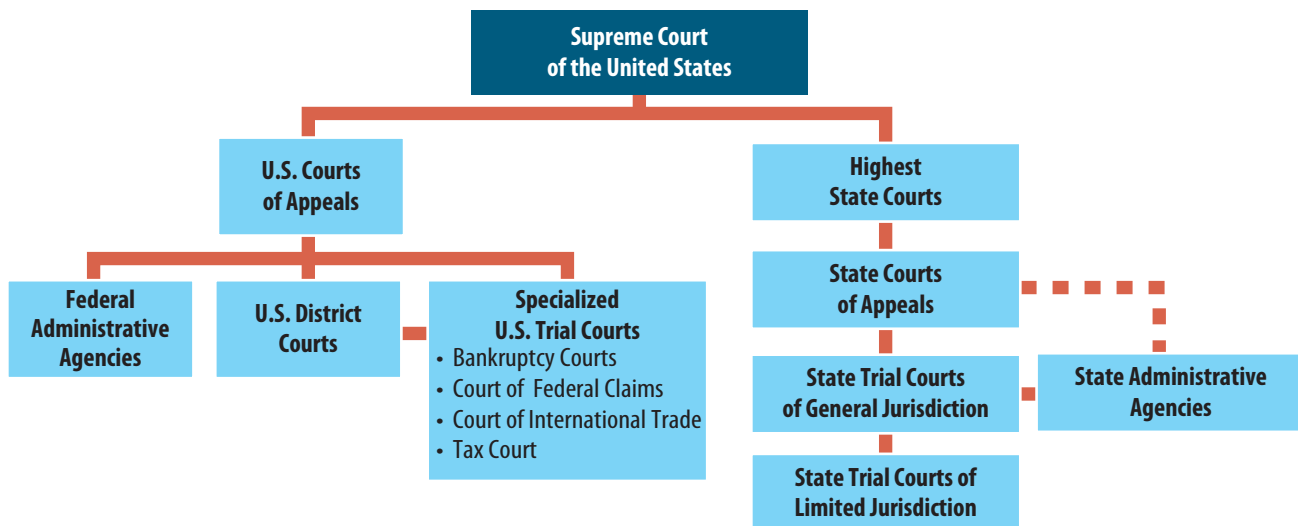
3–2a Trial Courts

The state trial courts have either general or limited jurisdiction. Trial courts that have general jurisdiction as to subject matter may be called county, district, superior, or circuit courts. The jurisdiction of these courts is often determined by the size of the county in which the court sits.

Courts with limited jurisdiction as to subject matter are often called special inferior trial courts or minor judiciary courts. **Small claims courts** are inferior trial courts that hear only civil cases involving claims of less than a certain amount, usually \$2,500. Most small claims are less than \$1,000. Suits brought in small claims courts are generally conducted informally, and lawyers are not required.

small claims courts

A trial court for small claims, usually involving \$2,500 or less.

Exhibit 3.1 The State and Federal Court Systems

Other courts of limited jurisdiction are domestic relations courts, local municipal courts, and probate courts. Domestic relations courts handle only divorce actions and child-custody cases. Local municipal courts mainly handle traffic or low-level criminal cases, while probate courts handle the administration of wills and estate-settlement problems.

3–2b Appellate, or Reviewing, Courts

Every state has at least one appellate, or reviewing, court. About half of the states have intermediate appellate courts. The subject-matter jurisdiction of these courts is substantially limited to hearing appeals.

Appellate courts normally examine the record of a case on appeal and determine whether the trial court committed an error. They look at questions of law and procedure, but usually not at questions of fact. An appellate court will modify a trial court's finding of fact, however, when the finding is clearly erroneous—that is, when it is contrary to the evidence presented at trial—or when there is no evidence to support the finding.

The highest appellate court in a state is usually called the supreme court but may be called by some other name. For instance, in both New York and Maryland, the highest state court is called the court of appeals. The decisions of each state's highest court on all questions of state law are final. Only when issues of federal law are involved can a state's highest court be overruled by the United States Supreme Court.

3–3 The Federal Court System

The federal court system is similar in many ways to most state court systems. It is a three-level model consisting of trial courts, intermediate courts of appeals, and the United States Supreme Court (see Exhibit 3.1).

3–3a U.S. District Courts

At the federal level, the United States is divided into thirteen federal judicial “circuits,” and the circuits are subdivided into districts. A federal district court is the equivalent of a state trial court of general jurisdiction. There is at least one

federal district court in every state. The number of judicial districts can vary over time, primarily owing to population changes and corresponding caseloads. The law now provides for ninety-four judicial districts.

U.S. district courts have original jurisdiction in federal matters. In other words, federal cases originate in district courts. There are other trial courts with original—although special (or limited)—jurisdiction, such as the U.S. Tax Court, the U.S. Bankruptcy Court, and the U.S. Court of Federal Claims.

3–3b U.S. Courts of Appeals

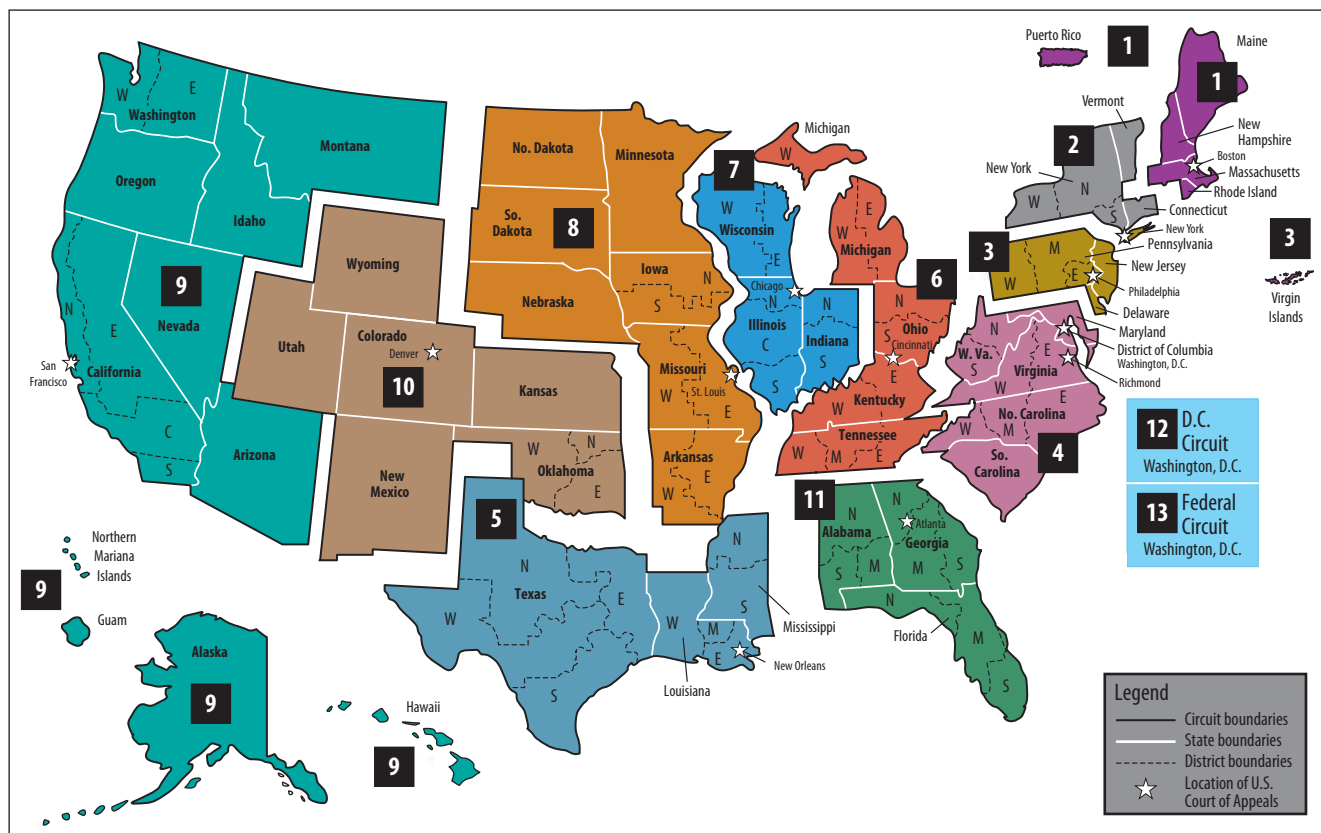
The U.S. courts of appeals for twelve of the thirteen federal judicial circuits hear appeals from the federal district courts located within their respective circuits. The court of appeals for the thirteenth circuit, called the federal circuit, has national jurisdiction over certain types of cases, such as those concerning patent law.

The decisions of the circuit courts of appeals are final in most cases. Appeal to the United States Supreme Court is possible, however. Appeals from federal administrative agencies, such as the Federal Trade Commission, are also made to the U.S. circuit courts of appeals. See Exhibit 3.2 for the geographical boundaries of the U.S. courts of appeals and U.S. district courts.

3–3c The United States Supreme Court

The highest level of the three-level model of the federal court system is the United States Supreme Court. All other courts in the federal system are considered “inferior.”

Exhibit 3.2 Boundaries of the U.S. Courts of Appeals and U.S. District Courts



Source: Administrative Office of the United States Courts.

The United States Supreme Court has original, or trial court, jurisdiction in a small number of situations. In all other cases, its jurisdiction is appellate. The Court can review any case decided by any of the federal courts of appeals. It also has appellate authority over some cases decided in the state courts. Whether the Court will review a case is entirely within its discretion.

3–3d Federal Court Jurisdiction

The Constitution gives Congress the power to control the number and kind of inferior courts in the federal system. Except in those cases in which the Constitution gives the Supreme Court original jurisdiction, Congress can also regulate the jurisdiction of the Supreme Court.

Federal Questions In general, federal courts have jurisdiction over cases involving federal questions. A **federal question** is an issue of law based, at least in part, on the Constitution, a treaty, or a federal law.

Diversity of Citizenship Federal jurisdiction also extends to cases involving diversity of citizenship. **Diversity of citizenship** cases are those arising between (1) citizens of different states, (2) a foreign country and citizens of a state or of different states, or (3) citizens of a state and citizens or subjects of a foreign country. The amount in controversy in diversity cases must be more than \$75,000 before a federal court can take jurisdiction.

Exclusive Versus Concurrent Jurisdiction Some cases can be heard in either federal or state courts. This is true of many cases involving federal questions, as well as diversity of citizenship cases. When both federal and state courts have the power to hear a case, **concurrent jurisdiction** exists. When cases can be tried only in federal courts or only in state courts, **exclusive jurisdiction** exists.

Federal courts have exclusive jurisdiction in cases involving federal crimes, bankruptcy, patents, and copyrights, as well as in suits against the United States and in some areas of admiralty law (law governing transportation on the seas). States also have exclusive jurisdiction over certain subject matters, such as divorce and adoption. The concepts of exclusive and concurrent jurisdiction are illustrated in Exhibit 3.3.

Learning Outcome 2

Define federal court jurisdiction.

federal question

An issue based on federal law.

diversity of citizenship

Situation in which parties to a lawsuit are citizens of different states or countries.

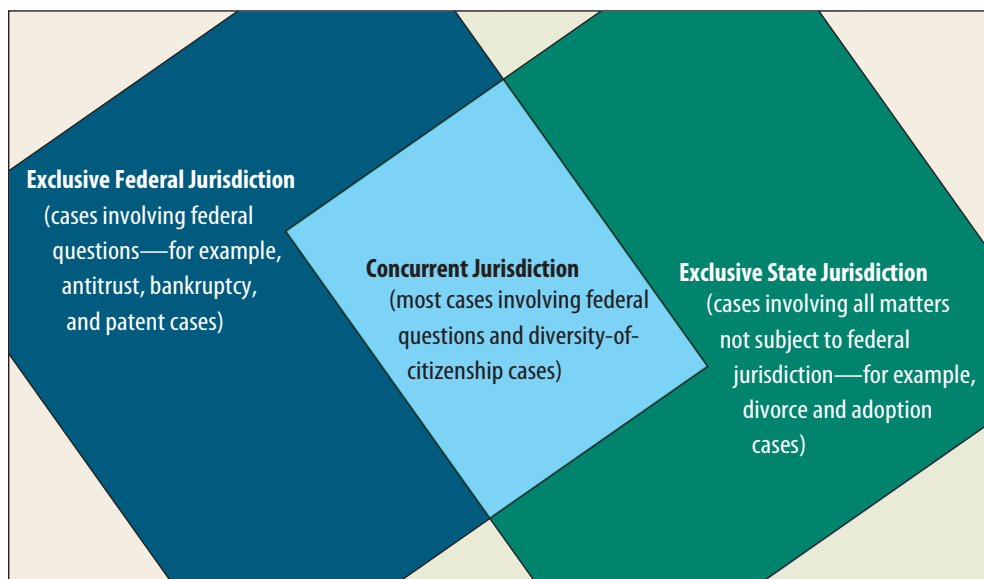
concurrent jurisdiction

When two different courts have the power to hear a case.

exclusive jurisdiction

When only one court has the power to hear a case.

Exhibit 3.3 Exclusive and Concurrent Jurisdictions



3–4 The State Court Case Process

Procedural law establishes the rules and standards for determining disputes in courts. The rules vary from court to court. There is a set of federal rules of procedure, and there are various sets of rules for state courts. In addition, procedural rules differ in criminal and civil cases. To clarify some of these procedural rules, we next follow a civil case, in which one party files a lawsuit against another party.

3–4a Standing to Sue

standing to sue

A stake in a controversy sufficient to entitle an individual to bring a lawsuit.

Before a person can bring a lawsuit before a court, the party must have **standing to sue**. To have standing, a party must have a legally protected and tangible interest at stake in the litigation. Additionally, the party must have suffered a harm, or have been threatened by a harm, as a result of the action about which they have complained.

3–4b The Pleadings

pleadings

Statements of facts, charges, and defenses in a case.

The **pleadings** inform each party of the claims of the other and specify the issues (disputed questions) involved in the case. Pleadings remove the element of surprise from a case. They allow lawyers to gather the most persuasive evidence and to prepare better arguments, thus increasing the probability that a just and true result will be forthcoming from the trial. The pleadings include the complaint, an answer or reply, and a counterclaim or crossclaim.

complaint

A pleading alleging wrongdoing on the part of the defendant.

plaintiff

A person who initiates a lawsuit.

defendant

A person against whom a lawsuit is brought.

Complaint A lawsuit begins when a lawyer files a **complaint** (sometimes called a petition or a declaration) with the clerk of the trial court with the appropriate jurisdiction. The party who files the complaint is known as the **plaintiff**. The party against whom a complaint is filed is the **defendant**.

The complaint contains the following:

1. A statement alleging the facts necessary for the court to take jurisdiction.
2. A short statement of the facts necessary to show that the plaintiff is legally entitled to a remedy. It must be specific and detailed enough to clearly show the legal basis for the complaint but does not need to include every relevant fact of the case. However, if important facts are missing or lacking, a court is within its rights to dismiss a complaint.
3. A statement of the remedy the plaintiff is seeking.



Highlighting the Point

Kevin Patel, driving his vehicle, is involved in a car accident with Lisa Marconi. The accident occurs at an intersection in Beverly Hills, California. Marconi suffers personal injuries, incurring medical and hospital expenses as well as lost wages for four months. Patel and Marconi are unable to agree on a settlement, and Marconi wants to sue Patel.

After obtaining a lawyer, what is Marconi's next step? Marconi's suit commences with the filing of a complaint against Patel. The complaint includes the facts that give rise to the suit and allegations concerning the defendant. Marconi's complaint may state that Marconi was driving her vehicle through a green light at the specified intersection, exercising good driving habits and reasonable care, when Patel carelessly drove his car through a red light and into the intersection from a cross street, striking Marconi and causing personal injury and property damage. The complaint should also state the relief that Marconi seeks—for instance, \$10,000 to cover medical bills, \$9,000 to cover lost wages, and \$8,500 to cover damage to her car.

Summons After the complaint has been filed, the defendant is served with a summons and a copy of the complaint on the defendant. The summons notifies the defendants that they are required to prepare an answer to the complaint and to file a copy of the answer with both the court and the plaintiff's attorney within a specified time period (usually twenty to thirty days after the summons has been served).

Once the defendant has been served with a copy of the complaint and summons, they must respond by filing a motion to dismiss or an answer. When a defendant does not respond, the court may enter a **default judgment** against them, awarding the plaintiff the remedy sought, without the need for a trial.

default judgment

A judgment against a defendant who has not appeared in court.

Motion to Dismiss A **motion to dismiss** is an allegation that the facts and issues presented in the complaint are insufficient to give the court jurisdiction, to give standing to the plaintiff, or on which the court could provide some type of relief. The court may deny the motion to dismiss. If so, the judge is indicating that the plaintiff has stated a recognized cause of action—that is, if the facts are true, the plaintiff has a right to judicial relief.

motion to dismiss

A pleading that asserts the plaintiff's claim has no basis in law.

If the court grants the motion to dismiss, the judge is saying that the plaintiff has failed to state a recognized cause of action or the court lacks jurisdiction to hear the case. A judgment may then be entered against the plaintiff with or without prejudice, meaning the plaintiff may not be allowed to bring a lawsuit on the matter again or they may be allowed to modify their complaint and refile it.

Answer An **answer** either admits the allegations in the complaint or denies them and outlines any defenses that the defendant may have. If the defendant admits to all the allegations, the court will enter a judgment for the plaintiff. If the allegations are denied, the matter will proceed to trial.

answer

A defendant's response to a complaint.

3–4c Pretrial Motions

There are numerous procedural avenues for disposing of a case without a trial. Many of them involve one party's attempts to get the case dismissed through the use of pretrial motions. We have already mentioned the motion to dismiss. Another important pretrial motion is the motion for summary judgment.

Sometimes, one party to a lawsuit believes that the other party does not have a valid case or that there are no important facts in dispute. In this situation, that party will make a **motion for summary judgment**. In short, the party making the motion claims no trial is necessary because the jury could only rule in its favor.

When the court considers a motion for summary judgment, it can consider evidence outside the pleadings. The evidence may consist of sworn statements (affidavits) by parties or witnesses, as well as documents, such as a contract.

motion for summary judgment

A request by one of the parties asserting that there are no disputed issues of fact that would necessitate a trial.

Real Case



L.F. believed that his daughters suffered from behavioral disorders that adversely affected their educational performance. He had a number of disagreements with the school district's staff regarding the best ways to address these issues. The school district claimed that he engaged in a pattern of abusive communications with school staff. The school district imposed a so-called Communication Plan for L.F. This plan involved limiting him to an in-person meeting with two school district administrators once every two weeks. He sued, claiming that the Communication Plan violated his First Amendment rights. A federal trial court granted summary judgment to the school district.

(Continues)

Was the court's decision to grant the motion for summary judgment proper? Yes. In *L.F. v. Lake Washington School District #414*, the U.S. Court of Appeals for the Ninth Circuit accepted the trial court's granting of summary judgment for the school district. That court agreed with the trial court that the Communication Plan was a reasonable effort to manage the parent's relentless and unproductive communications with the school district's staff.

—947 F.3d 621 (9th Cir.)

discovery

Method by which parties obtain information to prepare for trial.

deposition

Any evidence verified by oath.

interrogatory

Written questions and answers prepared and signed under oath.

3–4d Discovery

Before a trial begins, the parties obtain information and gather evidence about the case. The process of obtaining information from the opposing party or from other witnesses is known as **discovery**.

Discovery prevents surprises by giving parties access to evidence that might otherwise be hidden. This allows both parties to learn as much as they can about what to expect at a trial before they reach the courtroom. It also serves to narrow the issues so that trial time is spent on the main questions in the case.

Discovery can involve the use of depositions, interrogatories, or both along with subpoenas and records requests. A **deposition** is sworn testimony by the opposing party or any witness, recorded by an authorized court official. An **interrogatory** is a series of written questions for which written answers are prepared and then signed under oath.

Other Information A party can also serve a written request to the other party for an admission of the truth of matters relating to the trial. An admission in response to such a request is the equivalent of an admission in court.

Additionally, a party can gain access to documents and other items not in their possession in order to inspect and examine them. Likewise, a party can gain “entry upon land” to inspect premises relevant to the case.

When the physical or mental condition of one party is in question, the opposing party can ask the court to order a physical or mental examination. The court will make such an order only when the need for the information outweighs the right to privacy of the person to be examined.

Computer-generated or electronically recorded information are all subject to discovery requests.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Rugga files a claim with Secure Insurance Company to recover for a back injury. Rugga asserts that the injury prevents him from engaging in work or any strenuous activity. Secure denies the claim. In Rugga's subsequent lawsuit against the insurer, Secure asks him to supply all of his Twitter and Facebook postings since the accident. Rugga objects.

A Is Secure's request appropriate? Why or why not? Yes. If Rugga's Twitter and Facebook posts are public, Secure can review them without Rugga's specific consent. If the social media profiles are private, the court will likely require Secure to show that its discovery request is reasonably calculated to lead to relevant and admissible evidence. Secure would then argue that the social media posts will likely reveal whether or not Rugga suffers from the injury as he claims.

3–4e The Trial

Every trial follows a similar basic procedure. For a jury trial, the first step is to select the jurors and swear them in. If neither party requests a jury, the trial is held before a judge.

Procedures A trial commences with an opening statement by the attorney for each party. (The plaintiff's attorney goes first.) The plaintiff's attorney then calls and questions the first witness. This questioning is called **direct examination**. The defendant's attorney then questions the witness. This is **cross-examination**. The plaintiff's attorney may question the witness again, and the defendant's attorney may follow again.

After the plaintiff's attorney has called all of the witnesses and presented all of the evidence for the plaintiff's side of the case, the defendant's attorney presents the defendant's witnesses and evidence. Each side then presents a closing argument (a final statement summarizing its version of the evidence). Finally, the court reaches a verdict.

Motions at the Trial At every stage in a trial, either party can file a motion to dismiss, a motion for summary judgment, and a **motion for a directed verdict** (known in federal courts as a motion for judgment as a matter of law).

With a motion for a directed verdict, a party asks the judge to direct a verdict in favor of the moving party. The judge will grant the motion if the other party has not produced sufficient evidence to support their claim or defense and is usually requested by the defendant at the close of the plaintiff's case (when they have finished questioning all their witnesses and presenting their evidence).

Posttrial Motions At the end of the trial, a posttrial motion can be made to set aside the verdict and to hold a new trial. A motion for a new trial may be granted for several reasons. After looking at all the evidence, if the judge feels that there was some type of legal misstep such as jury misconduct, an irregularity in the court proceedings, or if the jury's finding was against the weight of the evidence, the judge may grant the motion for a new trial.

3–4f The Appeal

Either party can appeal the trial court's judgment to an appropriate court of appeals. A party who appeals is known as the **appellant**, or petitioner. The appellant's attorney files in the reviewing court the record on appeal, which includes trial testimony and the evidence. The party in opposition to the appellant is the **appellee**, or the respondent. Attorneys for both sides file **briefs** with the reviewing court that contain a summary of facts, a summary of law, and an argument about how the law applies to the facts. The attorneys may also present oral arguments.

Types of Rulings A court of appeals does not hear any evidence. In general, appellate courts only review the record for errors of law. If the reviewing court believes that an error was committed, the judgment will be reversed. Sometimes, the case will be remanded (sent back to the court that originally heard the case) for a new trial or additional determinations of fact by the judge. In most cases, the judgment of the lower court is affirmed, resulting in the enforcement of the court's judgment.

Final Review If the reviewing court is an intermediate appellate court, the losing party normally may appeal to the state's highest appellate court. If this court agrees to hear the case, new briefs must be filed, and there may again be oral arguments. This court may reverse or affirm the appellate court's decision or remand the case. At this point, unless a federal question is at issue, the case has reached its end.

The events of a typical lawsuit are illustrated in Exhibit 3.4.

Learning Outcome 3

Discuss trial procedure.

direct examination

Examination of a witness by the attorney who calls the witness to testify.

cross-examination

Questioning an opposing party's witness during a trial.

motion for a directed verdict

A motion for the judge to direct a verdict on the ground of insufficient evidence.

appellant

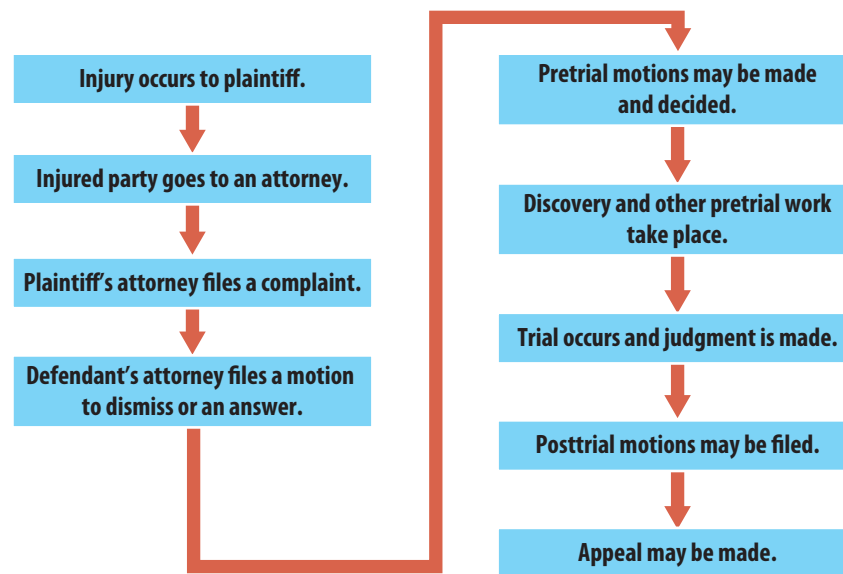
The party who takes an appeal from one court to another.

appellee

The party against whom an appeal is taken.

briefs

A written summary by a party to explain its case.

Exhibit 3.4 Stages in a Typical Lawsuit**Learning Outcome 4**

Summarize the steps in a lawsuit.

alternative dispute resolution (ADR)

The resolution of disputes outside the traditional judicial process.

Learning Outcome 5

Identify methods for resolving disputes outside of litigation.

negotiation

An attempt to settle a dispute without going to court.

mediation

The use of a neutral third party to facilitate a settlement.

arbitration

Dispute resolution made by a neutral third party.

3–5 Alternative Dispute Resolution

Litigation is an expensive and time-consuming process. For this reason and others, most lawsuits do not go to trial. Instead, many businesses use methods of **alternative dispute resolution (ADR)** to settle their disputes. Methods of ADR range from informal attempts to work out differences to formal hearings before experts.

Most states require or encourage parties to undertake ADR before a trial. Many federal courts have instituted ADR programs as well. The three traditional ADR methods are negotiation, mediation, and arbitration. A more recent ADR method is online dispute resolution.

3–5a Negotiation

The simplest form of ADR is **negotiation**, a process in which the parties attempt to settle their dispute informally, with or without attorneys to represent them. Attorneys frequently advise their clients to negotiate a settlement voluntarily.

3–5b Mediation

In **mediation**, a neutral third party acts as a communicating agent and works with both sides in the dispute to facilitate a resolution. The mediator talks with the parties and emphasizes their points of agreement to help them evaluate their options. The mediators may propose solutions, but they do not make decisions resolving the matter.

One of the main advantages of mediation is that it is not as adversarial as litigation. **Example 3.2** Jacy and Julie, who are business partners, have a dispute over how the profits of their firm should be distributed. If the dispute is mediated, the mediator will emphasize the common ground shared by Jacy and Julie and help them work toward an agreement. They can then work out the distribution of profits without damaging their continuing business relationship. ■

3–5c Arbitration

A more formal method of ADR is **arbitration**, in which an arbitrator (a neutral third party or a panel of experts) hears a dispute and imposes a resolution on the parties. Usually, the parties in arbitration agree that the third party's decision will

Exhibit 3.5 Basic Differences in the Traditional Forms of Alternative Dispute Resolution

Type of ADR	Description	Neutral Third Party Present	Who Decides the Resolution
Negotiation	The parties meet informally with or without their attorneys and attempt to agree on a resolution.	No	The parties themselves reach a resolution.
Mediation	A neutral third party meets with the parties and emphasizes points of agreement to help them resolve their dispute.	Yes	The parties decide the resolution, but the mediator may suggest or propose a resolution.
Arbitration	The parties present their arguments and evidence before an arbitrator at a hearing, and the arbitrator renders a decision resolving the parties' dispute.	Yes	The arbitrator imposes a resolution on the parties that may be either binding or nonbinding.

be legally binding, although they can also agree to nonbinding arbitration. In non-binding arbitration, the parties can go forward with a lawsuit if they do not agree with the arbitrator's decision.

The arbitrator's decision is called an award. An award is usually the final word on the matter. A court will set aside an award if the arbitrator's conduct or "bad faith" substantially prejudiced the rights of one of the parties. In addition, an award may be set aside if it violates an established public policy or the arbitrator arbitrated issues that the parties did not agree to submit to arbitration.

Arbitration is unlike other forms of ADR because the third party hearing the dispute makes a decision for the parties. Exhibit 3.5 outlines the basic differences among the traditional forms of ADR.

3–5d Online Dispute Resolution

The settlement of disputes in online forums is known as **online dispute resolution (ODR)**. The disputes resolved in these forums have most commonly involved disagreements over the rights to domain names or over the quality of goods sold via the internet, including goods sold through online auction sites.

ODR may be best for resolving small- to medium-sized business liability claims, which may not be worth the expense of litigation or traditional ADR. Most online forums do not automatically apply the law of a specific jurisdiction. Instead, results are often based on general, universal legal principles. As with most offline methods of dispute resolution, any party may appeal to a court at any time.

online dispute resolution (ODR)
The resolution of a dispute via the internet.

Chapter Summary—The Courts and Our Legal System

Learning Outcome 1: Outline the organization of a state court system.

A state court system includes trial courts and appellate courts. A trial court is where trials are held and testimony is taken. An appellate court is a court of appeal and review. Every state has at least one appellate court, and many have intermediate appellate courts. Each state has a high court, from which appeal to the United States Supreme Court is possible only if a federal question is involved.

Learning Outcome 2: Define federal court jurisdiction.

Any lawsuit concerning a federal question can originate in a federal court. A federal question is an issue of law based, at least in part, on the Constitution, a treaty, or a federal law. A case involving diversity of citizenship can also be heard in a federal court.

Learning Outcome 3: Discuss trial procedure.

A trial begins with opening statements from both parties' attorneys. The trial proceeds with each party's presentation of its side of the case (with the introduction and examination of witnesses and evidence). The trial ends with closing arguments from both sides and the court's verdict.

Learning Outcome 4: Summarize the steps in a lawsuit.

An injury occurs to a party, who then goes to an attorney. The plaintiff's attorney files a complaint, and a summons is issued. The defendant's attorney files a motion to dismiss or an answer. Pretrial motions may be made and decided. Discovery and other pretrial work take place. The trial occurs. A judgment is made. Posttrial motions may be filed. An appeal may be made.

Learning Outcome 5: Identify methods for resolving disputes outside of litigation.

Alternative methods include negotiation, mediation, and arbitration. In negotiation, the parties attempt to settle their dispute informally without the involvement of a third party. In mediation, the parties attempt to come to an agreement with the assistance of a neutral third party, a mediator, who does not make a decision in the dispute. In arbitration, a neutral third party or a panel of experts hears a dispute and renders a decision.

Straight to the Point

1. Over what must a court have jurisdiction before it can hear a case? (See Learning Outcome 1.)
2. What is the principal difference between trial and appellate courts? (See Learning Outcome 2.)
3. When do both federal and state courts have the power to hear a case? (See Learning Outcome 2.)
4. Before a party can bring a lawsuit, what must the party have? (See Learning Outcome 1.)
5. Before a trial begins, how can the parties obtain information and collect evidence about the case? (See Learning Outcome 3.)
6. Why do businesses use methods of alternative dispute resolution to settle their disputes? (See Learning Outcome 5.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Gabriel wants to sue Art's Supply Company for Art's failure to deliver supplies that Gabriel needed to prepare his work for an appearance at a local artists' fair. What must Gabriel establish before a court will hear the suit? (See Learning Outcome 1.)
2. Carlos, a citizen of California, is injured in an automobile accident in Arizona. Alex, the driver of the other car, is a citizen of New Mexico. Carlos wants Alex to pay Carlos's medical expenses and car repairs, which total \$125,000. Can Carlos sue in federal court? Why or why not? (See Learning Outcome 2.)

Real Law

3-1. Filing an Appeal. Frenchie's Hair Boutique sells hair extensions, clothing, and accessories. Rolande Christophe, the owner of Frenchie's, entered into a three-year commercial lease with Oxford Tower Apartments, LP, for a small storefront. Less than two years later, Oxford filed a suit in a Pennsylvania state court against Frenchie's and Christophe,

alleging breach of contract and seeking unpaid rent. The defendants counterclaimed for damages. At the trial, Christophe testified that from the start of the lease, problems with the store, including a lack of heat in the building, interfered with her business. She complained to Oxford, to no avail. Fifteen months into the term, a pipe erupted,

flooding the store with water and sewage. Frenchie's lost its inventory and was required to clear out so that the flooring could be replaced. Unable to reopen the store because of the lingering odor, Christophe stopped paying rent and gave Oxford the key. The trial court granted possession of the premises to Oxford and awarded damages for the loss of the inventory to Christophe. Oxford appealed, arguing that Christophe and Frenchie's were still obligated to pay the unpaid rent. Was the decision and award of the trial court supported by competent evidence in the record? [*Oxford Tower Apartments, LP v. Frenchie's Hair Boutique*, Superior Court of Pennsylvania, 2020 PA Super __, __ A.3d __, 2020 WL 119595 (2020)] (See Learning Outcome 4.)

3-2. Motion for Summary Judgment. Rebecca Nichols drove a truck for Tri-National Logistics, Inc. (TNI). On a delivery trip, Nichols's fellow driver James Paris made unwelcome sexual advances. Nichols reported this behavior to TNI. Their employer left her with Paris in Pharr, Texas, for another seven days before sending a driver to pick her

up. She filed a lawsuit in a federal district court against TNI, alleging discrimination on the basis of sex. Disputed facts included whether Nichols subjectively felt abused by Paris and whether TNI was aware of his conduct and failed to take appropriate action. Could TNI successfully file a motion for summary judgment at this point? Explain. [*Nichols v. Tri-National Logistics, Inc.*, 809 F.3d 981 (8th Cir. 2016)] (See Learning Outcome 1.)

3-3. Arbitration. Bruce Matthews played football for the Tennessee Titans. As part of his contract, he agreed to submit any dispute to arbitration. He also agreed that Tennessee law would determine all matters related to workers' compensation. After Matthews retired, he filed a workers' compensation claim in California. The arbitrator ruled that Matthews could pursue his claim in California but only under Tennessee law. Should this ruling be set aside? Explain. [*National Football League Players Association v. National Football League Management Council*, __ F.Supp.2d __ (S.D.Cal. 2011)] (See Learning Outcome 5.)

Ethical Questions

3-4. To Sue or Not to Sue? What ethical considerations might affect a decision to go to court?

3-5. Complaint. John Verble worked as a financial advisor for Morgan Stanley Smith Barney, LLC. After nearly seven years, Verble was fired. He filed a lawsuit in a federal district court against his ex-employer. In his complaint, Verble alleged that he had learned of illegal activity by Morgan Stanley and its clients, he reported that activity to the

Federal Bureau of Investigation, and as a result, he was fired in retaliation. His complaint contained no additional facts surrounding the situation. To avoid a dismissal of his lawsuit, does Verble have a legal obligation to be more specific with the facts? Does he owe an ethical duty to back up his claims with more facts? Explain your answers. [*Verble v. Morgan Stanley Smith Barney LLC*, 2017 WL 129040 (6th Cir. 2017)] (See Learning Outcome 3.)

Chapter 3—Work Set

True-False Questions

- _____ 1. Generally, a court can exercise jurisdiction over the residents of the state in which the court is located.
- _____ 2. All state trial courts have general jurisdiction.
- _____ 3. The decisions of a state's highest court on all questions of state law are final.
- _____ 4. Federal courts may refuse to enforce a state or federal statute that violates the U.S. Constitution.
- _____ 5. The United States Supreme Court can hear appeals on federal questions from state and federal courts.
- _____ 6. Pleadings consist of a complaint, an answer, and a motion to dismiss.
- _____ 7. If a party does not deny the truth of a complaint, the party is in default.
- _____ 8. In mediation, a mediator decides on the matter in dispute.

Multiple-Choice Questions

- _____ 1. National Computers, Inc., was incorporated in Nebraska, has its main office in Kansas, and does business in Missouri. National is subject to the jurisdiction of
 - a. Nebraska, Kansas, and Missouri.
 - b. Nebraska and Kansas, but not Missouri.
 - c. Nebraska and Missouri, but not Kansas.
 - d. Kansas and Missouri, but not Nebraska.
- _____ 2. Abraham, Inc., sues Ballard, Inc., in a state court. Abraham loses and files an appeal with the state appeals court. The appeals court will
 - a. not retry the case because the appropriate place for the retrial of a state case is a federal court.
 - b. not retry the case because an appeals court examines the record of a case, looking at questions of law and procedure for errors by the trial court.
 - c. retry the case because after a case is tried a party has a right to an appeal.
 - d. retry the case because Abraham and Ballard do not agree on the result of the trial.
- _____ 3. A lawsuit can be brought in a federal court if it involves
 - a. a question under the Constitution, a treaty, or a federal law.
 - b. citizens of different states, a foreign country and a U.S. citizen, or a foreign citizen and an American citizen, and the amount in controversy is more than \$75,000.
 - c. either a or b.
 - d. none of the above.
- _____ 4. Ace Corporation, which is based in Texas, advertises on the Web. A court in Illinois would be most likely to exercise jurisdiction over Ace if Ace
 - a. conducted substantial business with Illinois residents at its website.
 - b. interacted with any Illinois resident through its website.
 - c. only advertised passively on its website.
 - d. all of the above.
- _____ 5. Ann sues Carla in a state trial court. Ann loses the suit. If Ann wants to appeal, the most appropriate court in which to file the appeal is
 - a. the state appellate court.
 - b. the nearest federal district court.
 - c. the nearest federal court of appeals.
 - d. the United States Supreme Court.

- _____ 6. The first step in a lawsuit is the filing of pleadings, and the first pleading filed is the complaint. The complaint contains
- a statement alleging jurisdictional facts.
 - a statement of facts entitling the complainant to relief.
 - a statement asking for a specific remedy.
 - all of the above.
- _____ 7. The purposes of discovery include
- saving time.
 - narrowing the issues.
 - preventing surprises at trial.
 - all of the above.
- _____ 8. Dinh and Bill are involved in an automobile accident. Sue is a passenger in Bill's car. Dinh's attorney wants to ask Sue, as a witness, some questions concerning the accident. Sue's answers to the questions are given in
- a deposition.
 - a response to interrogatories.
 - a pretrial motion.
 - none of the above.
- _____ 9. After the entry of a judgment, who can appeal?
- Only the winning party.
 - Only the losing party.
 - Either the winning party or the losing party.
 - None of the above.
- _____ 10. Cobb and Roberts submit their dispute to binding arbitration. A court can set aside the arbitrator's award if
- Cobb is not satisfied with the award.
 - Roberts is not satisfied with the award.
 - the award involves at least \$75,000.
 - the award violates public policy.

Answering More Legal Problems

1. Bento Cuisine is a lunch-cart business. It occupies a street corner in Texarkana, a city that straddles the border of Arkansas and Texas. Across the street—and across the state line, which runs down the middle of the street—is Rico's Tacos. The two businesses compete for customers. Recently, Bento has begun to believe that Rico's is engaging in competitive behavior that is illegal.
2. Bento files a lawsuit against Rico's. Bento believes that it has both the law and the facts on its side. At the end of the trial, however, the jury decides against Bento, and the judge issues a ruling in favor of Rico's.

If Bento were to file a lawsuit against Rico's, in which type of court could Bento initiate the action? Bento could file a suit against Rico's in a trial court of _____ jurisdiction in either the state of Bento's location or the state of Rico's location. Because there appears to be diversity of _____ in this situation, if the amount in controversy could conceivably exceed \$75,000, a suit might instead be filed in a _____ district court, which is the equivalent of a state trial court of general jurisdiction.

If Bento is unwilling to accept this result, what are its options? Bento's first option might be to file a motion to set aside the verdict and hold a new _____. This motion will be granted if the judge is convinced, after examining the evidence, that the jury was in error but does not think it appropriate to issue a judgment for Bento's side. Bento's second option would be to appeal the trial court's judgment, including a denial of the motion for a new trial, to the appropriate court of _____. An appellate court is most likely to review the case for errors in _____, not fact. In any case, the appellate court will not hear new _____.



4 Constitutional Law

Conflict Presented

Tamina owns an acre of undeveloped land beside Interstate 8 within the limits of Centre City. On this lot stands a billboard. Tamina rents the billboard to Discount Mart, which is situated across the highway. A city ordinance prohibits signs that are not on the advertiser's property if the signs are visible from the highway. The ordinance is intended to make the city more appealing—thereby increasing property values—and to prevent distractions that might cause car accidents. Discount Mart files a lawsuit against the city, claiming that the ordinance violates its First Amendment rights.

Q Is Centre City's ordinance valid?

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Explain Congress's power to regulate commerce.
- 2 Discuss federal priority over state laws.
- 3 Describe the Bill of Rights.
- 4 Identify due process protections.
- 5 Outline privacy rights.

Laws that govern business have their origin in the lawmaking authority granted by the U.S. Constitution, which is the supreme law in this country. Neither Congress nor any state or municipality may pass a law that conflicts with the Constitution.

In this chapter, we first look at some basic constitutional concepts and clauses and their significance for business. Then we examine how certain freedoms guaranteed by the Constitution affect businesspersons.

4-1 The Constitutional Powers of Government

The United States has a **federal form of government** in which the national government and the states share sovereign power. The Constitution sets forth specific powers that can be exercised by the national government. The Constitution also provides that the national government has the implied power to undertake actions necessary to carry out its expressly designated powers. All other powers are “reserved” to the states. The broad language of the Constitution leaves much room for debate over the nature and scope of these powers. Generally, the courts determine where the line between state and national powers lies.

federal form of government
Government in which power is divided between a central government and member states.

4-1a The Separation of Powers

The U.S. Constitution divides these powers among three branches of government. The legislative branch makes the laws, the executive branch enforces the laws, and the judicial branch interprets the laws. Each branch performs a separate function. No branch may exercise the authority of another branch.

checks and balances

Divisions of power among the branches of government.

A system of **checks and balances** allows each branch to limit the actions of the other two branches. This prevents any one branch from exercising too much power. For instance, the judicial branch has the power to hold actions of the other two branches unconstitutional.

4-1b The Commerce Clause

Learning Outcome 1

Explain Congress's power to regulate commerce.

To prevent states from establishing laws and regulations that would interfere with trade and commerce among the states, the Constitution expressly delegates to the national government the power to regulate interstate commerce. (Interstate commerce crosses state lines and is under federal jurisdiction.)

Article I, Section 8, of the U.S. Constitution expressly permits Congress “[t]o regulate Commerce with foreign Nations, and among the several States.” This clause, referred to as the **commerce clause**, has had a greater impact on business than any other provision in the Constitution.

commerce clause

Constitutional provision that gives Congress the power to regulate commerce.

National Powers The power over commerce authorizes the national government to regulate virtually all commercial enterprises in the United States. Federal (national) legislation governs nearly every major activity conducted by businesses. It can affect hiring and firing decisions, workplace safety, and how businesses compete and finance their enterprises. The commerce clause may not justify national regulation of noneconomic conduct, however.

The Regulatory Powers of the States State governments have the authority to regulate affairs within their borders. This authority stems in part from the Tenth Amendment to the Constitution, which reserves all powers not delegated to the national government to the states or to the people.

police powers

Powers possessed by states as part of their inherent sovereignty.

State regulatory powers are often referred to as **police powers**. These powers include the right of state governments to regulate private activities to protect or promote the public order, health, safety, morals, and general welfare. Fire and building codes, antidiscrimination laws, parking regulations, zoning restrictions, licensing requirements, and other statutes are based on a state's police powers. Local governments, including cities, also exercise police powers.



Real Case

Panama City Beach, Florida, enacted an ordinance prohibiting overnight rental of motorized scooters as well as an ordinance prohibiting the rental of the scooters within the city limits. The city justified these ordinances by stating that a small city has a right to restrict a business from operating within the city when the restriction is for the safety of the city's citizens and visitors. Classy Cycles, Inc., sued the city government, arguing that no city has the power to ban a business unless the business is a nuisance. At trial, the city prevailed. Classy Cycles appealed.

Were the ordinances reasonable related to accomplishing the city's goal of protecting the safety of its citizens and visitors? Yes. In *Classy Cycles, Inc. v. Panama City Beach*, the Florida State District Court of Appeal affirmed the trial court's judgment. The appellate court stated that it was only looking at whether the regulation was “reasonably related to accomplishing its goal.” Irresponsible driving behavior of scooter renters, especially at night, existed throughout the entire city. This fact was sufficient to support a finding that the ordinances were neither arbitrary nor unreasonable.

—301 So.3d 1046 (1st Dis.)

The “Dormant” Commerce Clause The commerce clause gives the national government the exclusive authority to regulate commercial activities that substantially affect trade and commerce among the states. This express grant of authority to the national government implies that the states do not have the authority to regulate interstate commerce. In short, a state regulation that substantially interferes with interstate commerce violates the commerce clause. This aspect of the commerce clause is often referred to as the “dormant” (implied) commerce clause.

The dormant commerce clause comes into play when state regulations affect interstate commerce. In this situation, the courts normally weigh the state’s interest in regulating a certain matter against the burden that the state’s regulation places on interstate commerce.

Highlighting the Point



Tennessee law imposes a two-year residency requirement on any business that wants to acquire a state liquor license. A national chain, Better Wines, is therefore initially blocked from opening a store in Nashville. Tennessee officials claim that the residency requirement is justified under the Twenty-First Amendment, which gives states that responsibility for regulating alcohol for public benefit.

Is the state law valid? No, this law is primarily designed to shield state businesses from out-of-state competition. Such a residency requirement does not advance a legitimate local purpose and therefore violates the dormant commerce clause.

4–1c The Supremacy Clause

Article VI of the Constitution provides that the Constitution, laws, and treaties of the United States are “the supreme Law of the Land.” This article is referred to as the **supremacy clause**. When there is a direct conflict between a federal law and a state law, the state law is rendered invalid. Because some powers are concurrent (shared by the federal government and the states), however, it is necessary to determine which law governs in a particular circumstance.

Preemption occurs when Congress chooses to act exclusively in a concurrent area. In this circumstance, a valid federal statute or regulation will take precedence over a conflicting state or local law or regulation on the same general subject.

Learning Outcome 2

Discuss federal priority over state laws.

supremacy clause

Provision that declares the Constitution “the supreme Law of the Land.”

preemption

A doctrine under which federal laws preempt state laws.

4–1d The Taxing and Spending Powers

Article I, Section 8, provides that Congress has the “Power to lay and collect Taxes, Duties, Imposts, and Excises.” Section 8 further provides that “all Duties, Imposts and Excises shall be uniform throughout the United States.” The requirement of uniformity refers to uniformity among the states. Thus, Congress may not tax some states while exempting others.

If a tax measure bears some reasonable relationship to revenue generation, it is usually within the national taxing power. Also, the commerce clause almost always provides a basis for sustaining a federal tax.

Under Article I, Section 8, Congress has the power “to pay the Debts and provide for the common Defence and general welfare of the United States.” Through the spending power, Congress disposes of the revenues accumulated from the taxing power. Congress can spend revenues to promote just about any objective it deems worthwhile, so long as it does not violate the Constitution.

4–2 Business and the Bill of Rights

Learning Outcome 3

Describe the Bill of Rights.

Bill of Rights

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

The Constitution's first ten amendments, known as the **Bill of Rights**, embody protections for the individual against types of interference by the federal government. Some constitutional protections apply to business entities. Corporations exist as separate legal entities, or legal persons, and enjoy many of the same rights and privileges as natural persons do. The protections guaranteed by these ten amendments are summarized in Exhibit 4.1.

Most of the rights outlined in Exhibit 4.1 also apply to state governments under the Fourteenth Amendment. That amendment provides in part that “[n]o State shall . . . deprive any person of life, liberty, or property, without due process of law.” A law or other governmental action that limits one of the rights or liberties set out in the Constitution may violate the “due process of law.”

4–2a The First Amendment—Freedom of Speech

Freedom of speech is a prized freedom protected by the Bill of Rights. Indeed, it forms the basis for our democratic form of government. Our republic could not exist if people could not freely express their political opinions and criticize government actions and policies.

symbolic speech

Nonverbal expressive conduct.

Also protected is **symbolic speech**—such as gestures, movements, articles of clothing, and other forms of nonverbal expressive conduct. For instance, the burning of the American flag as part of a peaceful protest is a constitutionally protected form of expression. The test is whether a reasonable person would interpret the conduct as conveying some sort of message. **Example 4.1** As a form of expression, Josh has gang signs tattooed on his torso, arms, and neck. If Ekemma reasonably interprets this conduct as conveying a message, then the tattoos might be a protected form of symbolic speech. ■

Reasonable Restrictions To protect citizens from those who would abuse the right to free expression, speech is subject to reasonable restrictions. Reasonableness is analyzed on a case-by-case basis.

Exhibit 4.1 Protections Guaranteed by the Bill of Rights

First Amendment	Guarantees the freedoms of religion, speech, and the press and the rights to assemble peaceably and to petition the government.
Second Amendment	States that the right of the people to keep and bear arms shall not be infringed.
Third Amendment	Prohibits, in peacetime, the lodging of soldiers in any house without the owner's consent.
Fourth Amendment	Prohibits unreasonable searches and seizures of persons or property.
Fifth Amendment	Guarantees the right to <i>indictment</i> (formal accusation) by a grand jury. Also guarantees all the rights to due process of law and to fair payment when private property is taken for public use. Prohibits compulsory self-incrimination and double jeopardy (trial for the same crime twice).
Sixth Amendment	Guarantees the accused in a criminal case the right to a speedy and public trial by an impartial jury and with counsel. The accused has the right to cross-examine witnesses against him or her and to solicit testimony from witnesses in his or her favor.
Seventh Amendment	Guarantees the right to a trial by jury in a civil case involving at least twenty dollars.
Eighth Amendment	Prohibits excessive bail and fines, as well as cruel and unusual punishment.
Ninth Amendment	Establishes that the people have rights in addition to those specified in the Constitution.
Tenth Amendment	Establishes that powers neither delegated to the federal government nor denied to the states are reserved to the states and to the people.

If a restriction imposed by the government is content neutral, then a court may allow it. To be content neutral, the restriction must be aimed at a societal problem, such as crime, and not be aimed at the expressive conduct of the speech.

Example 4.2 Roosevelt High School officials confiscate a banner, which reads “Bong Hits 4 Jesus,” from Russell Lende, a high school sophomore. Lende is suspended from high school and files a lawsuit, claiming the banner is a protected form of expression. A federal court reasons that the banner could be interpreted as promoting drugs and concludes that the restrictions are justified. ■

In addition, speech that violates criminal laws is not constitutionally protected. For instance, if someone’s speech is used to defraud or cheat someone, then the government (through its courts) can restrict that speech.

Corporate Political Speech Political speech by corporations falls within the protection of the First Amendment. In a 2010 landmark case, *Citizens United v. Federal Election Committee*, the United States Supreme Court struck down a federal law that prohibited corporations from using their funds to advocate the election or defeat of a political candidate. The Court held that this prohibition violated the First Amendment.

Commercial Speech—Advertising Commercial speech consists of communications—primarily advertising—made by business firms involving only their commercial interests. The protection given to commercial speech under the First Amendment is not as extensive as that afforded to noncommercial speech. A state may restrict certain kinds of advertising in the interest of protecting consumers from being misled. States also have a legitimate interest in the beautification of roadsides, and this interest allows states to place restraints on billboards.

Generally, a restriction on commercial speech is valid as long as it meets the following three criteria:

1. It must seek to implement a substantial government interest.
2. It must directly advance that interest.
3. It must go no further than necessary to accomplish its objective.

A **substantial government interest** is a significant connection or concern of the government with respect to a particular matter. The substantial-interest requirement limits the power of the government to regulate commercial speech.

substantial government interest

A significant connection or concern that justifies a government restriction on commercial speech.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Tamina owns an acre of land on which a billboard stands. She rents the billboard to Discount Mart. Tamina’s land is within the limits of Centre City. A city ordinance prohibits signs that are not on the advertiser’s property if the signs are visible from a nearby interstate highway. The ordinance is intended to make the city more visually appealing and to prevent distractions that might cause car accidents. Discount Mart files a lawsuit against the city, challenging the ordinance as a violation of the First Amendment.

A Is Centre City’s ordinance valid? Yes. A government can regulate commercial speech if the regulation is reasonable. The regulation must implement a substantial government interest, directly advance that interest, and go no further than necessary to accomplish its objective.

Here, Centre City restricts billboard advertising to beautify the city and to prevent accidents. These legitimate government interests are directly advanced by the ordinance. Lastly, the ordinance’s sign-location restriction prevents it from going further than necessary to accomplish its objective.

Unprotected Speech Certain types of speech are not given any protection under the First Amendment. Speech that harms the good reputation of another, or defamatory speech, is not protected. Speech that violates criminal laws (such as threatening speech) is not constitutionally protected. Other unprotected speech includes “fighting words,” or words that are likely to incite others to respond violently.



Highlighting the Point

Stiller is awaiting trial on various firearm and drug charges. He creates a YouTube music video called “Off the Police.” In the video, he specifically identifies two local law-enforcement officers responsible for his arrest. In his song, he raps that he is going to “jam this rusty knife” into one of the officer’s “guts” and “chop his feet.” He is eventually convicted of making terroristic threats. On appeal, he argues that his video is a piece of artistic expression protected by the First Amendment.

Does the First Amendment protect Stiller’s YouTube music video? No. Besides referring to the two law enforcement officers by name, Stiller claimed to know when they would go off duty. This level of specificity differentiates Stiller’s words from “mere violent lyrics,” which would be protected speech and “true threats,” which are not.

The First Amendment also does not protect obscene speech. Material is obscene if, for instance, the average person finds that it violates contemporary community standards. Or, the work is clearly offensive sexual conduct.

4–2b The First Amendment—Freedom of Religion

The First Amendment states that the government may neither establish any religion nor prohibit the free exercise of religious practices. The first part of this constitutional provision is referred to as the **establishment clause**, and the second part is known as the **free exercise clause**. Government action, both federal and state, must be consistent with this constitutional mandate.

establishment clause

Constitutional provision that prohibits any law “respecting an establishment of religion.”

free exercise clause

Constitutional provision that prohibits any law “prohibiting the free exercise” of religion.

The Establishment Clause The establishment clause prohibits the government from establishing a state-sponsored religion. The clause also prohibits laws that promote religion or that show a preference for one religion over another. The establishment clause does not require a complete separation of church and state, however. On the contrary, it requires the government to accommodate religions.

The establishment clause covers conflicts about the legality of state and local government support for a particular religion or religious organization or school. It also applies to conflicts about such matters as school prayer and the teaching of evolution versus fundamentalist theories of creation in public schools.

For a law or policy to be constitutional, it must not have the primary effect of advancing or inhibiting religions. Generally, federal or state regulation that does not promote religion or place a significant burden on religion is constitutional, even if it has some impact on religion.

The Free Exercise Clause The free exercise clause guarantees that a person can hold any religious belief or no religious belief. When religious practices work against public policy and the public welfare, however, the government can act. For instance, regardless of a child’s or a parent’s religious beliefs, the government can require certain types of medical treatment if the child’s life is in danger.

To comply with the free exercise clause, a government action must not place a substantial burden on religious practices. A burden is substantial if it pressures an individual to change their behavior and to violate their beliefs.

4–3 Due Process and Equal Protection

Two other constitutional guarantees of great significance to Americans come from the due process clauses of the Fifth and Fourteenth Amendments and the equal protection clause of the Fourteenth Amendment.

4–3a Due Process

Both the Fifth and the Fourteenth Amendments provide that no person shall be deprived “of life, liberty, or property, without due process of law.” The **due process clause** of each of these amendments has two aspects—procedural and substantive.

Procedural Due Process Procedural due process requires that any government decision to take life, liberty, or property must be made fairly. Fair procedures must be used to determine whether a person will be subject to punishment or have some burden imposed on them.

Procedural due process requires that a person have at least an opportunity to object to a proposed action before a fair, neutral decision maker (who need not be a judge). **Example 4.3** Sabrina, a nursing student, takes a selfie with an unconscious patient who is a local celebrity. Sabrina is working her shift at the university hospital when she takes the photo. Although she quickly deletes the photo from her smartphone, she first sends it to some fellow nursing students and the photo ends up on Facebook. When the director of nursing sees the photo online, Sabrina is expelled immediately from the university’s nursing program. Sabrina successfully sues the university, which violated her due process rights by not giving her an opportunity to present her side to school authorities. ■

Substantive Due Process Substantive due process focuses on the content, or substance, of legislation. If a law or other governmental action limits a fundamental right, it will be held to violate substantive due process unless it promotes a substantial government interest. Fundamental rights include interstate travel, privacy, voting, and all First Amendment rights.

Substantial government interests include the public’s safety. Thus, laws designating speed limits are valid if they are shown to reduce highway fatalities, because the state has a compelling interest in protecting the lives of its citizens.

In situations not involving fundamental rights, a law or action must rationally relate to a legitimate governmental end. Nearly every business regulation is upheld on this basis against substantive due process challenges. These include insurance regulations, price and wage controls, banking controls, and controls of unfair competition and trade practices.

4–3b Equal Protection

Under the Fourteenth Amendment, a state may not “deny to any person within its jurisdiction the equal protection of the laws.” This **equal protection clause** also applies to the federal government. Equal protection means that the government must treat similarly situated individuals in a similar manner.

Equal protection, like substantive due process, relates to the substance of a law or other governmental action. A law or action that limits the liberty of all persons may violate substantive due process, while a law or action that limits the liberty of some persons but not others may violate the equal protection clause.

Learning Outcome 4

Identify due process protections.

due process clause

Constitutional provision that guarantees due process of law.

equal protection clause

Constitutional provision that guarantees equal protection of the laws.

Example 4.4 An Urban City law limits all outdoor business signs to a certain size. This raises a substantive due process question. A Metro City ordinance restricts the size of certain businesses’ signs but not those of others. This raises an equal protection issue. ■

Under the equal protection clause, when a law or action distinguishes between or among individuals, the basis for the distinction—that is, the classification—is examined. The courts use one of three standards: the “rational basis” test, intermediate scrutiny, or strict scrutiny.

The “Rational Basis” Test Generally, a law regulating economic or social matters is valid if there is any conceivable “rational basis” on which the classification might relate to any legitimate government interest. It is almost impossible for a law or action to fail the rational basis test.

Intermediate Scrutiny A higher standard applies to laws involving discrimination based on gender, sexual orientation, and legitimacy (children born out of wedlock). Laws using these classifications must substantially relate to important government objectives.

Example 4.5 An Oklahoma statute prohibits the sale of beer to males under twenty-one but allows it to females over eighteen. In a challenge by Peter (a male under twenty-one but over eighteen), the state is not able to show a substantial relationship between the statute and its alleged benefits. Thus, this law violates the equal protection clause. ■

Strict Scrutiny The highest standard applies to a law or an action that inhibits some persons’ exercise of a fundamental right or is based on a suspect trait (such as race, national origin, or citizenship status). This will stand only if it is necessary to promote a compelling government interest.

4–4 Privacy Rights

Learning Outcome 5

Outline privacy rights.

The U.S. Constitution does not explicitly mention a general right to privacy. The Supreme Court has held that a constitutional right to privacy is implied by the First, Third, Fourth, Fifth, and Ninth Amendments. Privacy rights also receive protection under various state and federal statutes.

Important federal legislation relating to privacy rights is listed and described in Exhibit 4.2. For a discussion of two laws pertaining to the collection of personal information by businesses, see this chapter’s Linking Business Law to Your Career feature.

Exhibit 4.2 Federal Legislation Relating to Privacy

Freedom of Information Act (1966)	Provides that individuals have a right to obtain access to information about them collected in government files.
Privacy Act (1974)	Protects the privacy of individuals about whom the federal government has information. Regulates agencies’ use and disclosure of data and gives individuals access to and a means to correct inaccuracies.
Electronic Communications Privacy Act (1986)	Prohibits the interception of information communicated by electronic means.
Health Insurance Portability and Accountability Act (1996)	Requires health care providers and health care plans to inform patients of their privacy rights and of how their personal medical information may be used. States that medical records may not be used for purposes unrelated to health care or disclosed without permission.
USA Patriot Act (2001) and USA Freedom Act (2015)	Increases government authority to monitor internet activities and to access personal financial and student information. Law enforcement officials can obtain phone data about targeted individuals from private phone companies.



Linking Business Law to Your Career

Pretexting and Marketing

If you work in marketing or sales, gathering and obtaining information about your current and target customers will be a significant part of your job. There are many legitimate strategies for gleaning customer and market details, such as purchasing mailing lists, installing certain software on the company's website, and conducting social media and phone surveys.

Because of the rising concern over privacy rights as technology improves, however, you will need to be cautious how you conduct market research and gather personal information. One problematic research method that you should know about is pretexting.

What Is Pretexting?

A pretext is a false motive to hide the real motive. Thus, pretexting is the process of obtaining information by false means. For instance, pretexters who claim that they are

from a certain bank may ask an individual—via the phone or e-mail—for personal and banking data to assist in updating that individual's account with a new security system. Once important details are given, pretexters can sell the information to a data broker who, in turn, can sell it to another party, such as your company or even an identity thief.

The Law and Pretexting

Congress has passed laws to help deal with the potential problems of pretexting, such as identity theft and the invasion of privacy. The Gramm-Leach-Bliley Act, for example, made pretexting to obtain financial information illegal. Another law—the Telephone Records and Privacy Protection Act—prohibits someone from using false representations to obtain another person's confidential phone records. The act also prohibits the buying or selling of such phone records without the owner's permission.

Chapter Summary—Constitutional Law

Learning Outcome 1: Explain Congress's power to regulate commerce.

The commerce clause expressly permits Congress to regulate commerce, authorizing the national government to regulate virtually all commercial enterprises in the United States. A state government may regulate private activities within its borders to protect or promote the public order, health, safety, morals, and general welfare. A state regulation that substantially interferes with interstate commerce violates the commerce clause, however.

Learning Outcome 2: Discuss federal priority over state laws.

The supremacy clause provides that the Constitution, laws, and treaties of the United States are "the supreme Law of the Land." Whenever a state or local law directly conflicts with a federal law, the state or local law is rendered invalid.

Learning Outcome 3: Describe the Bill of Rights.

The Bill of Rights consists of the first ten amendments to the U.S. Constitution. These amendments embody a series of protections for individuals against various types of government interference.

Learning Outcome 4: Identify due process protections.

Both the Fifth and the Fourteenth Amendments to the U.S. Constitution provide that no person shall be deprived "of life, liberty, or property, without due process of law." The due process clause of each of these constitutional amendments has two aspects—procedural and substantive.

Learning Outcome 5: Outline privacy rights.

There is no specific guarantee of a right to privacy in the Constitution, but such a right has been derived from guarantees found in the First, Third, Fourth, Fifth, and Ninth Amendments. Federal and state statutes also protect privacy rights.

Straight to the Point

1. Why is it necessary to determine where the line between state and national powers lies? (See Learning Outcome 1.)
2. Which part of the government has the exclusive authority to regulate trade and commerce among the states? (See Learning Outcome 1.)
3. How do protections guaranteed by the Bill of Rights apply to the states? (See Learning Outcome 3.)
4. What does due process require? (See Learning Outcome 4.)
5. What does “equal protection” mean? (See Learning Outcome 4.)
6. Is a constitutional right to privacy express or implied? (See Learning Outcome 5.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Can a state, in the interest of energy conservation, ban all advertising by power utilities if conservation could be accomplished by less restrictive means? Why or why not? (See Learning Outcome 3.)
2. Suppose that a state taxes out-of-state companies doing business in the state at a rate higher than the rate for in-state companies. The state’s purpose is to protect local firms from out-of-state competition. Does this tax violate the equal protection clause? Explain your answer. (See Learning Outcome 4.)

Real Law

4–1. Freedom of Speech and Social Media Companies. Prager University provides, among other things, short videos for high school, college, and graduate school-age audiences. It shares them regularly on the internet, usually through posting on YouTube, a subsidiary of Google. YouTube openly invites the public to post videos and is “committed to fostering a community where everyone’s voice can be heard.” In its terms of service, YouTube requires users to accept all of its terms of service, which include the company’s right to remove or restrict content. Because YouTube had restricted numerous PragerU videos that treated such subjects as the Constitution and gun control, PragerU sued YouTube and Google, alleging violation of the First Amendment right to freedom of speech. Google countered that it was a private entity without any state involvement. Therefore, it could not be subject to a federal free speech violation claim. Should a federal court rule in favor of PragerU? Why or why not? [*Prager University v. Google LLC*, 951 F.3d 991 (2020)] (See Learning Outcome 3.)

4–2. Reasonable Restrictions on Free Speech. Michael Mayfield, the president of Mendo Mill and Lumber Company in California, received a “notice of a legal claim” from Edward Starski. This “claim” alleged that a stack of lumber fell on a customer as a result of a Mendo employee’s “incompetence.” The “notice” presented a settlement offer on the customer’s behalf

in exchange for a release of liability for Mendo. In a follow-up phone conversation with Mayfield, Starski said that he was an attorney—which, in fact, he was not. Starski was arrested and charged with violating a state statute that prohibited the unlawful practice of law. He argued that “creating an illusion” that he was an attorney fell within the protection of his First Amendment right to free speech. Is Starski correct? Explain your answer. [*The People v. Edward Robert Starski*, 7 Cal.App.5th 215, 212 Cal.Rptr.3d 622 (1 Dist. 2017)] (See Learning Outcome 3.)

4–3. The Commerce Clause. Regency Transportation, Inc., operates a freight business throughout the eastern United States. Regency maintains its corporate headquarters and other facilities in Massachusetts. The vehicles in Regency’s fleet were bought in other states. Massachusetts imposes various taxes on all taxpayers subject to its jurisdiction, including those that, like Regency, do business in interstate commerce. When Massachusetts imposed a tax on the purchase price of each vehicle in Regency’s fleet, the trucking firm challenged the assessment as discriminatory under the commerce clause. What is the chief consideration under the commerce clause when a state law affects interstate commerce? Is Massachusetts’s tax valid? Explain. [*Regency Transportation, Inc. v. Commissioner of Revenue*, 473 Mass. 459, 42 N.E.3d 1133 (2016)] (See Learning Outcome 1.)

Ethical Questions

4–4. The Establishment Clause. Do religious displays on public property violate the establishment clause? Discuss. (See Learning Outcome 3.)

4–5. Free Speech. Aric Toll owns and manages the Balboa Island Village Inn, a restaurant and bar. Anne Lemen lives across from the inn. Lemen complained to the authorities about the inn’s customers, whom she called “drunks” and

“whores.” Lemen told the inn’s bartender Ewa Cook that Cook “worked for Satan.” She repeated her statements to potential customers, and the inn’s sales dropped more than 20 percent. The inn filed a suit against Lemen. Are her statements protected by the U.S. Constitution? Did she act unethically? Explain. [*Balboa Island Village Inn, Inc. v. Lemen*, 40 Cal.4th 1141, 156 P.3d 339 (2007)] (See Learning Outcome 1.)

Chapter 4—Work Set

True-False Questions

- _____ 1. A federal form of government is one in which a central authority holds all power.
- _____ 2. The president can hold acts of Congress and of the courts unconstitutional.
- _____ 3. Congress can regulate any activity that substantially affects commerce.
- _____ 4. A state law that substantially interferes with interstate commerce is unconstitutional.
- _____ 5. When there is a direct conflict between a federal law and a state law, the federal law is invalid.
- _____ 6. If a tax is reasonable, it is within the federal taxing power.
- _____ 7. The Bill of Rights protects individuals against types of interference by the federal government only.
- _____ 8. Any restriction on commercial speech is unconstitutional.
- _____ 9. Due process and equal protection are different terms for the same thing.
- _____ 10. The First Amendment protects individuals from speech that violates state criminal laws.

Multiple-Choice Questions

- _____ 1. Of the three branches of the federal government provided by the Constitution, the branch that makes the laws is
 - a. the administrative branch.
 - b. the executive branch.
 - c. the judicial branch.
 - d. the legislative branch.
- _____ 2. Under the commerce clause, Congress can regulate
 - a. any commercial activity in the United States.
 - b. any noncommercial activity in the United States.
 - c. both a and b.
 - d. none of the above.
- _____ 3. A business challenges a state law in court, claiming that it unlawfully interferes with interstate commerce. The court will consider
 - a. only the state's interest in regulating the matter.
 - b. only the burden that the law places on interstate commerce.
 - c. the state's interest in regulating the matter and the burden that the law places on interstate commerce.
 - d. none of the above.
- _____ 4. A state statute that bans corporations from making political contributions that individuals can legally make is likely to be unconstitutional under
 - a. the commerce clause.
 - b. the First Amendment.
 - c. the establishment clause.
 - d. the supremacy clause.
- _____ 5. A state statute that bans certain advertising practices for the purpose of preventing consumers from being misled is likely to be unconstitutional under
 - a. the commerce clause.
 - b. the First Amendment.
 - c. the supremacy clause.
 - d. none of the above.

- _____ 6. Procedures that are used to decide whether to take life, liberty, or property are the focus of constitutional provisions covering
- equal protection.
 - procedural due process.
 - substantive due process.
 - the commerce clause.
- _____ 7. A law that limits the liberty of all persons to engage in a certain activity may violate constitutional provisions covering
- equal protection.
 - procedural due process.
 - substantive due process.
 - the supremacy clause.
- _____ 8. A law that restricts most vendors from doing business in a high-traffic area might be upheld under constitutional provisions covering
- equal protection.
 - procedural due process.
 - substantive due process.
 - the free exercise clause.
- _____ 9. Congress enacts a law covering airports. If a state enacts a law that directly conflicts with this federal law,
- both laws are valid.
 - neither law is valid.
 - the federal law takes precedence.
 - the state law takes precedence.

Answering More Legal Problems

1. AgriCorp grows crops on farmland in three states. AgriCorp sells its harvests through USA Distributors, Inc., to Variety Mart and other national grocery chains. Small Potato Farm grows a limited crop on five acres chiefly for the personal use of its owners. The owners sell some of their produce on Saturdays at the Hector County Farmers' Market.
2. Global Enterprises Corporation zealously advocates the election of Courtney Smith as the next president of the United States and the defeat of the incumbent, Herbert Dumpty. The corporation produces and distributes *Humpty Dumpty*, a film underscoring President Dumpty's shortcomings. The firm buys airtime on satellite and cable networks to broadcast *Courtney!*, an unabashed tribute to Dumpty's opponent.

Which of these growers is subject to federal regulation under the commerce clause? Both of these enterprises are subject to federal regulation under the commerce clause. The U.S. Constitution expressly delegates to the national government the power to regulate _____ commerce. This power over commerce authorizes the national government to regulate _____ commercial enterprise in the United States. Federal legislation governs nearly every major activity conducted by businesses. Here, both growers market their products, and their actions have an impact, however great or small, on interstate commerce.

Has Global Enterprises violated the First Amendment? No. Freedom of _____ is a highly prized freedom. It forms the basis for our democratic form of government, which could not exist if we could not freely express our _____ opinions. The _____ Amendment to the U.S. Constitution guarantees the freedom of speech. Corporations exist as separate legal entities and enjoy many of the same rights as persons. Political speech by corporations falls under the protection of the First Amendment. Like persons, corporations can use their funds to advocate the election or defeat of a candidate.



5 Business Torts

Conflict Presented

The American Health Center provides plant-based supplements and pharmaceuticals. It has developed a cannabidiol (CBD) that is derived from hops rather than hemp or cannabis. The traditional market for CBD products is expanding rapidly. In a review on its website, HempTalk claims that it is impossible to produce a hops-derived CBD. It condemns American Health for “defrauding uninformed members of the alternative-care community seeking pain relief.”

Q If HempTalk’s accusation is false, has it committed a wrong (tort) against American Health Center?

A **tort** is wrongful conduct—a civil wrong not arising from a breach of contract. Through tort law, society compensates those who have suffered injuries as a result of the wrongful conduct of others. In this chapter, we discuss torts that can occur in any context, but we focus on **business torts**.

5–1 The Basis of Tort Law

Tort law recognizes that some acts are wrong because they cause injuries to others. A tort is not the only type of wrong that exists in the law. Crimes also involve wrongs. A crime is considered a wrong against society as a whole, as well as against the individual victim.

Therefore, the state prosecutes and punishes (through fines, imprisonment, and possibly death) persons who commit criminal acts. A tort action, in contrast, is a civil action in which one person brings a personal lawsuit against another.

Sometimes, the same wrongful act can result in both civil (tort) and criminal actions against the wrongdoer. Exhibit 5.1 illustrates how this might occur.

5–2 Intentional Torts Against Persons

An **intentional tort** requires intent. The **tortfeasor** (the one committing the tort) must intend to commit an act, the consequences of which interfere with the interests of another in a way not permitted by law. An evil or harmful motive is not required. Intent means only that the actor intended the consequences of their act or knew with substantial certainty that particular consequences would result from the act.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Identify the types of intentional torts against persons.
- 2 Identify the types of intentional torts against property.
- 3 Name the four elements of negligence.
- 4 Define strict liability.

tort

A civil wrong not arising from a breach of contract.

business torts

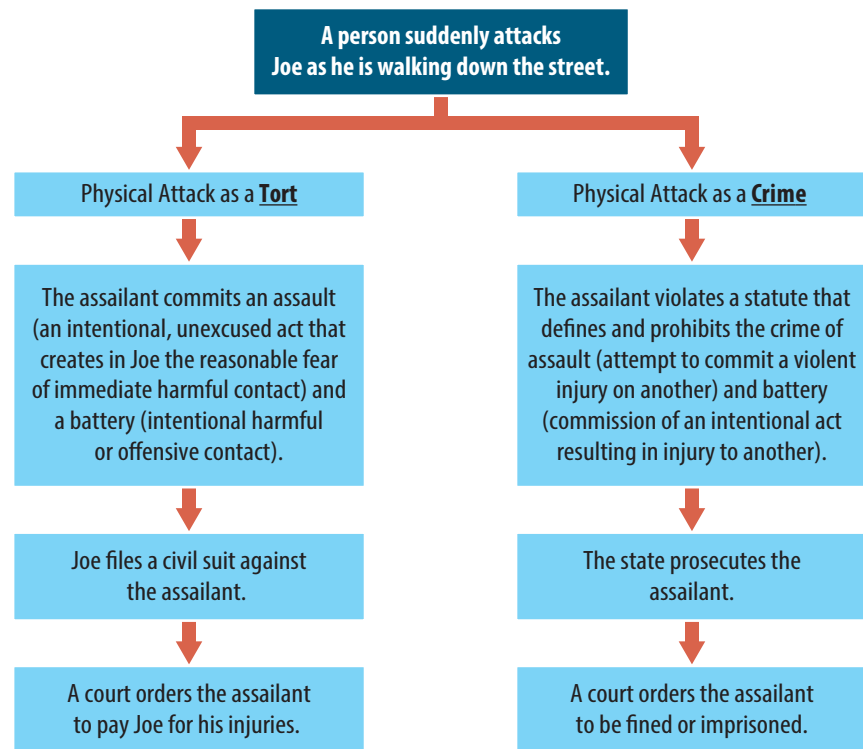
A tort occurring only within the business context.

intentional tort

A wrongful act knowingly committed.

tortfeasor

One who commits a tort.

Exhibit 5.1 Tort Lawsuit and Criminal Prosecution for the Same Act**Learning Outcome 1**

Identify the types of intentional torts against persons.

assault

Any word or action intended to make another person fearful of immediate physical harm.

battery

The intentional touching of another that is harmful or offensive.

Types of intentional torts against persons include assault and battery, false imprisonment, defamation, fraud, and wrongful interference.

5–2a Assault and Battery

An intentional, unexcused act that creates in another person a reasonable apprehension or fear of immediate harmful or offensive contact is an **assault**. Apprehension is not the same as fear. If a contact is such that a reasonable person would want to avoid it, and there is a reasonable basis for believing that the contact will occur, the plaintiff suffers apprehension, whether or not the plaintiff is afraid.

The completion of the act that caused the apprehension, if it results in harm to the plaintiff, is a **battery**—an unexcused and harmful or offensive physical contact intentionally performed. (Note that in common language, people might say “I was assaulted” when in fact they really mean “I suffered a battery.”)

Example 5.1 Ivan enters Crown Convenience, a small neighborhood store. Pulling out a handgun, he demands the money from the cash register from Ronnell, the store clerk. Once Ronnell gives Ivan the money, he shoots her. Ivan’s pointing of the gun at Ronnell is an assault. The firing of the gun and hitting Ronnell with a bullet is a battery. ■

5–2b False Imprisonment

False imprisonment is the intentional confinement or restraint of another person without justification. The confinement can be accomplished through the use of physical barriers, physical restraint, or threats of physical force.

Businesspersons are often confronted with lawsuits for false imprisonment after they have attempted to confine a suspected shoplifter for questioning. The detention must be conducted in a reasonable manner and for only a reasonable length of time. In some states, a merchant can use the defense of probable cause to justify delaying

a suspected shoplifter. Probable cause exists when the evidence to support the belief that a person is guilty outweighs the evidence against that belief.

5–2c Defamation

Defamation involves wrongfully hurting a person's good name, reputation, or character. Doing so in writing involves the tort of **libel**. Doing so orally involves the tort of **slander**. Defamation also occurs when a false statement is made about a person's product, business, or title to property.

To establish defamation, a plaintiff normally must prove the following:

1. The defendant made a false statement of fact. **Example 5.2** Kim's statement, "Laken cheats on his taxes," if false, can lead to **liability** for defamation. Kim's statement, "Laken is a jerk," however, cannot constitute defamation because it is an opinion. ■
2. The statement was understood as being about the plaintiff and tended to harm the plaintiff's reputation.
3. The statement was communicated to at least one person other than the plaintiff.
4. If the plaintiff is a public figure, they must prove actual malice.

defamation

Anything published or publicly spoken that causes injury to another's reputation.

libel

Defamation in written form.

slander

Defamation in oral form.

liability

Legal responsibility for a debt or an obligation.

Real Case



"2 Tha Limit MC" is a motorcycle club in Kentucky. Amos Scaife, Tanesha Perkins, and Lisa Mask organized it. Scaife had a falling out with other members, who voted to remove him from office. In subsequent documents filed with the state, Scaife accused Perkins and Mask of criminal misconduct. The defendants counterclaimed, seeking damages for defamation based on the officially filed documents with the state.

Was Scaife liable for defamation? Yes. In *Scaife v. Perkins*, an intermediate appellate court affirmed the trial court's judgment against Scaife. Once the official documents, which included the defamatory statements, were filed with the state government, they became part of the public record. Scaife was liable for defamation.

—Court of Appeals of Kentucky _ S.W.3d_, 2020 WL 864171(2020)

5–2d Fraud

Fraud leads another to believe in a condition that is different from the condition that actually exists. The tort of **fraud** involves intentional deceit for personal gain. The tort includes several elements:

1. A misrepresentation of facts or conditions with knowledge that they are false or with reckless disregard for the truth.
2. An intent to induce another to rely on the misrepresentation.
3. A justifiable reliance on the misrepresentation by the deceived party.
4. Injuries suffered as a result of this reliance.
5. A causal connection between the misrepresentation and the injury.

For fraud to occur, more than mere **puffery**, or seller's talk, must be involved. Fraud exists only when a person represents as a fact something they know is untrue. **EXAMPLE 5.3** Camila commits fraud when she claims that a building does not leak when she knows it does. ■

fraud

Any misrepresentation made with the intention of deceiving another.

puffery

A salesperson's opinion about property, products, or services.

Facts are objectively ascertainable, whereas seller's talk is not. **Example 5.4** Betty, who is a certified public accountant, says, "I am the best accountant in town." This is seller's talk. Betty is not trying to represent something as fact, because the term "best" is a subjective, not an objective, term. ■

5-2e Wrongful Interference

Wrongful interference with another's business rights is generally divided into two categories: wrongful interference with a contractual relationship and wrongful interference with a business relationship.

Wrongful Interference with a Contractual Relationship This business tort requires a valid, enforceable contract (a promise constituting an agreement) between two parties. A third party must know that this contract exists. The third party must intentionally cause either of the two parties to break the contract.

The contract may be between a firm and its employees or a firm and its customers. Sometimes, a firm's competitor may hire one of the firm's key employees. If the original employer can show that the competitor induced the former employee to break the contract, damages can be recovered from the competitor.

Wrongful Interference with a Business Relationship Businesspersons cannot interfere unreasonably in another's business in their attempts to gain a share of the market. **Example 5.5** Northgate Shopping Center contains two shoe stores: Johnson's Athletic Shoes and Lady Foot Locker. One day, Gordon, a Johnson's employee, stands near the Lady Foot Locker's entrance and tells incoming customers that his store will beat any Lady Foot Locker price on Nike running shoes. Gordon's actions constitute the tort of wrongful interference with a business relationship, which is commonly considered to be an unfair trade practice. ■

Defenses A person will not be liable for the tort of wrongful interference if the interference results from legitimate competitive behavior. **Example 5.6** If Antonio's Meats advertises so effectively that it induces Alex's Restaurant to break its contract with Quispe Meat Company, Quispe Meat Company will be unable to recover from Antonio's Meats for wrongful interference, because advertising is legitimate competitive behavior. ■

5-3 Intentional Torts Against Property

Learning Outcome 2

Identify the types of intentional torts against property.

Intentional torts against property include trespass to land, trespass to personal property, conversion, and disparagement of property. Land is real property, which also includes things "permanently" attached to the land. Personal property consists of all other items, which are basically movable. Thus, a house and lot are real property, whereas the furniture inside a house is personal property.

5-3a Trespass to Land

trespass to land

Entry without the owner's permission.

A **trespass to land** occurs when a person, without permission, (1) enters onto, above, or below the surface of land that is owned by another; (2) causes anything to enter onto the land; or (3) remains on the land or permits anything to remain on it. Actual harm to the land is not required.

Common types of trespass to land include walking or driving on the land, shooting a gun over the land, throwing rocks at a building, building a dam and thus causing water to back up on someone else's land, and placing part of one's building on an adjoining landowner's property.

5–3b Trespass to Personal Property

When an individual unlawfully harms the personal property of another or otherwise interferes with the owner's right to exclusive possession and enjoyment of that property, **trespass to personal property** occurs. **Example 5.7** Sakura takes Ryan's business law textbook as a practical joke. She hides it so that he cannot find it for several days before a final examination. Sakura has committed trespass to personal property. (She has also committed the tort of conversion, discussed next.) ■ If it can be shown that trespass to personal property was warranted, however, then a complete defense exists.

trespass to personal property

Unlawfully taking or harming another's personal property.

5–3c Conversion

When personal property is wrongfully taken from its rightful owner or possessor and placed in the service of another, the act of conversion occurs. **Conversion** is any act depriving an owner of personal property (including electronic data) without that owner's permission and without just cause.

Conversion is the civil side of crimes related to theft. A store clerk who steals merchandise from the store commits a crime and engages in the tort of conversion at the same time.

conversion

The wrongful taking, using, or retaining possession of personal property that belongs to another.

Highlighting the Point



Nick works for Welco, Inc., when he sets up his own company, Turbo Tech. Nick uses a Welco credit card to make unauthorized charges for Turbo Tech. Welco pays the charges through electronic deposits into Nick's personal account.

Is the use of another's credit card to obtain money conversion? Yes. The tort of conversion can be adapted to different types of property rights. When Nick uses Welco's credit card, he steals part of Welco's credit. In this way, Nick made an unauthorized transfer to himself of Welco's rights to its property (in this case, money).

5–3d Disparagement of Property

Disparagement of property occurs when economically injurious falsehoods (lies) are made about another's product or property. Disparagement of property is a general term for torts that can be more specifically referred to as slander of quality or slander of title.

disparagement of property

Economically injurious falsehoods about another's product or property.

Slander of Quality Publication of false information about another's product, alleging that it is not what its seller claims, constitutes the tort of **slander of quality**. This tort has also been given the name trade libel.

slander of quality

Publication of false information about another's product.

Conflict Resolved

The American Health Center provides plant-based supplements and pharmaceuticals. It has developed a cannabidiol (CBD) that is derived from hops rather than hemp or cannabis. The traditional market for CBD products is expanding rapidly. In a review on its website, HempTalk claims that it is impossible to produce a hops-derived CBD. It condemns American Health for "defrauding uninformed members of the alternative care community seeking pain relief"

(Continues)

A If HempTalk's accusation is false, has it committed a tort? Yes. The tort of slander of quality, or trade libel, leads to liability for businesses. In this situation, American Health's lawsuit against HempTalk would be for intentionally interfering with its prospective economic advantage. Most likely, American Health would prevail (provided that it truly has developed an effective alternative to CBD by using hops instead of cannabis).

slander of title

The publication of a statement that casts doubt on another's legal ownership of any property.

Slander of Title When a publication denies or casts doubt on another's legal ownership of any property, and when this results in financial loss to that property's owner, the tort of **slander of title** may exist. Usually, this is an intentional tort in which someone knowingly publishes an untrue statement about property with the intent of discouraging a third person from dealing with the person slandered.

Example 5.8 Skinner Autos and Lew's Used Cars are competitors for local auto sales. Larry, the manager at Skinner Autos, posts a notice on his company's website and on social media platforms, claiming that many of Lew's cars are stolen. As a result, customer traffic at Lew's dealership decreases drastically. ■

5-4 Negligence

negligence

Failure to exercise the standard of care that a reasonable person would exercise.

Learning Outcome 3

Name the four elements of negligence.

duty of care

The duty to exercise a reasonable amount of care in dealings with others.

The tort of **negligence** occurs when someone suffers injury because of another's failure to live up to a required duty of care. It is not required that the tortfeasor intended to bring about the consequences of the act. It is required only that the actor's conduct created a risk of such consequences. If no risk was created, there is no negligence.

Negligence comprises the following four elements:

1. Duty—Did the defendant owe a **duty of care** to the plaintiff?
2. Breach—Did the defendant breach that duty?
3. Harm—Did the plaintiff suffer an injury as a result of the defendant's breach of the duty of care?
4. Cause—Did the defendant's breach cause the plaintiff's injury?

5-4a The Duty of Care and Its Breach

People owe each other a duty to act with reasonable care. In determining whether the duty has been breached, the focus is on how a reasonable person would have acted in the same circumstances.

What meets this standard of care varies. Landowners are expected to exercise reasonable care to protect persons coming onto their property. For instance, landlords are expected to use reasonable care to ensure that their tenants are not harmed in common areas, such as stairways.

Persons invited to come onto business premises are considered **business invitees**. Firms are usually charged with a duty to exercise reasonable care to protect business invitees.

business invitees

A person invited onto business premises by the owner.



Highlighting the Point

Don enters Select Foods, a supermarket. One of the employees has just finished cleaning the floor, but there is no sign warning that the floor is wet. Don slips on the wet floor and sustains injuries as a result.

Is Select Foods liable for damages? Yes. A court would hold that Select Foods was negligent because the employee failed to exercise reasonable care in protecting the store's customers against risk that the employee knew or should have known about. That a patron might slip on a wet floor and be injured was a foreseeable risk, and the employee should have taken care to avoid this risk or to warn the customer of it. The store also has a duty to discover and remove any hidden dangers that might injure a customer or other invitee.

Reasonable care involving professionals contains a somewhat different standard. If an individual has knowledge, skill, or intelligence superior to that of an ordinary person, the individual's conduct must be consistent with that status. Professionals—including accountants, architects, physicians, and others—have a standard minimum level of special knowledge and ability.

5-4b The Injury Requirement

For a tort to have been committed, the plaintiff must have suffered an injury. If no harm or injury results from an action, there is nothing to compensate—and no tort exists. **Example 5.9** If Noah carelessly bumps into Lena, who stumbles and falls as a result, Noah may be liable in tort if Lena is injured in the fall. If she is unharmed, however, there normally could be no suit for damages, because no injury was suffered. ■

5-4c Causation

Another element necessary to a tort is causation. If a person fails in a duty of care and someone suffers injury, the wrongful activity must have caused the harm for a tort to have been committed.

How to Determine Causation In deciding whether a defendant's act caused a plaintiff's injury, there are two questions to ask:

1. Is there causation in fact? Did the injury occur because of the defendant's act? **Causation in fact** can usually be determined by use of the "but for" test. In other words, "but for" the wrongful act, the injury would not have occurred.
2. Was the act the actual proximate cause of the injury? **Proximate cause** exists when the connection between an act and an injury is strong enough to justify imposing liability.

causation in fact

An act without which an event would not have occurred.

proximate cause

Connection between an act and an injury strong enough to impose liability.

Example 5.10 Kasa carelessly leaves a campfire burning. The fire burns down the forest and sets off an explosion in a nearby chemical plant. The explosion spills chemicals into a river, killing all the fish downstream and ruining the economy of a tourist resort. Is Kasa liable to the resort owners? To the tourists whose vacations are ruined? These are questions of proximate cause. ■

Highlighting the Point



Jim checks into Travelers Inn. During the night, a fire is started by an arsonist. The inn has no emergency lights or clear exits. Attempting to escape, Jim finds the first-floor doors and windows locked. He forces open a second-floor window and jumps out. To recover for his injuries, he files a suit against Travelers Inn on the ground of negligence.

(Continues)

Is the harm caused by a fire set by an arsonist a reasonably foreseeable risk? Yes. The duty to protect others against unreasonable risks of harm extends to risks arising from acts of third persons, even criminals. The inn's failure to provide adequate lighting and clear exits created a foreseeable risk that a fire, however it started, would harm its guests.

Proximate Cause and Foreseeability Foreseeability is the test for proximate cause. If the victim of the harm or the consequences of the harm are unforeseeable, there is normally no proximate cause.

5-4d Defenses to Negligence

The basic defenses in negligence cases are assumption of risk and comparative negligence.

assumption of risk
Voluntarily assuming the risk of injury from a danger.

Assumption of Risk A plaintiff who voluntarily enters into a risky situation, knowing the risk involved, will not be allowed to recover. This is the defense of **assumption of risk**. The requirements of this defense are (1) knowledge of the risk and (2) voluntary assumption of the risk. For instance, a driver entering a car race knows there is a risk of being injured in a crash. The driver assumes this risk.

comparative negligence
Liability for injuries based on proportionate negligence.

Comparative Negligence Most states allow recovery based on the doctrine of **comparative negligence**. Under this doctrine, both the plaintiff's negligence and the defendant's negligence are computed and the liability distributed accordingly. Some jurisdictions have a "pure" form of comparative negligence that allows a plaintiff to recover even if the extent of the plaintiff's fault is greater than that of the defendant. Many states, however, have a "50 percent" rule by which the plaintiff recovers nothing if they were more than 50 percent at fault.

5-5 Strict Liability

strict liability
Liability regardless of fault.

Another category of torts is **strict liability**, or liability without fault. Strict liability for damages proximately caused by an abnormally dangerous activity is one application of this doctrine. Strict liability applies in such a case because of the extreme risk of the activity. Balancing that risk against the potential for harm, it is fair to ask the person engaged in the activity to pay for any injury caused by it.

Example 5.11 Newman Mining Corp. is using dynamite to create a new nickel mine located in an Idaho wilderness area. Despite the company's reasonable care in storing the dynamite, a vandal sets fire to its on-site storage facility, and the dynamite explodes. The subsequent explosion damages nearby homes and acres of harvestable timber. Although this damage is not Newman's fault, the company is still responsible because of the inherently dangerous nature of using dynamite in its operations. ■

Chapter Summary—Business Torts

Learning Outcome 1: Identify the types of intentional torts against persons.

An intentional tort is an act committed with the intent that its consequences interfere with another's interests in a way not permitted by law. Intentional torts against persons include assault, battery, fraud, false imprisonment, defamation, and wrongful interference.

Learning Outcome 2: Identify the types of intentional torts against property.

Intentional torts against property include trespass to land, trespass to personal property, conversion, and disparagement of property.

Learning Outcome 3: Name the four elements of negligence.

The four elements of negligence are (1) the existence of a legal duty of care, (2) a breach of the duty, and (3) an injury, harm, or damage to another (4) caused by the breach.

Learning Outcome 4: Define strict liability.

Strict liability is liability without fault. This doctrine applies when an injury or damage is proximately caused by an abnormally dangerous activity.

Straight to the Point

1. What is the difference between a tort and a crime? (See Learning Outcome 1.)
2. What must a plaintiff normally prove to establish defamation? (See Learning Outcome 1.)
3. Define fraud. (See Learning Outcome 1.)
4. What are the two categories of wrongful interference? (See Learning Outcome 1.)
5. Which tort is the civil side of crimes related to theft? (See Learning Outcome 1.)
6. State the two questions that determine whether a defendant's act caused a plaintiff's injury. (See Learning Outcome 3.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. A burst water pipe floods a Metal Fabrication Company utility room and trips the circuit breakers on a panel in the room. Metal Fabrication contacts Nelson, a licensed electrician with five years' experience, to check the damage and turn the breakers back on. Without testing for short circuits, which Nelson knows that he should do, he switches on a breaker. He is electrocuted, and his wife sues Metal Fabrication for negligence. What might the firm successfully claim in defense? (See Learning Outcome 3.)
2. After less than a year in business, Elite Fitness Club surpasses Good Health Club in number of members. Elite's marketing strategies attract many Good Health members, who then change clubs. Does Good Health have any recourse against Elite? Explain your answer. (See Learning Outcome 1.)

Real Law

5-1. Proximate Cause. Steve Pritchard boasted to his wife that he had set fires (arson) in the past to collect insurance payments. Pritchard arranged for his wife and children to be out of their residence during a certain morning. He set fire to the house, which he admitted. Both he and his wife were charged with malicious destruction of property by fire, and under federal law, that act allows punishment for arson causing death. The death occurred while firefighters were putting out the flames of the Pritchard residence. Firefighter

Charles Sparks suffered a heart attack while putting out the fire. Could a jury find Pritchard guilty of causing Sparks' death? [*U.S. v. Pritchard*, 964 F.3d 513 (2020)] (See Learning Outcome 3.)

5-2. Negligence. DSC Industrial Supply and Road Rider Supply are located in the North Kitsap Business Park in Seattle, Washington. Paul and Suzanne Marshall, who had outstanding commercial loans from Frontier Bank, owned both firms. Frontier dispatched one of its employees, Suzette

Gould, to North Kitsap to “spread Christmas cheer” to the Marshalls as an expression of appreciation for their business. Approaching the entry to Road Rider, Gould tripped over a concrete “wheel stop” and fell, suffering a broken arm and a dislocated elbow. The stop was not clearly visible, it had not been painted a contrasting color, and it was not marked with a sign. Gould had not been aware of the stop before she tripped over it. Is North Kitsap liable to Gould for negligence? Explain. [*Gould v. North Kitsap Business Park Management, LLC*, 192 Wash.App. 1021 (2016)] (See Learning Outcome 3.)

5-3. Negligence. Ronald Rawls and Zabian Bailey were in an auto accident in Bridgeport, Connecticut. Bailey

rear-ended Rawls at a stoplight. The evidence showed that Bailey had failed to apply his brakes in time to avoid the collision, failed to turn his vehicle to avoid the collision, failed to keep his vehicle under control, and was inattentive to his surroundings. Because Bailey’s auto insurance did not cover all of the costs, Rawls filed a suit in a Connecticut state court against his own insurance company, Progressive Northern Insurance Co. Rawls wanted to obtain benefits under an underinsured motorist clause. Rawls claimed that Bailey had been negligent. Could Rawls collect from Progressive because of Bailey’s negligence? Discuss. [*Rawls v. Progressive Northern Insurance Co.*, 310 Conn. 768, 83 A.3d 576 (2014)] (See Learning Outcome 3.)

Ethical Questions

5-4. Duty of Care. Does a person’s duty of care include a duty to come to the aid of a stranger in peril? (See Learning Outcome 3.)

5-5. Wrongful Interference. Julie Whitchurch was an employee of Vizant Technologies, LLC. After she was fired, she created a website falsely accusing Vizant of fraud and mismanagement to discourage others from doing business with the company. Vizant filed a suit in a federal district court against her, alleging wrongful interference with a business relationship. The court concluded that Whitchurch’s online

criticism of Vizant adversely affected its employees and operations, forced it to accept reduced compensation to obtain business, and deterred outside investment. The court ordered Whitchurch to stop her online efforts to discourage others from doing business with Vizant. How does the motivation for Whitchurch’s conduct differ from other cases that involve wrongful interference with a business relationship? What does this motivation suggest about the ethics in this situation? Discuss. [*Vizant Technologies, LLC v. Julie Whitchurch*, 2017 WL 128494 (3d Cir. 2017)] (See Learning Outcome 1.)

Chapter 5—Work Set

True-False Questions

- _____ 1. To be guilty of an intentional tort, a person must intend the consequences of their act or know with substantial certainty that those consequences will result.
- _____ 2. Immediate harmful or offensive contact is an element of assault.
- _____ 3. Legitimate competitive behavior does not constitute wrongful interference with a contractual relationship.
- _____ 4. Slander of title requires publication of false information that denies or casts doubt on another's legal ownership of any property.
- _____ 5. The tort of defamation does not occur unless a defamatory statement is made in writing.
- _____ 6. Ed tells customers that he is "the best plumber in town." This is fraudulent misrepresentation, unless Ed actually believes that he is the best.
- _____ 7. A person who borrows a friend's car and fails to return it at the friend's request is guilty of conversion.
- _____ 8. All individuals—regardless of their knowledge, skill, or intelligence—must exercise the same duty of care if they wish to avoid liability for negligence.
- _____ 9. Under the doctrine of strict liability, liability is imposed for reasons other than fault.

Multiple-Choice Questions

- _____ 1. Rudra owns Rudra's Computer Store. Rudra sees Nan, a customer, pick up software from a shelf and put it in her bag. As Nan is about to leave, Rudra tells her that she can't leave until he checks her bag. If Nan sues Rudra for false imprisonment, Nan will
 - a. win, because a merchant cannot delay a customer on a mere suspicion.
 - b. win, because Nan did not first commit a tort.
 - c. lose, because a merchant may delay a suspected shoplifter for a reasonable time based on probable cause.
 - d. lose, because Rudra did not intend to commit the tort of false imprisonment.
- _____ 2. Walking in Don's air-conditioned market on a hot day with her sisters, four-year-old Silvia drops her ice cream on the floor near the dairy case. Two hours later, Jan stops to buy milk, slips on the ice cream puddle, and breaks her arm. Don is
 - a. liable, because a merchant is always liable for customers' actions.
 - b. liable, if Don failed to take all reasonable precautions against Jan's injury.
 - c. not liable, because Jan's injury was her own fault.
 - d. not liable, because Jan's injury was Silvia's fault.
- _____ 3. Gus sends a letter to José in which he falsely accuses José of embezzling. José's secretary, Tina, reads the letter. If José sues Gus for defamation, José will
 - a. win, because Tina's reading of the letter satisfies the publication element.
 - b. win, because Gus's writing of the letter satisfies the publication element.
 - c. lose, because the letter is not proof that José is an embezzler.
 - d. lose, because the publication element is not satisfied.
- _____ 4. Online Services Company (OSC) is an internet service provider. Ads Unlimited, Inc., sends spam to OSC's customers, and some of them then cancel OSC's services. Ads Unlimited is most likely liable for
 - a. defamation.
 - b. disparagement of property.
 - c. fraud.
 - d. wrongful interference with a business relationship.

- _____ 5. Bio Box Company advertises so effectively that Product Packaging, Inc., stops doing business with Styro Cartons, Inc. Bio is
- liable to Styro for wrongful interference with a contractual relationship.
 - liable to Styro for wrongful interference with a business relationship.
 - liable to Styro for disparagement of property.
 - not liable.
- _____ 6. Erin borrows Desmond's iPad. When he asks for his iPad back, Erin says that she gave it to Floyd as a birthday gift. In this situation, Desmond can sue Erin for
- conversion.
 - fraud.
 - wrongful interference.
 - nothing.
- _____ 7. Banele buys a warehouse with a defective waste disposal system. He replaces part of the system and puts the property up for sale. His marketing sheet states, "Disposal system totally new—each part totally replaced." Relying on this representation, Kris buys the warehouse. Banele is most likely liable for
- conversion.
 - disparagement of property.
 - fraud.
 - nothing.
- _____ 8. Driving his car negligently, Paul crashes into a light pole. The pole falls, smashing through the roof of a house onto Karl, who is killed. But for Paul's negligence, Karl would not have died. Regarding Karl's death, Paul's crash is the
- cause in fact.
 - proximate cause.
 - intervening cause.
 - superseding cause.

Answering More Legal Problems

1. During a professional hockey game, Derek, a player for the Devils, collides with Alexei, a player for the Bruins, and falls, hitting his head hard against the ice. Dazed, Derek tells his coach that he thinks he might have a concussion. The coach orders him to "man up" and get back in the game. Derek suffers a second collision with Alexei and is removed from the game unconscious. He is later diagnosed with a brain injury.
- Has a tort been committed? If so, what is it, and who committed it? What is this party's best defense?** The tort that has most likely been committed is _____. The elements are (1) a duty of care, (2) a breach of the duty, and (3) the breach's causation of (4) an injury. The coach has a duty to exercise _____ care within the context of the game. Ordering a player with a possible concussion to "man up" is likely not an exercise of reasonable care. This breach leads to further injuries to Derek. The coach's best defense is _____. A party who voluntarily enters into a situation—such as a hockey game—knowing the risk involved cannot recover if the party suffers an injury as a consequence. The requirements are knowledge of the risk and a voluntary assumption of it. As a player of the game, Derek most likely meets both requirements.
2. Aileen is an assistant to the undergraduate dean at State University. As part of her duties, she helps students qualify for various summer internship programs around the state. The student website publishes an article about the university's success in placing students in these programs. The article includes a photo of Aileen with the caption that reads "Director of Dirty Little Secrets." Aileen files a lawsuit against the student website, arguing that the insult implies that she does not conduct herself ethically while doing her job.
- Which tort is most likely the basis for Aileen's claim? How does it apply to these facts?** The tort most likely to form the basis for Aileen's complaint is _____. To establish this tort, a plaintiff must prove that the defendant made a false _____ of _____. This must _____ the plaintiff's reputation, and it must be _____. Here, the defendant's best defense is that the phrase is not _____. It may be in bad taste, but it cannot be read as stating a _____. The article otherwise appears to present a positive view of Aileen.



6 Intellectual Property

Conflict Presented

Charles Furstenau was a manager at Radiant Global Logistics. He decided to join a competitor, BTX Logistics. Before doing so, he forwarded e-mails to BTX Logistics containing information on Radiant's profits, preferred shippers, and financial projections.

Q Could Radiant successfully sue Furstenau and BTX for misappropriation of trade secrets?

Intellectual property is any property resulting from intellectual, creative processes—the products of an individual's mind. It is familiar to everyone. The information in books is intellectual property—as are the apps on your smartphone, the movies you watch, and the music you hear.

The need to protect creative works was first recognized in the U.S. Constitution. Statutory protection of these rights began in the 1940s. Today, businesspersons continue to be concerned with protecting their rights in intellectual property, which can be very valuable. Thus, company trademarks, patents, copyrights, and trade secrets need legal protection.

6–1 Trademarks and Related Property

A **trademark** is a distinctive word, symbol, sound, or design that identifies the manufacturer as the source of particular goods and distinguishes its products from those made or sold by others. Clearly, if one manufacturer uses the trademark of another, consumers can be misled. For instance, an independent athletic clothing manufacturer that uses the trademarked Nike “swoosh” creates confusion. Consumers might believe that this manufacturer's products are Nike brand clothing, even though they are not. The law seeks to avoid this kind of confusion.

Once a trademark is established, the owner has exclusive use of it and has the right to bring a legal action against anyone who infringes on it. Trademark infringement occurs when one who does not own a trademark copies it to a substantial degree or uses it in its entirety.

6–1a Trademark Protection

The Lanham Act of 1946 protects manufacturers from losing business to competitors that use confusingly similar trademarks. Other federal laws allow trademark owners to bring a suit in federal court for trademark dilution.

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Identify intellectual property.
- 2 Discuss legal protection for trademarks.
- 3 Describe legal protection for patents.
- 4 Summarize legal protection for copyrights.
- 5 Define trade secret.

intellectual property

Property resulting from intellectual, creative processes.

Learning Outcome 1

Identify intellectual property.

trademark

A word, symbol, sound, or design associated with a good.

Trademark Dilution Trademark dilution occurs when a trademark is used, without permission, in a way that diminishes the distinctive quality of the mark. Unlike trademark infringement, trademark dilution does not require proof that consumers are likely to be confused by a connection between the unauthorized use and the mark. The products involved do not have to be similar. Dilution does require, however, that a mark be famous when the dilution occurs.

Example 6.1 Samantha opens a small coffee shop in her hometown. She names her business “Sambuck’s Coffeehouse.” Starbucks would have a strong dilution claim against Samantha because the Sambuck’s mark reduces the distinctive quality of Starbucks’ famous mark—even though most consumers would likely not be confused about the coffee products offered by each company. ■

In addition, trademark dilution can occur online. **Example 6.2** Theft Guard markets its industry-leading home security system under the mark “TheftGuard.” A new internet startup, Theftwatch.com, begins selling its anti-identity theft app using “theftguard” as part of its online advertising campaign. Theft Guard can stop Theftwatch’s use of “theftguard,” claiming trademark dilution. ■

Distinctive Marks Only trademarks that are deemed sufficiently distinctive from all competing trademarks are protected. Fanciful, arbitrary, or suggestive trademarks are generally considered to be the most distinctive (strongest) trademarks.

Fanciful trademarks include invented words. Examples include Xerox for one manufacturer’s copiers and Google for a search engine.

Arbitrary trademarks use common words that would not ordinarily be associated with the product, such as Dutch Boy as a name for paint. Sometimes, a single letter used in a particular style can be deemed an arbitrary trademark.

Learning Outcome 2

Discuss legal protection for trademarks.



Highlighting the Point

Quiksilver, Inc., a maker of surfer clothing, uses a stylized X on its products. Sports entertainment company ESPN, Inc., uses a similarly styled X in connection with its X Games, which are competitions in extreme action sports.

Can a single letter, such as an X, that has a particular style be an arbitrary trademark?

Yes. The X on Quiksilver’s products is clearly an arbitrary mark. Moreover, the two Xs are similar enough that a consumer might well confuse them. These parties have a basis for trademark infringement claims against each other.

Suggestive trademarks bring to mind something about a product without describing the product directly. For instance, “Dairy Queen” suggests an association between its products and milk, but it does not directly describe ice cream.

Descriptive terms, geographical terms, and personal names are not inherently distinctive and do not receive protection under the law until they acquire a secondary meaning. A secondary meaning may arise when customers begin to associate a specific trademark with the source of the trademarked product. For example, even though it is a personal name, Calvin Klein is a distinctive trademark because consumers associate that name with designer clothing and goods marketed by Calvin Klein or licensed distributors of Calvin Klein products.

Trademark Registration The state and federal governments provide for the registration of trademarks. Once a trademark has been registered, a firm is entitled to its exclusive use for marketing purposes.

To register for protection under federal trademark law, a person must file an application with the U.S. Patent and Trademark Office. This registration gives national notice that the trademark belongs exclusively to the registrant.

Infringement Whenever someone else uses a registered trademark in its entirety or copies it to a substantial degree, intentionally or unintentionally, the trademark has been infringed—that is, used without authorization. When a trademark has been infringed, the owner has a cause of action against the infringer.

6–1b Counterfeit Goods

Counterfeit goods copy or otherwise imitate trademarked goods. Clearly, the sale of counterfeit goods has negative financial effects on legitimate businesses. In addition, sales of certain counterfeit goods, such as pharmaceuticals and nutritional supplements, can present serious public health risks. So, too, can counterfeit airplane parts.

It is a crime to intentionally traffic in counterfeit goods or services or to knowingly use a counterfeit mark on or in connection with goods or services. It is also a crime to knowingly traffic in counterfeit labels, stickers, packaging, and the like—regardless of whether the item is attached to any goods.

The world's largest online retailer, Amazon, has faced numerous issues with counterfeit goods. Some large companies, such as France's Chanel, have taken legal action to protect themselves against counterfeiters on the Amazon.com site. Chanel won a multimillion-dollar trademark infringement lawsuit against 30 vendors who were using Amazon to sell fake Chanel goods, such as bags, shirts, and cellphone cases. As part of the settlement, a federal judge in California ordered Amazon to disable the vendor sites and transfer any funds in their accounts to Chanel.

6–1c Service Marks and Trade Names

A **service mark** is similar to a trademark but is used to distinguish the services of one person or company from those of another. For example, each commercial airline has a particular mark or symbol associated with its name. Titles and character names used in radio and television are frequently registered as service marks. Service marks are protected in the same way as trademarks.

The term **trade name** is used to indicate part or all of a business's name. Generally, a trade name is directly related to a business and its goodwill. As with trademarks, words must be unusual or fancifully used if they are to be protected as trade names. For instance, the word Safeway is sufficiently fanciful to obtain protection as a trade name for a grocery store chain.

For more considerations involving trademarks and service marks, see the Linking Business Law to Your Career feature at the end of this chapter.

service mark

A mark that distinguishes business services.

trade name

A name used in commercial activity to designate a business.

6–1d Domain Names

A **domain name** is an internet address, such as www.amazon.com. The top-level domain (TLD) is the part of the name to the right of the period. The TLD indicates the type of entity that is using the name. For instance, “com” is an abbreviation for “commercial.” The second-level domain (SLD) often consists of the name of the entity that owns the site, such as Amazon.

No two businesses can use the same domain name. **Example 6.3** Acme Truck Rentals in Oklahoma and Acme Plumbing in Maine can own the trademark “Acme,” but only one business can operate on the internet with the domain name acme.com. ■

The unauthorized use of another's mark in a domain name constitutes trademark infringement, if the use would likely cause customer confusion. The Internet

domain name

An internet address.

Corporation for Assigned Names and Numbers (ICANN) oversees the distribution of domain names and operates an online arbitration system to handle complaints and disputes.

6–1e Cybersquatting

cybersquatting

Registering a domain name similar to the trademark of another and then offering to sell that domain name to the trademark owner.

Cybersquatting occurs when a person registers a domain name that is the same as, or confusingly similar to, the trademark of another and then offers to sell the domain name back to the trademark owner. Under the Anticybersquatting Consumer Protection Act (ACPA), cybersquatting is illegal when the person offering the domain name for sale has a “bad faith intent” to profit from using the trademark. The ACPA applies to all domain name registrations of trademarks.

6–1f Meta Tags

meta tags

A keyword used in online coding.

Search engines compile their results by looking through a website’s keyword coding. **Meta tags**, or keywords, are inserted in this coding to increase the frequency with which a site appears in search engine results. Using this technique, one site may appropriate the keywords of more popular sites, so that the appropriating site appears in the same search engine results as the other sites. Using another’s trademark in a meta tag without the owner’s permission constitutes trademark infringement.



Highlighting the Point

Michael and Lisa Tabot are auto brokers—that is, they offer personal car-shopping services. The Tabots offer these services on their website, which includes “lexus” in its keyword coding. Toyota Motor Sales, Inc., is the exclusive distributor of Lexus vehicles and the owner of the Lexus mark.

Does the Tabots’ use of the Lexus mark as a meta tag, without Toyota’s permission, constitute trademark infringement? Yes. Toyota owns the rights to the Lexus mark, and “lexus” is not a name by which the Tabots’ business is known. The Tabots’ use of the “lexus” mark to attract internet users to their website creates a likelihood of confusion. Thus, the Tabots could be ordered to stop using the mark.

6–2 Patents

patent

A government grant of the exclusive right to make, use, or sell an invention for a limited time period.

A **patent** is a grant from the government that gives an inventor the exclusive right to make, use, and sell an invention for a period of twenty years. Patents for fourteen years are given for designs, as opposed to inventions.

For either a regular patent or a design patent, the applicant must demonstrate to the satisfaction of the U.S. Patent and Trademark Office that the invention, discovery, or design is novel, useful, and not obvious in light of current technology. Almost anything is patentable, including artistic methods, certain business processes, and storyline structures and patterns.

The first person to file an application for a patent on the product or process receives patent protection. In addition, after issuance there is a nine-month limit for challenging a patent on any ground. The word Patent or Pat. with a patent number gives notice to the world that the article or design is patented.

6–2a Patent Infringement

If a firm makes, uses, or sells another's patented design, product, or process without the patent owner's permission, patent infringement occurs. This can happen even though not all features or parts of an invention are copied. (With respect to a patented process, however, all steps or their equivalent must be copied for infringement to occur.)

Learning Outcome 3

Describe legal protection for patents.

6–2b Licensing

To avoid litigation, many patent holders will instead offer to sell a **license** to the infringer. A license for a patent allows the use of the patented design, product, or process for certain specified purposes. Licensing is one of the best ways to protect patents—as well as trademarks, copyrights, and trade secrets—and to avoid costly litigation. Also, a license can limit the use of the patent to the licensee (the person gaining the licensing rights). Licensees typically pay **royalties** to the owner of a patent.

Example 6.4 West Coast Beverage Company produces Blast Off, its newly patented sports drink, at its headquarters in California. Garth, one of West Coast's founding partners, is moving to Vermont and wants to sell and distribute Blast Off there. To expand their product's territory, the other partners enter into a licensing agreement with Garth, allowing him to use the patented soft drink formula to produce and distribute Blast Off in Vermont. ■

license

An agreement permitting the use of intellectual property.

royalties

Payments made by a licensee to a licensor as part of an agreement for the ongoing use of the licensor's trademarked asset.

6–3 Copyrights

A **copyright** is an intangible right granted by statute to the author or originator of certain literary or artistic productions to publish, print, or sell the production. These works are protected by the federal government's Copyright Act.

Works created after January 1, 1978, are automatically given copyright protection for the life of the author, plus 70 years. For copyrights owned by publishing houses, the copyright expires 95 years from the date of publication or 120 years from the date of creation, whichever is first. For works by one or more authors, the copyright expires 70 years after the death of the last surviving author.

copyright

The exclusive right to publish, print, or sell an intellectual production.

6–3a Copyright Protection

Copyrights can be registered with the U.S. Copyright Office. This registration is evidence that the copyright is valid. Registration is not required, though. Protection is automatic. And the copyright owner need not place a © on the work to ensure its protection. Chances are that if somebody created it, somebody owns it.

Example 6.5 Rusty Carroll operates an online term paper business, R2C2 Inc., that offers up to 300,000 research papers for sale. Some individuals whose work is posted without their permission sue. The court then prohibits Carroll and R2C2 from selling any term paper without proof that the paper's author has given permission. ■

6–3b What Is Protected Expression?

Works that are copyrightable include books, records, films, artworks, architectural plans, menus, music videos, and product packaging. To obtain protection under the Copyright Act, a work must be original. It must also fall into one of the following categories:

- Literary works
- Musical works
- Dramatic works
- Pantomimes and choreographic works

- Pictorial, graphic, and sculptural works
- Motion pictures and other audiovisual works
- Sound recordings
- Computer software

To be protected, a work must be “fixed in a durable medium” from which it can be perceived, reproduced, or communicated.

6–3c Copyright Exclusions

Learning Outcome 4

Summarize legal protection for copyrights.

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.” Note that it is not possible to copyright an idea. The underlying ideas embodied in a work may be freely used by others. What is copyrightable is the way in which an idea is expressed. Whenever an idea and an expression are inseparable, the expression cannot be copyrighted. (A standard calendar, for instance, cannot be copyrighted.)

6–3d Copyright Infringement

Whenever the form or expression of an idea is copied without the permission of the copyright owner, an infringement of copyright occurs. The reproduction does not have to be exactly the same as the original. Penalties—including criminal proceedings for willful violations or the payment of damages—can be imposed on those who infringe copyrights.

The “Fair Use” Exception An exception to liability for copyright infringement is made under the “fair use” doctrine. A person or organization can reproduce copyrighted material without paying royalties for purposes such as criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, and research.

In determining whether the use of a work in a particular case is a fair use, a court takes several factors into account. The purpose of the use is considered, along with the nature of the copyrighted work and how much of it is copied. The most important factor is the effect of the use on the market for the copyrighted work.



Real Case

What happens when you mash-up the Star Trek television and movie series with the 1990 children’s classic by Dr. Seuss entitled “Oh, the Places You’ll Go!”? (This was the final book written by the late Theodor S. Geisel—who used the pseudonym Dr. Seuss.) Specifically, the company, ComicMix, LLC, created a so-called primer on Star Trek characters which replicated broad swaths of the Dr. Seuss original copyrighted work. ComicMix entitled its version “Oh, the Places You’ll Boldly Go!” ComicMix argued that its publication was permissible under the Fair Use Exception to current copyright law.

Was ComicMix’s use of “Oh, the Places You’ll Go!” fair use? No. In *Dr. Seuss Enterprises, L.P. v. ComicMix, LLC*, the U.S. Court of Appeals for the Ninth Circuit reversed a lower federal court ruling in favor of ComicMix. The appellate court pointed out that the creators of the new Star Trek primer asserted that they would be protected by its use of parody. The court was not convinced and also pointed out that this so-called parody utilized substantial portions of the copyrighted materials from the Dr. Seuss book. Fair use typically does not allow for substantial use.

—983 F.3d 443 (9th Cir.)

The First Sale Doctrine Once a copyright owner sells or gives away a copy of a work, the copyright owner no longer has the right to control the distribution of that copy. This rule is known as the first sale doctrine. **Example 6.6** Lisa buys a copyrighted book, such as *Harry Potter and the Philosopher's Stone* by J.K. Rowling. Lisa can then legally sell it to another person. ■

6–3e Copyright Protection for Software

In 1980, the Computer Software Copyright Act added computer programs to the list of creative works protected by federal copyright law. This protection extends not only to those parts of a computer program that can be read by humans, such as the source code. It also covers the binary-language object code of the program, which is readable only by the computer. Such elements as the overall structure, sequence, and organization of a program may also be copyrightable.

Highlighting the Point



Oracle America, Inc., owns many application programming interfaces, or APIs. The company grants licenses to other firms to use the APIs to write apps in Java (a processing language). Without Oracle's permission, Google, Inc., begins to use some of Oracle's APIs to run Java on its Android devices.

Is this copyright infringement? Yes. A court is likely to conclude that the APIs are source code and entitled to copyright protection.

Copyright protection does not extend to the “look and feel”—meaning the general appearance, command structure, video images, menus, windows, and other screen displays—of computer programs. Copying the look and feel of another's product may be a violation of trademark laws, however.

6–3f Copyrights in Digital Information

Copyright law is probably the most important form of intellectual property protection on the internet. This is because much of the material on the internet (including software and database information) is copyrighted. For that material to be transferred online, it must be “copied.” Generally, whenever a party downloads software or music into a computer's random access memory, or RAM, without authorization, a copyright is infringed. Technology has vastly increased the potential for copyright infringement.

Highlighting the Point



Bridgeport Music and Westbound Vinyl own the copyright to the song “Rock Around the World,” which opens with a three-note solo guitar riff that lasts four seconds. The rap song “Runnin' Away” contains a two-second sample from that guitar solo, but at a lower pitch. The guitar riff is also looped and extended to sixteen beats in five places in the rap song, with each looped segment lasting about seven seconds.

Does the use of the guitar riff in “Runnin' Away” without the permission of Bridgeport and Westbound constitute copyright infringement? Yes. Digitally sampling a copyrighted sound recording of any length is copyright infringement. Even when a small part of a sound recording is sampled, the part taken is something of value.

The Digital Millennium Copyright Act The Digital Millennium Copyright Act (DMCA) gives significant protection to owners of copyrights in digital information. The act established civil and criminal penalties for anyone who circumvents (bypasses) encryption software or other technological antipiracy protection. Also prohibited are the manufacture, import, sale, and distribution of devices or services for circumvention.

The DMCA does not restrict the “fair use” of circumvention methods for educational and other noncommercial purposes. For instance, circumvention is allowed to test computer security and to enable parents to monitor their children’s use of the internet.

internet service provider (ISP)

A business that offers users internet access.

ISP Limited Liability The DMCA limits the liability of **internet service providers (ISPs)**. Under the act, an ISP is not liable for copyright infringement by a subscriber unless the ISP is aware of the subscriber’s violation. An ISP may be held liable only if it fails to take action to shut down the subscriber after learning of the violation. A copyright holder must act promptly, however, by pursuing a claim in court, or the subscriber has the right to be restored to online access.

File-Sharing The DMCA also plays a role in protecting copyrights when file-sharing technology is used. File-sharing technology is especially prevalent in copyright disputes in the music industry.

When file-sharing is used to download others’ stored music files, copyright issues arise. For instance, individuals can make digital downloads available on distributed networks. Anyone can get the music for free on these networks, resulting in large revenue losses for recording artists and their labels. Not surprisingly, recording companies have pursued individuals for file-sharing copyrighted works.

File-sharing also creates problems for the motion picture industry, which loses significant amounts of revenue annually as a result of pirated Blu-ray discs and streamed movies and series.

6–4 Trade Secrets

Learning Outcome 5

Define trade secret.

trade secret

Information giving a business an advantage over competitors.

Some business processes and information that are not, or cannot be, patented, copyrighted, or trademarked are nevertheless protected as trade secrets. A **trade secret** may consist of customer lists, plans, research and development, pricing information, marketing techniques, or production techniques. Generally, anything that makes an individual company unique and that would have value to a competitor is considered a trade secret.

Conflict Resolved

Charles Furstenau was a manager at Radiant Global Logistics. He decided to join a competitor, BTX Logistics. Before doing so, he forwarded emails to BTX Logistics containing information on Radiant’s profits, preferred shippers, and financial projections.

A Could Radiant successfully sue Furstenau and BTX for misappropriation of trade secrets? Yes, a court would probably prohibit Furstenau from contacting clients he had worked with at Radiant for the last six months. Also, presumably BTX would be barred from using the information in the e-mails to its advantage.

Highlighting the Point



ZURU Inc. designs, makes, and sells toys. It debuted its ZURU Action Figures in Walmart stores and on Walmart's website. The toy manufacturer LEGO filed suit against ZURU, alleging infringement of LEGO's copyrights covering the appearances of its own Minifigures. LEGO pointed out that ZURU's Action Figures were substantially similar in overall look and feel to its own Minifigures.

Were ZURU's Action Figures sufficiently similar to LEGO's Minifigures to infringe on LEGO's copyrights? Yes. The standard test of substantial similarity involves whether an ordinary observer would be disposed to overlook any small differences. If the average person would recognize a copy (Action Figures) as having been taken from an original copyrighted work (Minifigures), the two items are substantially similar. And this was clearly the situation.

6–5 International Protection for Intellectual Property

Various international agreements relate to intellectual property rights. One of the first was the Paris Convention of 1883, to which 174 countries are signatories. The Paris Convention allows parties in one country to file for patent and trademark protection in any of the other member countries.

6–5a The Berne Convention

The Berne Convention of 1886 is an international copyright agreement. Every member country must recognize the copyrights of authors who are citizens of other member countries. If a citizen of a country that has not signed the agreement first publishes a book in a country that has signed, all other countries that have signed the agreement must recognize that author's copyright.

6–5b The TRIPS Agreement

Almost 165 countries have signed the agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Under this agreement, a member nation cannot give its citizens more favorable treatment, in terms of the administration, regulation, or adjudication of intellectual property rights, than it offers to the citizens of other member countries.

TRIPS specifically provides copyright protection for computer programs by stating that compilations of data, databases, or other materials are “intellectual creations” and that they are to be protected as copyrightable works. Other provisions relate to patents, trademarks, trade secrets, and the rental of computer programs and cinematographic works.

6–5c The Anti-Counterfeiting Trade Agreement

Nine countries plus the European Union (27 countries) have signed the Anti-Counterfeiting Trade Agreement (ACTA). This international treaty's goals are to increase international cooperation, facilitate the best law enforcement practices, and provide a legal framework to combat counterfeiting. ACTA applies to counterfeit physical goods, such as medications, as well as to pirated copyrighted works being distributed online.



Linking Business Law to Your Career

Trademarks and Service Marks

You might plan on having a career in marketing. As a marketing manager, you might be involved in creating trademarks or service marks for your firm and protecting the firm's existing marks.

The Broad Range of Trademarks and Service Marks

The courts have held that trademarks and service marks consist of much more than well-known brand names, such as Chanel™. Be aware that parts of a brand or other product identification often qualify for trademark protection. Keep the following examples of branding in mind when working in a marketing department:

- **Catchy Phrases**—Certain brands have established phrases that are associated with them, such as Nike's "Just Do It!"
- **Abbreviations**—Sometimes, the public abbreviates a well-known trademark. For example, Budweiser™ is also known as Bud.

- **Shapes**—The shape of a brand name, service mark, or even a container can take on exclusivity if these shapes clearly aid in product or service identification, such as the shape of a Coca-Cola bottle.
- **Ornamental Colors**—Color combinations can become part of a service mark or trademark. For instance, FedEx established its identity with the use of bright orange and purple.
- **Ornamental Designs**—Symbols and designs associated with a mark normally are protected.

When to Protect Your Trademarks and Service Marks

Once your company has established a trademark or a service mark, if you fail to protect it, your company faces the possibility that it will become generic. Always include the trademark symbols in your advertising—both online and off. You want to take every opportunity to have your trademark on all company documents, too.

Chapter Summary—Intellectual Property

Learning Outcome 1: Identify intellectual property.

Trademarks, patents, copyrights, and trade secrets are forms of intellectual property.

Learning Outcome 2: Discuss legal protection for trademarks.

To be protected, a registered trademark must be sufficiently distinctive from other trademarks. Trademark infringement occurs when one who does not own a trademark copies it to a substantial degree or uses it in its entirety.

Learning Outcome 3: Describe legal protection for patents.

To be patentable, an invention, discovery, or design must be novel, useful, and not obvious in light of current technology. Patent infringement occurs when one makes, uses, or sells another's patented design, product, or process without the patent owner's permission.

Learning Outcome 4: Summarize legal protection for copyrights.

Copyright infringement occurs when the form or expression of an idea is copied without the permission of the copyright owner. The copy does not have to be exactly the same as the original to infringe. There is an exception for copying deemed a "fair use."

Learning Outcome 5: Define trade secret.

Customer lists, plans, research and development, pricing information, and marketing or production techniques are all considered trade secrets.

Straight to the Point

1. When does trademark infringement occur? (See Learning Outcome 1.)
2. Which trademarks are protected by the law? (See Learning Outcome 1.)
3. How does licensing protect intellectual property? (See Learning Outcome 2.)
4. Which works are copyrightable? (See Learning Outcome 4.)
5. What is the federal legislation that significantly protects copyrights in the digital age? (See Learning Outcome 4.)
6. How are trade secrets protected by the law? (See Learning Outcome 5.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Karl self-publishes a cookbook titled *Hole Foods*, in which he sets out recipes for donuts, Bundt cakes, tortellini, and other foods with holes. To publicize the book, Karl designs the website holefoods.com. Karl appropriates the key words of other cooking and cookbook sites with more frequent hits so that holefoods.com will appear in the same search engine results as the more popular sites. Has Karl done anything wrong? Explain your answer. (See Learning Outcome 1.)
2. Roslyn is a food buyer for Organic Cornucopia Food Company when she decides to go into business for herself as Roslyn's Kitchen. She contacts Organic's suppliers, offering to buy their entire harvest for the next year, and Organic's customers, offering to sell her products for less than her ex-employer's prices. Has Roslyn violated any of the intellectual property rights discussed in this chapter? Explain. (See Learning Outcome 5.)

Real Law

6–1. Copyright. The “Jimmy Smith Rap” is a copyrighted rap recording asserting the supremacy of jazz over other types of music. Many years later, “Pound Cake” is a hip-hop song in which Aubrey Graham and Shawn Carter (professionally known as Drake and Jay-Z), rap about the greatness and authenticity of their own work. At the beginning of the seven-minute-long “Pound Cake” rap is a sampling of 35 seconds of the “Jimmy Smith Rap.” Criticizing jazz elitism, “Pound Cake” emphasizes that it is not the genre but the authenticity of the music that matters. The release of “Pound Cake” had no effect on the demand for the “Jimmy Smith Rap,” for which there was no active market at the time. Did Drake and Jay-Z make “fair use” of the “Jimmy Smith Rap” or are they liable for copyright infringement? Explain. [*Estate of Jimmy Smith v. Graham*, 799 F.Appx 36 (2nd Cir. 2020)] (See Learning Outcome 4.)

6–2. Copyright. Savant Homes, Inc., is a custom home designer and builder. Using what it called the Anders Plan, Savant built a model house in Windsor, Colorado. This was a ranch house with two bedrooms on one side and a master suite on the other, separated by a combined family room, dining room, and kitchen. Ron and Tammie Wagner toured the Savant house.

The same month, the Wagners hired builder Douglas Collins and his firm, Douglas Consulting, to build a house for them. After it was built, Savant filed a lawsuit in a federal district court against Collins for copyright infringement, alleging that the builder had copied the Anders Plan in the design and construction of the Wagner house. Collins showed that the Anders Plan consisted of standard elements and standard arrangements of elements. In these circumstances, has infringement occurred? Explain. [*Savant Homes, Inc. v. Collins*, 809 F.3d 1133 (10th Cir. 2016)] (See Learning Outcome 4.)

6–3. Patents. The U.S. Patent and Trademark Office (PTO) denied Raymond Gianelli's application for a patent for a “Rowing Machine”—an exercise machine that requires a user to pull on handles to perform a rowing motion against a selected resistance in order to strengthen the back muscles. The PTO considered the device obvious in light of a previously patented “Chest Press Apparatus for Exercising Regions of the Upper Body”—a chest press exercise machine on which a user pushes on handles to overcome a selected resistance. On what ground might this result be reversed on appeal? Discuss. [*In re Gianelli*, 739 F.3d 1375 (Fed. Cir. 2014)] (See Learning Outcome 2.)

Ethical Questions

6–4. File-Sharing. From an ethical perspective, is it important to protect copyrighted music from unauthorized file-sharing and other forms of distribution online? Why or why not? (See Learning Outcome 4.)

6–5. Copyrights in Digital Information. Usenet is an online bulletin board network. A user gains access to Usenet posts through a commercial service, such as Giganews, Inc. Giganews deletes or blocks posts that contain child pornography. Otherwise, the service does not monitor content. Perfect 10, Inc., owns the copyrights to tens of

thousands of images—many of which have been illegally posted on Usenet through Giganews. When Perfect 10 notified Giganews of posts that contained infringing images, the service took them down. Despite these efforts, however, illegal posting continued. Perfect 10 filed a suit in a federal district court against Giganews, alleging copyright infringement. Is Giganews liable? Do internet service providers have an ethical duty to do more to prevent copyright infringement? Why or why not? [*Perfect 10, Inc. v. Giganews, Inc.*, 847 F.3d 657 (9th Cir. 2017)] (See Learning Outcome 4.)

Chapter 6—Work Set

True-False Questions

- _____ 1. To obtain a patent, individuals and companies must prove to the patent office that their inventions are novel, useful, and not obvious in light of contemporary technology.
- _____ 2. To obtain a copyright, an author must prove to the copyright office that a work is novel, useful, and not a copy of another copyrighted work.
- _____ 3. A personal name can be trademarked if it has acquired a secondary meaning.
- _____ 4. Using a domain name that is similar but not identical to the trademark of another is legal.
- _____ 5. Dilution occurs when a trademark is used, without permission, in a way that diminishes the distinctive quality of the mark.
- _____ 6. Downloading music onto a computer is not copyright infringement, even if it is done without authorization.
- _____ 7. A formula for a chemical compound is not a trade secret.
- _____ 8. A copy must be exactly the same as an original work to infringe on its copyright.
- _____ 9. A license permits the use of another's intellectual property for certain limited purposes.

Multiple-Choice Questions

- _____ 1. Mandy registers a domain name that is confusingly similar to the trademark of Security Services Corporation. She then offers to sell the domain name to Security Services. This is
 - a. cybersquatting.
 - b. a smart way to do business.
 - c. trademark infringement.
 - d. trademark dilution.
- _____ 2. Ruslan invents a light bulb that lasts longer than ordinary bulbs. To prevent others from making, using, or selling the bulb or its design, he should obtain
 - a. a trademark.
 - b. a copyright.
 - c. a patent.
 - d. none of the above.
- _____ 3. Standard Products, Inc., obtains a patent on a portable laser printer. This patent is violated if another firm reproduces the printer
 - a. in its entirety only.
 - b. either in its entirety or in part.
 - c. in part only.
 - d. none of the above.
- _____ 4. Lyydia works for Consolidated Manufacturing Company under a contract in which she agrees not to disclose any process she uses while in Consolidated's employ. When Lyydia goes into business for herself, she copies some of Consolidated's unique production techniques. Lyydia has committed
 - a. trademark infringement.
 - b. patent infringement.
 - c. copyright infringement.
 - d. theft of a trade secret.

- _____ 5. To identify its goods, Nationwide Products uses a red, white, and blue symbol that combines the letter N and a map of the United States. This symbol is protected by
- trademark law.
 - copyright law.
 - patent law.
 - all of the above.
- _____ 6. The graphics used in “Grave Raiders,” a computer game, are protected by
- copyright law.
 - patent law.
 - trademark law.
 - trade secrets law.
- _____ 7. Sales Track, Inc., creates, makes, and sells inventory control software for businesses. Generally, copyright protection extends to
- no parts of the software.
 - the “look and feel” of the software.
 - those parts of the software that can be read by humans.
 - the brand name of the software.
- _____ 8. Realty Markets Corporation allows Sam, an independent real estate salesperson, to use Realty’s trademark to advertise the properties that Sam represents for sale. This is
- a license.
 - likely to confuse consumers.
 - counterfeiting.
 - dilution.
- _____ 9. Ordinarily, you may not reproduce a copyrighted object without the owner’s permission. The exception to this general rule is contained in the
- Lanham Act.
 - appropriation doctrine.
 - “fair use” doctrine.
 - “fair copy” doctrine.

Answering More Legal Problems

1. Apple, Inc., obtains design patents on its iPhones and iPads that cover the devices’ graphical user interface, shell, and screen and button design. Other patents cover the way the information is displayed, the way the windows pop open, the way the information is scaled and rotated, and other aspects.

What is a patent? A patent is a grant from the government that gives an inventor the exclusive _____ to make, use, and sell an invention for a period of twenty years. For designs, patents are given for _____ years.

How is a patent obtained? To obtain a patent, an applicant must show to the satisfaction of the patent office that the invention, discovery, or design is novel, useful, and not _____ in light of current technology. The word Patent or Pat. with the patent number gives notice to the world that the article or design is patented.

2. Apple, Inc., files a suit in a federal district court against Samsung Electronics Company, alleging that Samsung’s Galaxy mobile phones and tablets infringe on Apple’s patents. Apple claims that the features of these phones and tablets violate all of Apple’s design patents on the features of its iPhones and iPads.

What is patent infringement? The tort of patent infringement exists when a firm makes, uses, or sells another’s patented design, product, or process without the patent owner’s _____.

Can patent infringement exist even though not all features of a design or parts of an invention are copied? _____. Only with respect to a patented process must all of the steps, or their equivalent, be copied to constitute infringement.



7 Business Crimes

Conflict Presented

Capitol Bank customers receive e-mails telling them to click on a “secure” link. On the linked site, they are asked to enter personal information to complete the installation of a new “Online Security Certificate.” The site is a fraud, however. When unsuspecting customers click on the link, their computers are infected by programs that funnel personal data to a server. The stolen data are then sold.

Q What is this crime called?

To protect the ability of individuals engaging in business to compete and flourish, our society imposes various sanctions, or punishments. These sanctions include damages for torts and damages for breaches of contract. Other sanctions are imposed under criminal law. As a result, criminal law is an important part of the business world.

In this chapter, we focus on crimes affecting business and the defenses that can be raised to avoid liability for criminal actions. We conclude with an overview of cybercrime.

7-1 Civil Law and Criminal Law

Civil law spells out the duties that exist between persons or between citizens and their governments, excluding the duty not to commit crimes. Contract law, and the whole body of tort law, for instance, are part of civil law. When a civil wrong is committed, the person who suffered the harm can bring a lawsuit for damages.

Criminal law, in contrast, has to do with crime. A **crime** is a wrong against society proclaimed in a statute and punishable by society through fines, imprisonment, or, in some cases, death. Because crimes are offenses against society as a whole, they are prosecuted by a public official, such as a district attorney, rather than by the crime victims.

7-1a Key Differences

One important difference between civil and criminal law involves the burden of proof required. In a civil case, the plaintiff usually must prove their case by a preponderance of the evidence. That is, the plaintiff must convince the court (judge or jury) that, based on the evidence, it is more likely than not that the plaintiff’s allegation is true. In a criminal case, in contrast, the state must prove its case beyond a reasonable doubt—a much stricter standard.

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Indicate elements of criminal liability.
- 2 Outline the rights of criminal suspects.
- 3 List the crimes that affect business.
- 4 Summarize the defenses to criminal liability.
- 5 Know the legal protection for online victims.

crime

A wrong against society punishable by fines, imprisonment, or death.

In a criminal case, the jury's verdict normally must be unanimous—that is, every juror must agree in order to convict the defendant. In a civil trial by jury, however, typically only three-fourths of the jurors need to agree.

Another difference is that the sanctions—fines, imprisonment, or death—imposed on criminal wrongdoers are harsher than those in civil cases. The purpose of tort law is to compensate the victims of torts, not to punish the wrongdoers. In contrast, criminal sanctions are designed to punish those who commit crimes and to deter others from committing similar acts in the future.

Exhibit 7.1 presents additional ways in which criminal and civil law differ.

7–1b Classification of Crimes

felonies

A crime that carries the most severe sanctions.

misdemeanor

A lesser crime than a felony.

Crimes are classified as felonies or misdemeanors. **Felonies** are serious crimes punishable by death or by imprisonment in a federal or state penitentiary for more than a year.

Under federal law and in most states, any crime that is not a felony is a **misdemeanor**. Misdemeanors are crimes punishable by a fine or by confinement for up to a year. If imprisoned, the guilty party goes to a local jail instead of a penitentiary. Disorderly conduct and trespass are common examples of misdemeanors.

7–1c What Constitutes Criminal Liability?

Learning Outcome 1

Indicate elements of criminal liability.

Two elements must exist for a person to be convicted of a crime: (1) the performance of a prohibited act and (2) a specified state of mind, or intent, on the part of the actor.

Every criminal statute prohibits certain acts. Most crimes require an act of commission—that is, a person must do something to be accused of a crime. An act of omission can be a crime but only when a person has a legal duty to perform the omitted act. Failure to file a tax return is an example of an omission that is a crime.

A wrongful mental state is generally as necessary as a wrongful act in establishing criminal liability. For theft, the guilty act is the taking of another person's property, and the mental state involves both the knowledge that the property belongs to another and the intent to deprive the owner of it.

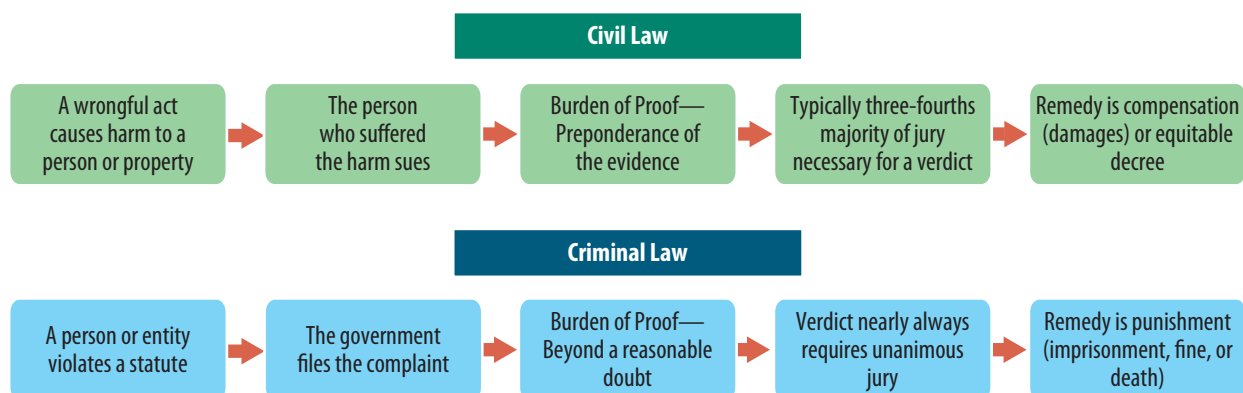
7–2 Constitutional Safeguards

Learning Outcome 2

Outline the rights of criminal suspects.

Criminal law brings the force of the state, with all its resources, to bear against the individual. The U.S. Constitution provides safeguards to protect the rights of individuals and to prevent the arbitrary use of power on the part of the government.

Exhibit 7.1 Key Differences Between Civil Law and Criminal Law



The United States Supreme Court has ruled that most of these safeguards apply not only in federal but also in state courts. They include the following:

1. The Fourth Amendment protection from unreasonable searches and seizures.
2. The Fourth Amendment requirement that no warrants for a search or an arrest can be issued without probable cause.
3. The Fifth Amendment requirement that no one can be deprived of “life, liberty, or property without due process of law.”
4. The Fifth Amendment prohibition against **double jeopardy**—that is, trying someone twice for the same criminal offense.
5. The Fifth Amendment requirement that no persons can be forced to be witnesses against (incriminate) themselves.
6. The Sixth Amendment guarantees of a speedy trial, a trial by jury, a public trial, the right to confront witnesses, and the right to a lawyer at various stages in some proceedings.
7. The Eighth Amendment prohibitions against excessive bail and fines and against cruel and unusual punishment.

double jeopardy

A situation occurring when a person is tried twice for the same criminal offense.

7–2a Searches and Seizures

Before searching or seizing private property, a law enforcement officer must obtain a **search warrant**—an order from a judge or other public official authorizing the search or seizure.

Probable Cause To obtain the warrant, the officer must convince the judge that there is **probable cause** to believe a search will reveal a specific illegality. Probable cause requires evidence that would convince a reasonable person that the proposed search or seizure is more likely justified than not. The officer must describe what is to be searched or seized.

Businesses as well as individuals are protected against unreasonable searches. For instance, government inspectors do not have a right to search business premises without a warrant. The standard of probable cause is not the same as that required in nonbusiness contexts. The existence of a general and neutral plan of regulatory enforcement will justify the issuance of a warrant. A warrant normally is not required for a seizure of spoiled or contaminated food. Nor are warrants required for searches of businesses in highly regulated industries, such as those dealing with liquor, guns, and strip mining.

Reasonable Expectation of Privacy The Fourth Amendment only protects against searches that violate a person’s reasonable expectation of privacy. This exists if an individual actually expects privacy and the expectation is one that society, as a whole, thinks is legitimate.

search warrant

An order from a judge authorizing the search or seizure of private property.

probable cause

Reasonable grounds for believing a search will reveal a specific illegality.

7–2b The Exclusionary Rule

Under the **exclusionary rule**, all evidence obtained in violation of the constitutional rights spelled out in the Fourth, Fifth, and Sixth Amendments usually must be excluded—as well as all evidence derived from the illegally obtained evidence.

Evidence derived from illegally obtained evidence is known as “fruit of the poisonous tree.” For instance, if a confession is obtained after an illegal arrest, the arrest is “the poisonous tree.” The confession, if “tainted” by the arrest, is the “fruit.” The purpose of the exclusionary rule is to deter police from misconduct.

exclusionary rule

Rule preventing the government from using evidence gathered in violation of the U.S. Constitution.



Highlighting the Point

An investigator with the Laguna Beach Police Department enlists the aid of a local trash collector to gather evidence against Greenwood. Instead of taking Greenwood's trash bags to be incinerated, the trash collector agrees to give them to the investigator. The investigator finds enough drug paraphernalia to obtain a search warrant. Greenwood is charged with possession of illegal drugs and is convicted.

Was the search illegal? No. Once persons place trash on a curb, that trash is exposed to any number of intrusions by animals, scavengers, and snoopers. If Greenwood had truly intended to keep the contents of his garbage private, he would not have left it on the side of the road.

7-2c Informing Suspects of Their Rights

Individuals who are arrested must be informed of certain constitutional rights—also known as *Miranda* rights. These include the right to remain silent and the right to legal counsel. If the arresting officer fails to inform a criminal suspect of these rights, any statement the suspect makes normally will not be admissible in court.

7-3 Crimes Affecting Business

Learning Outcome 3

List the crimes that affect business.

white-collar crime

Nonviolent crime committed in the business world.

Numerous forms of crime occur in a business context. Many of these are referred to as **white-collar crimes**. The term is used to mean an illegal act or series of acts committed by an individual or business using some nonviolent means to obtain a personal or business advantage. In this section, we focus on white-collar property crimes, as well as violations of the Racketeer Influenced and Corrupt Organizations Act that affect business.

7-3a Forgery

forgery

The fraudulent making or altering of any writing.

The fraudulent making or altering of any writing in a way that changes the legal rights and liabilities of another is **forgery**. **Example 7.1** Without authorization, Chudy signs Bennett's name to the back of a check made out to Bennett. Chudy is committing forgery. ■ Forgery also includes changing trademarks, falsifying public records, counterfeiting, and altering a legal document.

7-3b Robbery

robbery

The act of forcefully and unlawfully taking personal property from another.

Robbery is forcefully and unlawfully taking personal property of any value from another. The use of force or intimidation is usually necessary for an act of theft to be considered a robbery.

7-3c Larceny

larceny

The wrongful taking and carrying away of another person's personal property.

The crime of **larceny** involves the unlawful taking and carrying away of someone else's personal property with the intent to permanently deprive the owner of possession. In short, larceny is stealing or theft. As noted, robbery involves force or fear, but larceny does not. So, shoplifting is larceny, not robbery.

7–3d Embezzlement

When a person who is entrusted with another person's property or money fraudulently takes it over, **embezzlement** occurs. Typically, this involves an employee who steals money. Embezzlement is not larceny, because the wrongdoer does not physically take the property from the possession of another, and it is not robbery, because no force or fear is used.

embezzlement

The fraudulent taking of money or other property by a person to whom it has been entrusted.

Highlighting the Point



While hauling a load of refrigerators from San Diego to New York in a truck owned by National Appliance Company, Fred tries to sell some of the refrigerators. To display them, Fred breaks the truck's seals, enters the cargo compartment, and opens two refrigerator cartons. No one buys them, and they never leave the truck. Fred is arrested and charged with embezzlement. Fred claims that there are no grounds for the charge because he never took anything off the truck.

Does the charge of embezzlement apply when property is not physically removed from the owner's possession? Yes. If persons have control over the property of another and have the intent of converting the goods to their own use, then embezzlement occurs. By trying to sell the refrigerators and keep the proceeds, Fred exercised control over the property with the intent to convert it to his own use.

7–3e Mail and Wire Fraud

A potent weapon against white-collar criminals is federal law that prohibits mail fraud and wire fraud. Under such law, it is a federal crime to devise a scheme that uses the U.S. mail, commercial carriers (such as FedEx), or wire (including telegraph, telephone, television, and the internet) with the intent to defraud the public. These laws are often applied, for instance, when e-mailed ads are sent with the intent to obtain money or personal data by false pretenses. Violators may be fined or imprisoned or both.

Highlighting the Point



Franklin Systems offers a warranty program to authorized resellers of Franklin parts. George Taylor and Minsun Yang devise a scheme to intentionally defraud Franklin by using this reseller program to obtain replacement parts to which they are not entitled. Taylor and Yang send numerous e-mails and internet service requests to Franklin to convince the company to ship them new parts via commercial carriers.

Does Taylor and Yang's use of e-mail and the internet constitute mail and wire fraud? Yes. They sent e-mails with the intent to obtain goods by false pretenses—that is, goods to which they were not entitled. They have committed mail and wire fraud.

7–3f Bribery

Basically, three types of bribery are considered crimes: bribery of public officials, commercial bribery, and bribery of foreign officials.

Bribery of Public Officials The attempt to influence a public official to act in a way that serves a private interest is a crime. The bribe can be anything the recipient considers to be valuable. The commission of the crime occurs when the bribe is offered. The recipient does not have to agree to perform whatever action is desired by the person offering the bribe, nor does the recipient have to accept the bribe.

Commercial Bribery Typically, people make commercial bribes to obtain proprietary information, cover up an inferior product, or secure new business. Industrial espionage sometimes involves commercial bribes. **Example 7.2** Rosemary works for Telecom. She offers Augusto, an employee at QMC Services (a Telecom competitor), a payoff in exchange for QMC trade secrets. ■ So-called kickbacks, or payoffs for special favors or services, are a form of commercial bribery in some situations.

Bribery of Foreign Officials Bribing foreign officials to obtain favorable business contracts is a crime. The Foreign Corrupt Practices Act was passed to prevent U.S. businesspersons from using bribery to secure foreign contracts.

7–3g Racketeer Influenced and Corrupt Organizations Act

The purpose of the Racketeer Influenced and Corrupt Organizations Act (RICO) was to curb the apparently increasing entry of organized crime into the legitimate business world.

Federal Crimes Under RICO Under RICO, it is a federal crime to do the following:

- Use income obtained from racketeering activity to purchase any interest in an enterprise.
- Acquire or maintain an interest in an enterprise through racketeering activity.
- Conduct or participate in the affairs of an enterprise through racketeering activity.
- Conspire to do any of the preceding acts.

RICO incorporates twenty-six separate types of federal crimes and nine types of state felonies. It stipulates that if a person commits two or more of these offenses, that person is guilty of “racketeering activity.”

Business Crimes Under RICO Most of the criminal RICO offenses have little to do with normal business activities. Securities fraud (involving the sale of stocks and bonds) and mail fraud, however, can be criminal violations under RICO. The act has become an effective tool in attacking these white-collar crimes.

7–4 Defenses to Criminal Liability

Learning Outcome 4

Summarize the defenses to criminal liability.

The law recognizes several defenses that excuse a defendant’s criminal behavior. Among the most important defenses to criminal liability are mistake, insanity, and entrapment. Also, in some cases, defendants are given immunity and thus relieved, at least in part, of criminal liability for crimes they committed.

7-4a Mistakes

Everyone has heard the saying, “Ignorance of the law is no excuse.” Ordinarily, a mistake of law—that is, ignorance of the law or a mistaken idea about what the law requires—is not a valid defense. In contrast, a mistake of fact can often excuse criminal responsibility, if it negates the mental state necessary to commit a crime.

Example 7.3 Wyatt mistakenly walks off with Julie’s briefcase at a popular restaurant because he thinks it is his. Wyatt has not committed a crime because theft requires knowledge that the property belongs to another. (If Wyatt’s act causes Julie to incur damages, however, she may sue him in a civil action for conversion.) ■

7-4b Insanity

Someone suffering from a mental illness is sometimes judged incapable of the state of mind required to commit a crime. Different courts use different tests for legal insanity. Almost all federal courts and some state courts hold that a person is not responsible for criminal conduct if, as a result of mental disease or defect, the person lacked the capacity to appreciate the wrongfulness of the conduct or to obey the law.

Some states use a test under which criminal defendants are not responsible if, at the time of the offense, they did not know the nature and quality of the act or did not know that the act was wrong. Other states use the irresistible-impulse test. A person operating under an irresistible impulse may know an act is wrong but cannot refrain from doing it.

7-4c Entrapment

Entrapment is a defense designed to prevent police officers or other government agents from encouraging crimes in order to apprehend persons wanted for criminal acts.

In the typical entrapment case, an undercover agent suggests that a crime be committed and somehow pressures or induces an individual to commit it. The agent then arrests the individual for the crime. The crucial issue is whether a person who committed a crime was inclined to commit the crime or did so only because the agent induced it.

entrapment

An act by which a public official induces someone to commit a crime.

7-4d Immunity

Another form of criminal defense is immunity (or release) from prosecution. Accused persons cannot be forced to give information to the police or other authorities if it will be used to prosecute them. This privilege against self-incrimination is granted by the Fifth Amendment to the U.S. Constitution.

To obtain information from a person accused of a crime, however, the state can grant that person immunity from prosecution. In addition, the state can agree to prosecute the accused person for a less serious offense in exchange for the information.

7-5 Cybercrime

Computer crime is any violation of criminal law that involves knowledge of computer technology for its perpetration, investigation, or prosecution. Criminal activity occurring online is **cybercrime**.

computer crime

Crime that involves knowledge of computer technology for its perpetration, investigation, or prosecution.

cybercrime

A crime that occurs online.

7-5a Cyber Fraud

Fraud is any misrepresentation knowingly made with the intention of deceiving another and on which a reasonable person would and does rely to their detriment.

Cyber fraud is fraud committed in the virtual community of the internet.

cyber fraud

Any misrepresentation knowingly made online with the intention of deceiving another for gain.

Example 7.4 Anthony selects two online auction sites and creates fake seller accounts on each. He then creates an auction page on each site for a rare antique clock, complete with a detailed description and photos. His minimum starting bid is \$500. The clock sells for more than \$500 on each site. Anthony sends one buyer a clock, but it is not the one advertised and is worth only \$50. The other buyer receives nothing. ■

7-5b Identity Theft

identity theft

The act of stealing another's identifying information and using it to access the victim's financial resources.

Identity theft occurs when the wrongdoer steals a form of identification—such as a name, date of birth, or Social Security number—and uses the information to access the victim's financial resources.



Real Case

Karen Gagarin worked for American Income Life Insurance Company. While working for the company, she engaged in a conspiracy with two other employees to submit hundreds of applications for life insurance policies on behalf of people who did not know that a policy was applied for or issued in their names. Gagarin and her accomplices then shared the commissions and bonuses issued by the insurance company in connection with the fraudulent policies. Gagarin created phony drivers licenses so that she and the others could take medical exams while pretending to be the applicants.

Was Gagarin guilty of, among other things, identity theft? Yes. In *United States v. Gagarin*, the U.S. Court of Appeals for the Eleventh Circuit affirmed Gagarin's conviction. She and her coconspirators had used a means of identification of other persons in order to fraudulently (without lawful authority) submit life insurance applications.

—950 F.3d 596 (11th Cir.)

phishing

Sending an electronic message purportedly from a legitimate business to induce the recipient to reveal personal information.

Phishing is a distinct form of identity theft (and cyber fraud). In a phishing attack, the perpetrators “fish” for financial data and passwords from consumers by posing as legitimate businesses and asking for personal data that help them steal a user's identity. Phishing scams typically use e-mail but have spread to include text messaging and social networking sites.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, a bank's customers receive e-mails telling them to click on a link. At that site, they are asked to enter personal information to complete the installation of a new security application. The site is a fraud. Unsuspecting users' computers are infected, and their personal data are stolen and sold.

A What is this crime called? This is a form of identity theft known as phishing. A perpetrator, posing as a legitimate business, “fishes” for personal data using e-mails. The e-mails ask recipients to provide vital information. Once the personal information is obtained, the phisher can use or sell it.

7–5c Hacking

A person who uses one computer to break into another is referred to as a **hacker**. Hackers who break into computers and mobile devices without authorization often commit cyber theft. The goals of a hacking operation might include a wholesale theft of data, such as a merchant's customer files, or the monitoring of a computer to discover a business firm's plans and transactions.

In particular, retail companies take risks by storing their customers' debit and credit card numbers and personal information online. The electronic warehouses that store these data are attractive targets for cyber thieves and hackers. (See the Linking Business Law to Your Career feature at the end of this chapter.)

Example 7.5 Bella hacks into the website of Urban Mix Boutique, a popular clothing outlet in her community. Customers can purchase items at the retail store or online. After hacking into the site, Bella installs **malware** that sends to her the financial data of every Urban Mix customer. Bella can then sell the stolen data to other cyber thieves or use the information to make fraudulent purchases herself. ■

hacker

A person who uses one computer to break into another.

malware

Malicious software programs designed to disrupt or harm computers.

7–5d Cyberterrorism

A **cyberterrorist** is a hacker who exploits computers to create a serious negative impact. For instance, false code entered into the processing control system of a food manufacturer could alter the levels of ingredients so that consumers of the food would become ill. Computer viruses could also cripple communications networks. A prolonged disruption of computer, cable, satellite, or telecommunications systems would have serious effects on business operations—and national security—on a global level.

cyberterrorist

A hacker whose purpose is to create a serious negative impact.

7–5e Prosecuting Cybercrime

Cyberspace has raised new issues in the investigation of crimes and the prosecution of offenders.

Learning Outcome 5

Know the legal protection for online victims.

Jurisdiction and Identification Challenges A threshold issue in investigating and prosecuting cybercrime is jurisdiction. For instance, a person who commits an act against a business in California, where the act is a cybercrime, might never have set foot in California but might instead reside in New York, where the act may not be a crime.

Identifying the wrongdoer can also be difficult. Cybercriminals do not leave physical traces, such as fingerprints or DNA samples, as evidence of their crimes. Even electronic “footprints” can be hard to find and follow.

The Computer Fraud and Abuse Act At the federal level, the Counterfeit Access Device and Computer Fraud and Abuse Act, which is commonly known as the Computer Fraud and Abuse Act (CFAA), is the most important legislation targeting cybercrime. The CFAA provides that a person who accesses a computer online without authority to obtain classified, restricted, or protected data, or attempts to do so, is subject to criminal prosecution.

The theft is a felony if it is committed for a commercial purpose or for private financial gain, or if the value of the stolen data (or computer time) exceeds \$5,000. Penalties include fines and imprisonment for up to twenty years.



Linking Business Law to Your Career

Protect Your Company Against Hacking

Because millions of dollars are hacked from business accounts every year, you should encourage your company to act to protect its funds. Unfortunately, many businesses do not take steps to reduce the risk of hacking. Their accounts are often in local banks or credit unions, which may have inadequate security measures and lack the services of cyber-security experts.

Know What Is “Commercially Reasonable”

Many small-business owners believe that if their bank accounts are hacked and disappear, their banks will reimburse them. That is not always true, however.

In numerous cases, small-business owners have been unsuccessful in their attempts to force their banks to

reimburse them for funds lost due to hacking. Some courts have ruled that it is up to the individual business to protect itself from such cybercrimes.

Know Your Insurance Coverage Policy

Similarly, small-business owners often think that their regular insurance policy will cover cyber losses at their local banks. In reality, unless there is a specific “rider” to a business’s insurance policy, its bank accounts are not covered.

In other words, your insurance company may reimburse your business if thieves break in and steal your machines and network servers. But that does not mean you will be covered if hackers break into your bank account.

Chapter Summary—Business Crimes

Learning Outcome 1: Indicate elements of criminal liability.

The elements of criminal liability are (1) the performance of a prohibited act and (2) a specified state of mind, or intent.

Learning Outcome 2: Outline the rights of criminal suspects.

The rights of accused persons are protected under the U.S. Constitution, particularly by the Fourth, Fifth, Sixth, and Eighth Amendments. Under the exclusionary rule, evidence obtained in violation of the constitutional rights of the accused will not be admissible in court. Individuals must be informed of their constitutional rights, including their right to counsel and their right to remain silent when taken into custody.

Learning Outcome 3: List the crimes that affect business.

Crimes affecting business include forgery, robbery, larceny, embezzlement, mail and wire fraud, and bribery. The Racketeer Influenced and Corrupt Organizations Act (RICO) helps to curb organized crime.

Learning Outcome 4: Summarize the defenses to criminal liability.

The most important defenses to criminal liability include mistakes, insanity, and entrapment. In some cases, defendants can be granted immunity from prosecution, or be prosecuted for a less serious offense, in exchange for information.

Learning Outcome 5: Know the legal protection for online victims.

The Counterfeit Access Device and Computer Fraud and Abuse Act prohibits cyber theft, which is accessing, or attempting to access, a computer without authority to obtain classified or protected data. Penalties include fines and imprisonment for up to twenty years.

Straight to the Point

1. What is the definition of crime? (See Learning Outcome 1.)
2. What must a law enforcement officer obtain before searching or seizing private property? (See Learning Outcome 2.)
3. What is the definition of white-collar crime? (See Learning Outcome 3.)
4. When can a person refuse to give information to law enforcement officers? (See Learning Outcome 4.)
5. How is cybercrime distinguished from other crimes? (See Learning Outcome 5.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Without Jim's permission, Lee signs Jim's name to several checks that were issued to Jim and then cashes them. Jim reports that the checks were stolen and receives replacements. Has Lee committed forgery? Why or why not? (See Learning Outcome 3.)
2. Carl appears on television talk shows touting a cure for AIDS that he knows is fraudulent. He frequently mentions that he needs funds to make the cure widely available, and donations pour into local television stations to be forwarded to Carl. Has Carl committed a crime? If so, what? (See Learning Outcome 3.)

Real Law

7-1. Mail and Wire Fraud. Donovan Davis and several associates launched Capital Blu Management to trade in the foreign currency marketplace (often called Forex). Over the course of several days, Capital Blu engaged in a disastrous series of trades, losing almost \$3 million. Davis feared that if those losses were reported to investors, the investors would abandon the company, and his reputation in the financial community would suffer. So, Capital Blu sent out a monthly report via mail and e-mail falsely reporting a 1.6 percent gain that month. This monthly pattern of transmitting fraudulent records continued until regulators shut Capital Blu down a year later. Davis was responsible for approximately \$10 million in investor losses. Was he guilty of mail and wire fraud? [*United States v. Davis*, 789 FedAppx. 105 (11th Cir. 2019)] (See Learning Outcome 3.)

7-2. Criminal Procedures. Federal officers obtained a warrant to arrest Kateena Norman on charges of credit card fraud and identity theft. Evidence of the crime included videos, photos, and a fingerprint on a fraudulent check. A previous search of Norman's house had uncovered credit cards, new merchandise, and identifying information for other persons. An internet account registered to the address had been used to apply for fraudulent credit cards and a fraudulently obtained rental car was parked on

the property. As the officers arrested Norman outside her house, they saw another woman and a caged pit bull inside. They further believed that Norman's boyfriend, who had a criminal record and was also suspected of identity theft, could be there. In less than a minute, the officers searched only those areas within the house in which a person could hide. Would it be reasonable to admit evidence revealed in this "protective sweep" during Norman's trial on the arrest charges? Discuss. [*United States v. Norman*, 638 Fed.Appx. 934 (2016)] (See Learning Outcome 2.)

7-3. White-Collar Crime. Matthew Simpson and others created and operated a series of corporate entities to defraud telecommunications companies, creditors, and credit reporting agencies, among others. Through these entities, Simpson and the others used routing codes and spoofing services to make long-distance calls appear to be local. They stole other firms' network capacity and diverted payments to themselves. They leased goods and services without paying for them. To hide their real identities, they assumed false identities, addresses, and credit histories, and issued false bills, invoices, financial statements, and credit references. Did these acts constitute mail and wire fraud? Discuss. [*United States v. Simpson*, 741 F.3d 539 (5th Cir. 2014)] (See Learning Outcome 3.)

Ethical Questions

7-4. Informing Suspects of Their Rights. Should there be any exceptions to the rule that suspects be informed of their rights? Discuss. (See Learning Outcome 2.)

7-5. Identity Theft. Heesham Broussard obtained counterfeit money instruments. To distribute them, he used account information and numbers on compromised FedEx accounts procured from hackers. Text messages from Broussard indicated that he had participated previously in a similar scam and that he knew the packages would be delivered

only if the FedEx accounts were “good.” For his use of the accounts, Broussard was charged with identity theft. In defense, he argued that the government could not prove he knew the misappropriated accounts belonged to real persons or businesses. Does the evidence support this assertion? From an ethical perspective, does it matter whether Broussard knew that the accounts belonged to real customers? Why or why not? [*United States v. Heesham Broussard*, 2017 WL 150495 (5th Cir. 2017)] (See Learning Outcome 5.)

Chapter 7—Work Set

True-False Questions

- _____ 1. A crime is a wrong against society proclaimed in a statute.
- _____ 2. A person can be convicted simply for intending to commit a crime.
- _____ 3. If a crime is punishable by death, it must be a felony.
- _____ 4. Ordinarily, “ignorance of the law” is a valid defense to criminal liability.
- _____ 5. A person who has been granted immunity from prosecution cannot be compelled to answer any questions.
- _____ 6. Malware is software designed to protect consumers from identity theft.
- _____ 7. Immunity is a defense to criminal liability.
- _____ 8. Fraudulently altering a public document can be forgery.
- _____ 9. RICO has become an effective law in fighting certain white-collar crime, such as securities fraud.
- _____ 10. Persons suffering from mental illness are sometimes judged incapable of the state of mind required to commit a crime.

Multiple-Choice Questions

- _____ 1. Which of the following statements is true?
 - a. Criminal defendants are prosecuted by the state.
 - b. Criminal defendants must prove their innocence.
 - c. Criminal law actions are intended to give the victims financial compensation.
 - d. A crime is never a violation of a statute.
- _____ 2. Crime requires
 - a. the performance of a prohibited act.
 - b. the intent to commit a crime.
 - c. both a and b.
 - d. none of the above.
- _____ 3. Helen, an undercover police officer, pressures Pete to buy stolen goods. When he does so, he is arrested and charged with dealing in stolen goods. Pete will likely be
 - a. acquitted because he was entrapped.
 - b. acquitted because Helen was entrapped.
 - c. acquitted because both parties were entrapped.
 - d. convicted.
- _____ 4. Police officer Malik arrests John on suspicion of embezzlement. Malik advises John of his rights. He informs John
 - a. that John has the right to remain silent.
 - b. that John has the right to consult with an attorney.
 - c. of both a and b.
 - d. of none of the above.

- _____ 5. In a jewelry store, April takes a diamond ring from the counter and puts it in her pocket. She walks three steps toward the door before the manager stops her. April is arrested and charged with larceny. She will likely be
- a. acquitted because she was entrapped.
 - b. acquitted because she took only three steps.
 - c. acquitted because she did not leave the store.
 - d. convicted.
- _____ 6. Kevin takes home the company-owned laptop computer that he uses in his office. He has no intention of returning it. Kevin has committed
- a. larceny.
 - b. embezzlement.
 - c. robbery.
 - d. none of the above.
- _____ 7. Police detective Howard suspects Alexandra of a crime. Howard may be issued a warrant to search Alexandra's premises if he can show
- a. probable cause.
 - b. proximate cause.
 - c. causation in fact.
 - d. intent to search the premises.
- _____ 8. Arturo signs Beth's name, without her consent, to the back of a check payable to Beth. This is
- a. burglary.
 - b. embezzlement.
 - c. forgery.
 - d. larceny.
- _____ 9. Police officer Katy obtains a confession from criminal suspect Bart after an illegal arrest. At Bart's trial, the confession will likely be
- a. admitted as proof of Bart's guilt.
 - b. admitted as evidence of Bart's crime.
 - c. admitted as support for Katy's suspicions.
 - d. excluded.

Answering More Legal Problems

1. Sylvia requires her students, including Ralph, to submit their written assignments to CopyCat Detection Agency. CopyCat compares the work to the universe of material online to expose plagiarism. Ralph obtains another person's password, login ID, and credit card number via the internet to submit papers to CopyCat, misrepresenting himself as a student at a different school.

What is a cybercrime? Has Ralph committed such a crime? If so, which one? Criminal activity occurring _____ is referred to as cybercrime. One of the cybercrimes that Ralph has committed is _____. This occurs when a wrongdoer steals a form of identification, such as a name, and uses it to access the victim's financial resources. Here, Ralph obtained another's password, login ID, and credit card number via the internet. By using the credit card number

without the other's _____, Ralph accessed that person's financial resources.

2. CopyCat quickly discovers what Ralph has done. The company files a suit against him, alleging that he has gained unauthorized access to its online services in violation of a certain federal statute.

Which statute mentioned in this chapter has Ralph most likely violated? The Counterfeit Access Device and Computer _____ and Abuse Act is one of the statutes that Ralph has violated. Under this act, a person who accesses a computer online without authorization to obtain classified, restricted, or protected data commits _____. Here, Ralph used another's identity to access _____ data on CopyCat's website. If the company's loss, in terms of the cost to verify its security and other expenses, exceeds \$5,000, this act is a _____.



Unit 2 | Contracts

Unit Contents

Chapter 8

Introduction to Contracts

Chapter 9

Offer and Acceptance

Chapter 10

Consideration

Chapter 11

Capacity

Chapter 12

The Legality of Agreements

Chapter 13

Voluntary Consent

Chapter 14

Contracts That Must Be in Writing

Chapter 15

Third Party Rights

Chapter 16

Termination and Remedies

8

Introduction to Contracts

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 List the four requirements of a contract.
- 2 Contrast express and implied contracts.
- 3 Distinguish valid, voidable, unenforceable, and void contracts.
- 4 Understand the plain meaning rule.

promise

A declaration that binds the person who makes it to do or not to do a certain act.

promisor

A person who makes a promise.

promisee

A person to whom a promise is made.

contract

An agreement that can be enforced in court.

Conflict Presented

Chandra, who is twenty-five years old, attends a classical music concert at the Bijoux Theater. Before she purchases a ticket, a theater staff member reminds her that recording any part of the concert is prohibited. This restriction is printed on the ticket as well. Chandra agrees. During the concert, theater security personnel clearly see Chandra recording the performance on her smartphone. Chandra is asked to leave the premises because she has breached her contract with the theater by using her phone to record the concert.

Q Did Chandra and Bijoux enter into a binding contract?

Contract law deals with, among other things, the formation and keeping of promises. A **promise** is a declaration that something either will or will not happen now or in the future. The party making the promise is the **promisor**, and the party to whom the promise is made is the **promisee**.

Contract law does not govern all promises. Sometimes, promises create moral rather than legal obligations. Failure to perform a moral obligation, such as an agreement to take a friend to lunch, usually does not create legal liability.

Some promises create both moral and legal obligations. **Example 8.1** Jaxon and Pam are getting a divorce. Jaxon's promise to pay a set amount of child support to Pam every month creates both a moral and a legal duty. ■

In addition, many promises are kept because of a sense of duty or because keeping them is in the mutual self-interest of the parties involved, not because the parties are conscious of the rules of contract law.

Nevertheless, business agreements depend to a great extent on the rules of contract law. These rules assure the parties that the promises they make will be enforceable and help them to avoid potential problems.

8-1 The Definition of a Contract

A **contract** is an agreement that can be enforced in court. It is formed by two or more parties who agree to perform or refrain from performing some act now or in the future. If the contractual promise is not fulfilled, the party who made it is subject to the sanctions of a court. That party may be required to pay monetary damages for failing to perform. In a few instances, the party may be required to perform the promised act.

8–1a The Objective Theory of Contracts

The element of intent is of prime importance in determining whether a contract has been formed. In contract law, intent is determined by what is called the **objective theory of contracts**, not by a party's personal or subjective intent or belief. That is, a party's intention to enter into a contract is judged by outward, objective facts as interpreted by a reasonable person, rather than by the party's own secret, subjective intentions.

What the party said when entering into the contract, for instance, is an objective fact. So is how the party acted or appeared. What circumstances surrounded the transaction is also an objective fact.

objective theory of contracts

The view that the intent to contract should be determined by outward, objective facts.

Real Case



The Leaf Clean Energy Company invested \$30 million with Invenergy Wind, a wind energy developer. The contract prohibited Invenergy from conducting a "Material Partial Sale" without Leaf's consent. If such a sale occurred, Invenergy was required to pay Leaf a penalty. After Invenergy Wind concluded a \$1.8 billion "Material Partial Sale" without Leaf's consent, Leaf sued to obtain its penalty under the contract, about \$126 million.

Did Leaf Clean Energy have the right to a payment by Invenergy Wind of \$126 million? Yes. In *Leaf Invenergy Co. v. Invenergy Renewables LLC*, reversing a lower court decision, the Supreme Court of Delaware applied the objective theory of contracts to the agreement. Indeed, the appellate court scolded the lower court for ignoring the "clear and unambiguous" terms of the contract, which were designed to prevent Invenergy from making any major financial decision without Leaf's consent.

—210 A.3d 688

8–1b The Basic Requirements of a Contract

There are four basic requirements that must be met before a valid contract exists: (1) agreement, (2) consideration, (3) capacity, and (4) legality. If any of these elements is lacking, normally no contract will have been formed.

Learning Outcome 1

List the four requirements of a contract.

Agreement An agreement includes an offer and an acceptance. One party must offer to enter into a legal agreement, and another party must accept the terms of the offer.

Consideration Any promises made by the parties must be supported by legally sufficient and bargained-for consideration. Consideration is something of value received or promised to convince a person to make a deal.

Capacity Both parties entering into the contract must have the legal capacity to do so. The law must recognize them as possessing characteristics that qualify them as competent parties. Such characteristics include being of legal age to enter into contracts (over age twenty-one, in most states) and mentally capable.

Legality The contract's purpose must be to accomplish some goal that is legal and not against public policy. For instance, you cannot make a contract to rob a bank, which is a crime. Similarly, if a financial adviser contracts with a company to help facilitate hiding part of its sales income, then the contract's purpose is not legal.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Chandra goes to the Bijoux Theater to attend a concert. Before buying a ticket, she is asked by a theater staff member not to record any part of the concert. This restriction is also printed on the ticket. She agrees. During the concert, however, she is seen recording part of the concert on her smartphone. She is asked to leave for breaching her contract with the theater.

A Did Chandra and Bijoux have a binding contract? Yes. The theater's terms for the ticket sale include Chandra's agreement not to record any part of the concert. The term appears in writing on the ticket. The consideration is Bijoux's granting of a ticket to the concert in exchange for the promise not to record any part of the performance. As an adult, Chandra presumably has capacity. The agreement's subject matter is legal. Chandra's consent is voluntary. The agreement is valid. Bijoux can ask Chandra to leave the concert.

8-1c Defenses to Enforceability

Even if all of these four requirements are satisfied, a contract may be unenforceable if the following additional requirements are not met. These requirements typically are raised as defenses to the enforceability of an otherwise valid contract.

1. Voluntary consent. The apparent consent of both parties must be voluntary. For instance, if a contract was formed as a result of fraud, undue influence, mistake, or duress, the contract may not be enforceable.
2. Form. The contract must be in whatever form the law requires. Some contracts must be in writing to be enforceable.

8-2 Types of Contracts

There are many types of contracts, and they are categorized according to differences in formation, enforceability, or performance. The best method of explaining each is to compare one type of contract with another.

8-2a Bilateral Versus Unilateral Contracts

Every contract involves at least two parties. The **offeror** is the party making the offer. The **offeree** is the party to whom the offer is made. The offeror always promises to do or not to do something and thus is also a promisor. Whether the contract is classified as unilateral or bilateral depends on what the offeree must do to accept the offer and to bind the offeror to a contract.

Bilateral Contracts If, to accept the offer, the offeree must only promise to perform, the contract is a **bilateral contract**. Hence, a bilateral contract is a "promise for a promise." The contract comes into existence at the moment the promises are exchanged.

Example 8.2 Brian offers to buy Tara's Android-based smartphone for \$250. Brian tells Tara that he will give her the \$250 next Friday, after he gets paid. Tara accepts his offer and promises to give him the smartphone when he pays her on Friday. They have formed a bilateral contract. ■

offeror

A person who makes an offer.

offeree

A person to whom an offer is made.

bilateral contract

A contract that includes the exchange of a promise for a promise.

Unilateral Contracts If the offer is phrased so that the offeree can accept only by completing the contract performance, the contract is a **unilateral contract**. Hence, a unilateral contract is a “promise for an act.” In other words, the contract is not formed at the moment when promises are exchanged but rather when the contract is performed.

Contests, lotteries, and other competitions for prizes are examples of offers for unilateral contracts. **Example 8.3** Trey buys an Oregon lottery ticket. His ticket has the winning numbers for the jackpot prize. He submits his winning ticket to the state lottery agency before the deadline. By following the rules of the contest, Trey has a unilateral contract. The state must pay him his prize. ■

What if the promisor attempts to revoke (cancel) the offer after the promisee has begun performance but before the act has been completed? The offer becomes irrevocable (irreversible) once performance has begun. Thus, even though the offer has not yet been accepted, the offeror is prohibited from revoking it for a reasonable time.

unilateral contract

A contract exchanging a promise for an act.

Highlighting the Point



Margo offers to buy Harry's sailboat, moored in San Francisco, on delivery of the boat to Margo's dock in Newport Beach, three hundred miles south of San Francisco. Harry rigs the boat and sets sail. Shortly before his arrival at Newport Beach, Harry receives a radio message from Margo withdrawing her offer.

Does Margo's message terminate the offer, or is the offer irrevocable because Harry has begun performing? Margo's offer is part of a unilateral contract, and only Harry's delivery of the sailboat at her dock is an acceptance. The offer is irrevocable, though, because Harry has undertaken performance (and has, in fact, sailed almost three hundred miles). Thus, Harry can deliver the boat and bind Margo to the contract.

8–2b Express Versus Implied Contracts

An **express contract** is one in which the terms of the agreement are fully and explicitly stated in words, oral or written. For instance, a signed lease for an apartment or a house is an express written contract.

Example 8.4 Katie and her friend Issa are talking to each other using FaceTime. During the online conversation, Katie agrees to buy Issa's used Macbook Pro computer for \$350 on the first day of the following month. They have an express oral contract. ■

A contract that is implied from the conduct of the parties is called an **implied contract**. This contract differs from an express contract in that the conduct of the parties, rather than their words, creates and defines the terms of the contract.

The following three steps normally establish an implied contract:

1. A party furnishes some goods or services.
2. That party expects to be paid for those goods or services. The party to whom the goods or services were provided knows, or should know, that payment is expected (based on the objective theory of contracts test).
3. The party who receives the goods or services that were provided has a chance to reject them but does not.

Example 8.5 Ted visits Halina, an accountant, about doing his income tax returns. They discuss her fee and services. The next day, Ted brings in his tax information and leaves it with Halina's assistant. Ted and Halina have entered into an implied

Learning Outcome 2

Contrast express and implied contracts.

express contract

A contract that is stated in words, oral or written.

implied contract

A contract formed from the conduct of the parties.

contract because of their conduct. Halina expects to be paid for completing the tax return, and by bringing in the records she needs to do the job, Ted has implied an intent to pay her. ■

8–2c Quasi Contracts

quasi contract

A fictional contract imposed by law to prevent unjust enrichment.

Quasi contracts are wholly different from actual contracts. Express contracts and implied contracts are actual, or true, contracts. Quasi contracts, as their name suggests, are not true contracts. They do not arise from any agreement, express or implied, between the parties themselves. Rather, quasi contracts are fictional contracts implied by courts and imposed on parties in the interests of fairness and justice. Usually, quasi contracts are imposed to avoid the unjust enrichment of one party at the expense of another.



Highlighting the Point

Freshwater Services operates a water-distribution system that serves a residential area, including Joe and Carol Green's home. The Greens do not have an express contract with Freshwater, but the couple pays the firm's monthly charge for water. When Freshwater increases the monthly price, however, the Greens refuse to pay more. Freshwater files a suit against the Greens to collect the additional charge.

Can a quasi contract be imposed for the value of Freshwater's services? Yes. A quasi contract can be imposed when a person knowingly receives a benefit from another party and it would be unjust for the person not to pay for its value. Here, the Greens enjoy the benefits of Freshwater's water services and would be unjustly enriched if they did not pay for those services.

There are situations in which the party obtaining the unjust enrichment is not liable. Basically, a quasi contract cannot be invoked by a party who has conferred a benefit on someone else unnecessarily or as a result of misconduct or negligence.

Example 8.6 Rhonda leaves her RAV4 at the Northgate Toyota dealership for its regular oil and lube service. When she returns to pick up the car, she learns that a Northgate employee mistakenly performed a coolant fluid exchange service in addition to the requested oil and lube service. Rhonda does not have to pay for the additional service that she did not request. ■

8–2d Formal Versus Informal Contracts

formal contract

A contract requiring a specific form to be valid.

informal contract

A contract not requiring a specific form to be valid.

Formal contracts require a special form or method of creation (formation) to be enforceable. They include negotiable instruments and letters of credit. Negotiable instruments include checks, notes, drafts, and certificates of deposits. Letters of credit are often used in international sales contracts.

Informal contracts include all contracts other than formal contracts. No special form is required (except for certain types of contracts that must be in writing) because the contracts are usually based on their substance rather than on their form.

Example 8.7 Southwest Grocers Association signs an agreement to lease a warehouse from Commercial Properties for a certain term. In turn, United Trucking Company signs a contract to transport goods to and from the warehouse for Southwest for the same period of time. These are informal contracts. ■

8–2e Executed Versus Executory Contracts

Contracts are also classified according to their state of performance. A contract that has been fully performed on both sides is called an **executed contract**. A contract that has not been fully performed on either side is called an **executory contract**. If one party has fully performed but the other has not, the contract is said to be executed on the one side and executory on the other, but the contract is still classified as executory.

Example 8.8 Standard Retail Lumber, Inc., agrees to buy two truckloads of 2x4s from Forest Milling Company. Forest delivers the 2x4s to Standard. Standard is currently selling the 2x4s to its retail and wholesale customers. At this point, the contract is an executory contract because it is executed on the part of Forest but executory on the part of Standard Retail. After Standard Retail pays Forest for the 2x4s, the contract will be executed on both sides. ■

executed contract

A contract that has been fully performed by both parties.

executory contract

A contract that has not yet been fully performed.

8–2f Valid, Voidable, Unenforceable, and Void Contracts

A **valid contract** has the necessary elements to entitle at least one of the parties to enforce it in court. Those elements consist of an offer and an acceptance that are supported by legally sufficient consideration and are made for a legal purpose by parties who have the legal capacity to enter into the contract. As you can see in Exhibit 8.1, valid contracts may be enforceable, voidable, or unenforceable.

Voidable Contracts A **voidable contract** is a valid contract that can nevertheless be avoided by one or both of the parties. The party that legally has the option can elect to avoid any duty to perform or can elect to ratify (confirm) the contract. If the contract is avoided, both parties are released from it. If it is ratified, both parties must fully perform their respective legal obligations.

As a general rule, but subject to exceptions, contracts made by minors are voidable at the option of the minor. Contracts entered into under fraudulent conditions are voidable at the option of the innocent party. In addition, contracts entered into because of mutual mistakes and those entered into under legally defined duress or undue influence are voidable.

Unenforceable Contracts An **unenforceable contract** is one that cannot be enforced because of certain legal defenses against it. It is not unenforceable because a party failed to satisfy a legal requirement of the contract. Rather, it is a valid contract

Learning Outcome 3

Distinguish valid, voidable, unenforceable, and void contracts.

valid contract

A contract having legal strength or force.

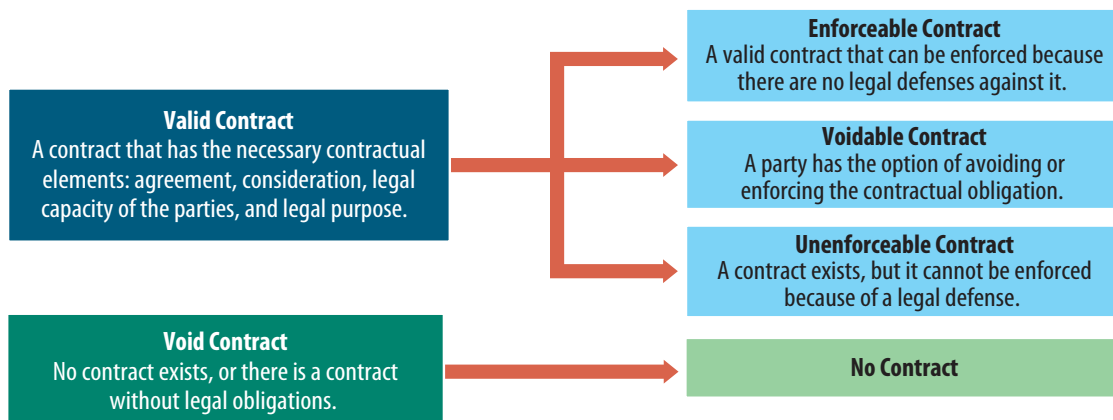
voidable contract

A contract that can be legally avoided.

unenforceable contract

A valid contract that cannot be enforced by a court.

Exhibit 8.1 Enforceable, Voidable, Unenforceable, and Void Contracts



rendered unenforceable by law. For instance, certain contracts must be in writing. If they are not, they will not be enforceable except under certain exceptional circumstances.

void contract

A contract having no legal force.

Void Contracts In contrast to a valid contract, a **void contract** is no contract at all. The terms void and contract are contradictory. A void contract produces no legal obligations on the part of any of the parties.

Example 8.9 Parveen contracts with Brad to shoplift a designer leather jacket for him from a department store. There is no contract because shoplifting is against the law. ■

8–2g E-Contracts

e-contract

A contract entered into online.

E-contracts are contracts entered into online. They require the same four basic requirements—agreement, consideration, capacity, and legality—as valid paper contracts.

Example 8.10 Jordan, a graduate student, agrees to rent an apartment from Penny Rentals for \$650 a month. The rental agreement is sent to Jordan via e-mail. Jordan electronically signs the contract, agreeing to its terms, and e-mails it back to Penny. This is a valid e-contract. ■

8–3 Interpretation of Contracts

When a contract dispute arises, a court is sometimes asked to interpret contract terms. Whether the court will do so depends on whether the terms are clear or ambiguous (unclear).

8–3a The Plain Meaning Rule

If what is written in a contract is clear, a court will enforce the contract according to its obvious terms. This is sometimes referred to as the plain meaning rule.

Under this rule, if the words in a contract appear clear, a court cannot consider any evidence not contained in the document itself. The words—and their plain, ordinary meanings—determine the intent of the parties at the time that they entered into the contract. Thus, a court must interpret the contract according to this intent.

8–3b Ambiguity and Outside Evidence

If a contract is ambiguous, the court may have to consider outside evidence to determine the parties' intent. A contract may be ambiguous under the following circumstances:

1. The intent of the parties cannot be determined from the contract's language.
2. The contract lacks a provision on a disputed issue.
3. A contract term can be interpreted in more than one way.
4. There is uncertainty about a particular provision.

Outside evidence may include oral testimony, additional agreements or communications between the parties, and other relevant information. If this evidence fails to make the ambiguous term or provision clear, the court may interpret the ambiguity against the party who was responsible for creating it.

Learning Outcome 4

Understand the plain meaning rule.

Chapter Summary—Introduction to Contracts

Learning Outcome 1: List the four requirements of a contract.

The requirements of a contract are (1) agreement, (2) consideration, (3) capacity, and (4) legality.

Learning Outcome 2: Contrast express and implied contracts.

The terms of an express contract are fully and explicitly stated in words, oral or written. The terms of an implied contract are based on the conduct of the parties. An implied contract differs from an express contract in that the conduct of the parties, rather than their words, creates and defines the terms.

Learning Outcome 3: Distinguish valid, voidable, unenforceable, and void contracts.

A valid contract has all four basic requirements, which entitles at least one of the parties to enforce it in court. A voidable contract is a valid contract that can be avoided by one or both of the parties. An unenforceable contract is a valid contract rendered unenforceable by law because of certain legal defenses against it. A void contract is no contract at all.

Learning Outcome 4: Understand the plain meaning rule.

The plain meaning rule tells a court that it cannot consider any outside evidence, if the words in a contract appear clear and ambiguous.

Straight to the Point

1. Define contract. (See Learning Outcome 1.)
2. Identify the element that is of prime importance in determining whether a contract has been formed. (See Learning Outcome 1.)
3. What determines whether a contract is classified as unilateral or bilateral? (See Learning Outcome 2.)
4. Which steps normally establish an implied contract? (See Learning Outcome 2.)
5. What do formal contracts require to be enforceable? (See Learning Outcome 2.)
6. When is a contract so ambiguous that a court may have to interpret its terms? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Molly tells Nick that she will pay him \$10,000 to set fire to her store, so that she can collect the money from her fire insurance policy. Nick sets fire to the store, but Molly refuses to pay him. Can Nick recover the \$10,000 from Molly? Why or why not? (See Learning Outcome 2.)
2. Alison receives a notice of property taxes due from the local tax collector. The notice is for tax on Jerry's property, but Alison believes that the tax is hers and pays it. Can Alison recover from Jerry the amount that she paid? Why or why not? (See Learning Outcome 2.)

Real Law

8-1. Quasi Contracts. Chad Parker owned an acre of property and a mobile home on that property. He sold the mobile home to David and Allison Wilson for \$1,000 and sold the property to them for \$10,000. These agreements were made orally. No title or deed transfers took place. The Wilsons lived in the mobile home for seven years, making \$11,228.19 of improvements to the structure and to the property. After a falling out between Chad and David, Chad had the Wilsons evicted and moved back into the mobile home. Because there was no written contract between the parties, could Chad therefore legally evict the Wilsons and legally move back into the mobile home? [*Wilson v. Parker*, 227 A.3d 343 (2020)] (See Learning Outcome 2.)

8-2. Interpretation of Contracts. Lehman Brothers, Inc. (LBI), wrote a letter to Mary Ortégón offering her employment. The offer included a salary of \$150,000 per year and an annual “minimum bonus” of \$350,000. The bonus was not a “signing” bonus—it was clearly tied to her performance on the job. Ortégón accepted the offer. Before she started work, however, LBI canceled the contract. Later, Ortégón filed a claim with a court to recover the amount of

the \$350,000 bonus on the ground that LBI had breached its contract with her by not paying it. Can outside evidence be admitted to interpret the meaning of the bonus term? Explain. [*Ortegón v. Giddens*, 638 Fed.Appx. 47 (2d Cir. 2016)] (See Learning Outcome 4.)

8-3. Implied Contracts. Ralph Ramsey insured his car with Allstate Insurance Co. He also owned a house on which he maintained a homeowner’s insurance policy with Allstate. Bank of America had a mortgage on the house and paid the insurance premiums on the homeowner’s policy from Ralph’s account. After Ralph died, Allstate cancelled the car insurance. Ralph’s son, Douglas, inherited the house. The bank continued to pay the premiums on the homeowner’s policy, but from Douglas’s account, and Allstate continued to renew the insurance. When a fire destroyed the house, however, Allstate denied coverage, claiming that the policy was still in Ralph’s name. Douglas filed a suit in a federal district court against the insurer. Was Allstate liable under the homeowner’s policy? Explain. [*Ramsey v. Allstate Insurance Co.*, 2013 WL 467327 (6th Cir. 2013)] (See Learning Outcome 2.)

Ethical Questions

8-4. Quasi Contract. Should any enrichment always be considered unjust? Discuss. (See Learning Outcome 2.)

8-5. Contract Requirements. Mark Carpenter, a certified financial planner, contracted to recruit investors for GetMoni.com, which owned a defunct gold mine in Arizona. Carpenter then contracted with clients to invest their funds, sending more than \$2 million to GetMoni.com. Carpenter collected another \$1 million, but instead of sending it to GetMoni.com, he deposited the money into his

own account. A federal investigation unraveled the scheme. Carpenter was charged with two counts of fraud—one for his deal with GetMoni.com and one for his misrepresentations to clients after he stopped dealing with GetMoni.com. Which contract requirements were lacking in these agreements that prevent them from being enforced? Can Carpenter argue successfully that he acted ethically? Discuss. [*United States v. Mark J. Carpenter*, 2017 WL 129037 (6th Cir. 2017)] (See Learning Outcome 1.)

Chapter 8—Work Set

True-False Questions

- _____ 1. All contracts involve promises, and every promise is a legal contract.
- _____ 2. An agreement includes an offer and an acceptance.
- _____ 3. Consideration, in contract terms, refers to a party's competency to enter into a contract.
- _____ 4. A unilateral contract involves performance instead of promises.
- _____ 5. Formal contracts are contracts between parties who are in formal relationships—employer-employee relationships, for example.
- _____ 6. An unenforceable contract is a contract in which one or both of the parties have the option of avoiding their legal obligations.
- _____ 7. A court imposes a quasi contract to avoid one party's unjust enrichment at another's expense.
- _____ 8. An express contract is one in which the terms are fully stated in words.
- _____ 9. An oral contract is an implied contract.

Multiple-Choice Questions

- _____ 1. Don contracts with Jan to paint Jan's townhouse while she's on vacation. By mistake, Don paints Alberto's townhouse. Alberto sees Don painting but says nothing. From whom can Don recover?
 - a. Jan because she was the party with whom Don contracted.
 - b. Jan under the theory of quasi contract.
 - c. Alberto because his house was painted.
 - d. Alberto under the theory of quasi contract.
- _____ 2. Brian offers to sell Ashley his vintage vinyl records collection, forgetting that he does not want to sell some of the records. Unaware of Brian's forgetfulness, Ashley accepts. Is there a contract including all of Brian's records?
 - a. Yes, according to the objective theory of contracts.
 - b. Yes, according to the subjective theory of contracts.
 - c. No because Brian did not intend to sell his favorite records.
 - d. No because Ashley had no reason to know of Brian's forgetfulness.
- _____ 3. Denzel promises to imprint four thousand T-shirts with Rona's logo. Rona pays in advance. Before Denzel delivers the shirts, the contract is classified as
 - a. executory because it is executory on Denzel's part.
 - b. executory because it is executory on Rona's part.
 - c. executed because it is executed on Denzel's part.
 - d. none of the above.
- _____ 4. Without mentioning payment, Mary accepts the services of Razi, a contractor, and is pleased with the work. Is there a contract between them?
 - a. Yes, there is an express contract.
 - b. Yes, there is an implied contract.
 - c. No because they made no agreement concerning payment.
 - d. Yes, there is a quasi contract.

- _____ 5. The requirements of a contract include
- agreement only.
 - consideration only.
 - agreement and consideration only.
 - agreement, consideration, and other elements.
- _____ 6. Sam contracts with Hugo's Sports Equipment to buy a jet ski and to pay for it in installments. Sam is a minor, and so he can choose to avoid his contractual obligations. The contract between Sam and Hugo is
- valid.
 - void.
 - voidable.
 - both a and c.
- _____ 7. A contract consists of promises between two or more parties to
- refrain from performing some act.
 - perform some act in the future.
 - perform some act now.
 - any of the above.
- _____ 8. Donny tells Elise that he will pay her \$2,000 to hack into the database of Filipe, Donny's competitor, so that Donny can obtain the names and credit card numbers of Filipe's customers, as well as other trade secrets. This deal is
- an enforceable contract.
 - a voidable contract.
 - a void contract.
 - an executed contract.
- _____ 9. Talisa calls Rick on the phone and agrees to buy his antique rocking chair for \$200. This is
- an express contract.
 - an implied contract.
 - a quasi contract.
 - no contract.

Answering More Legal Problems

1. Rocky Mountain Races, Inc., sponsors the Pioneer Trail Ultramarathon, which has an advertised first prize of \$10,000. The rules require the competitors to run one hundred miles from the floor of Blackwater Canyon to the top of Pinnacle Mountain. The rules also provide that Rocky reserves the right to change the terms of the race at any time. Monica enters the race and is declared the winner. Rocky offers her a prize of \$1,000 instead of \$10,000.
2. For employment with the Firestorm Smokejumpers—a crew of elite wild-land firefighters who parachute into dangerous situations to fight fires—applicants must complete a series of tests. The crew chief sends the most qualified applicants a letter stating that they will be admitted to Firestorm's training sessions if they pass a medical exam. Scott receives one of the letters and passes the exam, but a new crew chief changes the selection process and rejects him.

Did Rocky and Monica have a contract? Yes. These parties had a contract. Contests, lotteries, and other competitions for prizes are offers for contracts. Here, the _____ is phrased so that each competitor can accept only by completing the run. At that point, a contract is formed—a _____ contract—binding its sponsor to perform as promised.

By changing the prize, did Rocky breach this contract? No. Rocky did not breach the contract when the prize was changed. Under the rules, Rocky could _____ the terms at any time.

Did the letter from Firestorm to Scott constitute a contract? Yes. Firestorm and Scott had a contract. The letter was a unilateral offer phrased so that the offeree could accept only by completing the required performance. The contract was formed when the _____ was complete. This was a _____ contract. Scott accepted the offer by passing the medical exam.

Did Firestorm breach this contract? Yes. Firestorm breached the contract when the new crew chief rejected Scott, who had already received the offer and _____ it. The appropriate remedy would be to allow Scott to attend Firestorm's training sessions.

9 Offer and Acceptance

Conflict Presented

Code Tech Corporation contracts to provide technical services and support for Standing Stone Brewery's retail website. Later, Code Tech files a lawsuit against Standing Stone, claiming nonpayment for some of its work. To resolve their dispute, the parties exchange e-mails that outline essential settlement terms.

Q Do the e-mails create a binding settlement agreement?

Essential to any contract is that the parties agree on the terms of the contract. **Agreement** exists when an offer made by one party is accepted, or assented to, by the other. Ordinarily, agreement is evidenced by an offer and an acceptance. One party offers a certain bargain to another party, who then accepts that bargain.

9-1 Requirements of the Offer

An **offer** is a promise or commitment to perform or refrain from performing some specified act in the future. The party making an offer is called the offeror, and the party to whom the offer is made is called the offeree. Three elements necessary for an offer to be effective are (1) intention, (2) definiteness of terms, and (3) communication.

9-1a Intention

The first requirement for an effective offer is a serious intention on the part of the offeror. Furthermore, the offeror's intention to become bound by the offer must be objectively clear to others.

Serious intent is not determined by the subjective (personal, unspoken) intentions, beliefs, or assumptions of the offeror. It is determined by what a reasonable person in the offeree's position would conclude that the offeror's words and actions meant. Offers made in obvious anger, jest, or undue excitement do not meet the serious-intent test.

Expressions of Opinion An expression of opinion is not an offer. An expressed opinion does not evidence an intention to enter into a binding agreement.

Example 9.1 Henry takes his daughter, Miranda, to Dr. Ryan and asks him to operate on her hand, which has been injured in an accident. Ryan says Miranda

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Identify the elements of an offer.
- 2 Recognize a counteroffer.
- 3 Identify the elements of a valid acceptance.
- 4 Describe a click-on agreement.

agreement

When two or more parties consent to a contract's terms.

Learning Outcome 1

Identify the elements of an offer.

offer

A promise to perform some specified act in the future.

will be in the hospital three or four days and that the hand will probably heal within a few days. Ryan's words do not constitute an offer to heal Miranda's hand in three or four days. Rather, he is expressing an opinion as to when the hand might heal. ■

Preliminary Negotiations A request or invitation to negotiate is not an offer. It is only an expression of a willingness to discuss the possibility of entering into a contract. For instance, statements such as “Will you sell your three-bedroom house?” and “I wouldn't sell my car for less than \$8,000” are not offers.

Similarly, when the government and private firms need to have construction work done, contractors are invited to submit bids. The invitation to submit bids is not an offer, and a contractor does not bind the government or private firm by submitting a bid. The bids that the contractors submit are offers, however, and the government or private firm can bind the contractor by accepting the bid.



Highlighting the Point

An ad on *ScienceNOW's* website asks for “news tips.” Erik submits a manuscript in which he claims to have solved a famous mathematical problem. *ScienceNOW* declines to publish the manuscript. Erik files a lawsuit, alleging breach of contract. He asserts that *ScienceNOW's* ad is an offer, which he has accepted.

Is the ad on *ScienceNOW's* website an offer? No. Most courts would dismiss this suit. Ads are not offers—they invite offers. Responses to ads are not acceptances—they are offers. Thus, Erik's submission of the manuscript for publication is the offer, which *ScienceNOW* did not accept.

Advertisements In general, advertisements, catalogues, and widely circulated e-mails and texts are considered invitations to negotiate. They are not considered evidence of an intention to enter into a contract.

Price lists are another form of invitation to negotiate or trade. A seller's price list is not an offer to sell at that price. It merely invites the buyer to offer to buy at that price. In fact, a seller usually puts “prices subject to change” on a price list. Only in rare circumstances will a price quotation be regarded as an offer.

Auctions In a live auction, a seller “offers” goods for sale through an auctioneer, but this is not an offer to form a contract. Rather, it is an invitation, asking bidders to submit offers. In the context of an auction, a bidder is the offeror, and the auctioneer is the offeree.

Online auctions are the most familiar type of auction today. Online auction sites, such as eBay, eBid.net, and Atomic Mall, provide a forum for buyers and sellers to sell almost anything. Like an advertisement, an “offer” to sell an item on one of these sites is generally treated as an invitation to negotiate.

9–1b Definiteness of Terms

The second requirement for an effective offer concerns the definiteness of its terms. An offer must have reasonably definite terms—such as the names of the parties, quantity of items, how work will be performed, and payment details. This definiteness enables a court to determine if a breach has occurred and give an appropriate remedy.

An offer may invite an acceptance to be worded in such specific terms that the contract is made definite. **Example 9.2** Soccer Warehouse e-mails Eastport

Athletic Store and offers to sell “from one to twenty-five Kwik Goal heavy-duty anchor bags for \$200 each. State the number desired in acceptance.” In an e-mail reply, Eastport’s general manager agrees to buy one dozen of the bags. Because the quantity is specified in the acceptance, the terms are definite. The contract is enforceable. ■

9–1c Communication

The third requirement for an effective offer is communication. The offer must be communicated to the offeree, so that they will know the offer has been made.

9–2 Termination of the Offer

The communication of an effective offer to an offeree gives the offeree the power to transform the offer into a binding legal obligation—a contract. This power of acceptance, however, does not continue forever. It can be terminated by action of the parties or by operation of law.

9–2a Termination by Action of the Parties

An offer can be terminated by the action of the parties by (1) revocation, (2) rejection, or (3) a counteroffer.

Revocation of the Offer The offeror’s act of withdrawing an offer is called **revocation**. Unless an offer is irrevocable, the offeror usually can revoke the offer (even if they promise to keep the offer open), as long as the revocation is communicated to the offeree before they accept. The offeror can revoke the offer by expressly repudiating it or by performing acts that are inconsistent with the existence of the offer and that are made known to the offeree. For instance, a statement such as “I withdraw my previous offer of October 17” is an express repudiation.

revocation

The withdrawal of an offer by an offeror.

Most states follow the general rule that a revocation becomes effective when the offeree or offeree’s agent actually receives it. Therefore, a revocation sent via FedEx on April 1 and delivered at the offeree’s residence or place of business on April 3 becomes effective on April 3. Similarly, an offer made to the public can be revoked in the same manner in which the offer was originally communicated.

Highlighting the Point



Rocky Mountain Adventures sells an exclusive line of mountain bikes at its downtown location. After the store is robbed in an overnight break-in, the owner, Jerry, offers a \$5,000 reward for information leading to the arrest and conviction of the burglars. He publicizes the offer for four days on the company’s Facebook page and on a flyer posted on the store’s main entrance.

Can Jerry revoke his offer of a reward before someone comes forward with information? Yes. Jerry can revoke his reward offer as long as he does so using the same methods for communicating the offer (Facebook and the store flyer) for the same number of days.

Rejection of the Offer The offer may be rejected by the offeree, which terminates the offer. The offeree can reject the offer by words or by conduct. As with revocation, rejection of an offer is effective only when it is actually received by the offeror or the offeror's agent.

Simply inquiring about an offer does not constitute rejection. **Example 9.3** Ketill offers to buy Jasmine's iPhone 12 for \$250, and Jasmine responds, "Is that your best offer?" or "Will you pay me \$300 for it?" Jasmine has not rejected the offer but has merely made an inquiry about it. She can still accept and bind Ketill to his offered \$250 purchase price. ■

Learning Outcome 2

Recognize a counteroffer.

counteroffer

An offeree's rejection of the original offer and simultaneous making of a new offer.

mirror image rule

A rule requiring that the terms of the offeree's acceptance exactly match the terms of the offeror's offer.

Counteroffer A **counteroffer** is a rejection of the original offer and the simultaneous making of a new offer, giving the original offeror (now the offeree) the power of acceptance. **Example 9.4** Burke, a beet farmer, offers to sell her product to Lang, the owner of Lang's Roadside Veggie stand, for \$1.70 a pound. Lang responds, "Your price is too high. I'll offer to pay \$1.30 a pound for your beets." Lang's response is a counteroffer because it rejects Burke's offer to sell her beets at \$1.70 a pound and creates a new offer by Lang to purchase the beets at \$1.30 a pound. ■

The **mirror image rule** requires that the offeree's acceptance match the offeror's offer exactly. In other words, the terms of acceptance must "mirror" those of the offer. If the acceptance materially (substantially) changes or adds to the terms of the original offer, it usually will be considered not an acceptance but a counteroffer.

9-2b Termination by Operation of Law

The offeree's power to transform an offer into a binding obligation can be terminated by operation of law in several ways. Lapse of time, destruction or death, or supervening illegality all act to terminate the offer by operation of law.

Lapse of Time An offer terminates automatically when the period of time specified in the offer has passed. For instance, an offer specifying that it will be held open for twenty days will lapse at the end of twenty days.

The time period normally begins to run when the offer is actually received by the offeree, not when it is sent or drawn up. When receipt of the offer is delayed, the period begins to run from the date the offeree would have received the offer, but only if the offeree knows or should know that the offer is delayed.

If no time for acceptance is specified in the offer, the offer terminates at the end of a reasonable period of time. A reasonable period of time is determined by the subject matter of the contract, business and market conditions, and other relevant circumstances. **Example 9.5** Winston's offer to sell his farm produce to West Valley Grange obviously terminates sooner than his offer to sell West Valley a piece of farm equipment. This is because Winston's produce is perishable and subject to greater fluctuations in market value. ■

Destruction or Death An offer is automatically terminated if the specific subject matter of the offer (such as a digital device reader or a house) is destroyed before the offer is accepted. An offeree's power of acceptance is also terminated when the offeror or offeree dies or becomes legally incapacitated, unless the offer is irrevocable.

Supervening Illegality A statute or court decision that makes an offer illegal automatically terminates the offer. **Example 9.6** Vladimir offers to lend Kim \$10,000 at an annual interest rate of 15 percent. Before Kim can accept Vladimir's offer, a state law is enacted that prohibits interest rates higher than 12 percent in personal loans. Vladimir's offer is automatically terminated. ■

9–3 Acceptance

Acceptance is a voluntary act by the offeree that shows assent, or agreement, to the offer. It may consist of words or conduct. An acceptance has three requirements:

1. An offer must be accepted by the offeree, not by a third party.
2. The acceptance must be unequivocal.
3. In most situations, the acceptance must be communicated to the offeror.

Learning Outcome 3

Identify the elements of a valid acceptance.

acceptance

The offeree's willing consent to the terms of an offer.

9–3a Offeree Acceptance Only

The identity of the offeree is as much a condition of a bargaining offer as any other term. Thus, except in special circumstances, only the person to whom the offer is made (or that person's agent) can accept the offer and create a binding contract. **Example 9.7** Lottie makes an offer to Paul. Paul is not interested, but Paul's friend José says, "I accept the offer." No contract is formed. ■

9–3b Unequivocal Acceptance

The offeree must accept without adding or changing any terms. This is the mirror image rule previously discussed. If the acceptance is subject to new conditions, or if the terms of the acceptance materially change the original offer, the acceptance may be deemed a counteroffer.

Ordinarily, silence cannot constitute acceptance. This general rule applies even if the offeror states, "By your silence and inaction, you will be deemed to have accepted this offer."

9–3c Communication of Acceptance

Whether the offeror must be notified of the acceptance depends on the nature of the contract. In a unilateral contract, the full performance of some act is called for. Acceptance is usually evident, and notification is therefore unnecessary (unless the law requires it or the offeror asks for it).

In a bilateral contract, in contrast, communication of acceptance is necessary, because acceptance is in the form of a promise. The bilateral contract is formed when the promise is made rather than when the act is performed. Additionally, acceptance must be timely. The general rule is that acceptance is timely if it is effective before the offer is terminated.

Highlighting the Point



Gaynelle, a commodities trader, works for the brokerage firm Superior Markets. Superior sent her an e-mail offering to continue her employment as in her existing contract. Gaynelle replied in an e-mail "I accept, please send contract." Superior's CEO responded with an e-mail stating "Gaynelle. Looking forward to another great run." Superior Markets never sent Gaynelle a written contract and eventually terminated her employment.

Could Superior Markets terminate Gaynelle's employment because no formal written contract had been sent to her? No. The e-mail exchange contained an offer, an acceptance, and a congratulatory exclamation with the forward-looking statement about a continued working relationship. As such, these communications formed the basis for a valid employment contract.

mailbox rule

A rule providing that an acceptance of an offer becomes effective on dispatch.

The Mailbox Rule Acceptance takes effect, which completes formation of the contract, at the time the communication is sent via the mode authorized by the offeror. This is called the **mailbox rule**.

Under this rule, if the authorized mode of communication is via the U.S. mail, then an acceptance becomes valid when the offeror sends it and not when the offeror receives it. (This is an exception to the rule that acceptance requires a completed communication in bilateral contracts.)

The mailbox rule does not apply to instantaneous forms of communication, such as face-to-face, phone, text, and e-mail communication. E-mail is considered sent when it either leaves the control of the sender or is received by the recipient. Either circumstance allows an e-mail acceptance to become effective when sent.

Authorized Means of Acceptance When an offeror specifies how acceptance should be made, such as by overnight delivery, the contract is not formed unless the offeree uses that mode of acceptance. **Example 9.8** Mikelson Wholesale offers to sell one hundred Samsung fifty-five-inch 8K smart TVs to Larson's Electronics. The offer states that Larson's must accept the offer via FedEx overnight delivery. The acceptance is effective (and a binding contract is formed) the moment Larson's gives the overnight envelope containing the acceptance to the FedEx driver. ■

If the offeror does not expressly specify a certain mode of acceptance, then acceptance can be made by any reasonable means. Prevailing business practices and other surrounding circumstances determine whether a mode of acceptance is reasonable. Usually, the offeror's choice of a particular means in making the offer implies that the offeree can use the same or a faster means for acceptance. For instance, if the offer is made via Priority U.S. Mail, it would be reasonable to accept the offer via Priority Mail or a faster method, such as UPS overnight delivery or e-mail.

Substitute Method of Acceptance What if the offeror authorizes a particular method of acceptance, but the offeree accepts by a different means? The acceptance may still be effective if the substituted method serves the same purpose as the authorized means. The use of a substitute method of acceptance is not effective on dispatch, though. No contract will be formed until the acceptance is received by the offeror.

Example 9.9 Michigan Metals offers to sell Hilton Hardware a truckload of steel roof panels. Its offer specifies FedEx overnight delivery for acceptance. Hilton accepts the offer using UPS overnight delivery. The acceptance is effective only when Michigan receives it. ■

9-4 E-Contracts—Offer and Acceptance

Today, e-contracts dominate business interactions. Most often, e-contracts are formed for the sale of goods and services online. Disputes regarding e-contracts tend to center on the terms and whether the parties agreed to them.

9-4a Online Offers

To avoid legal disputes, offerors should make sure that online offers are obvious and easy to read. On a website, this requirement can be accomplished with a link to a separate page that contains the contract's full details. Usually, these details cover specific provisions regarding the acceptance of the terms, payment, disclaimers, the seller's return policy, remedy limitations, and dispute resolution.

9-4b Online Acceptances

As with traditional paper contracts, acceptance of e-contracts must show that the offeree voluntarily assented to the offer's terms. When ordering online, offerees often indicate their assent through the use of click-on agreements.

Learning Outcome 4

Describe a click-on agreement.

A **click-on agreement** may consist of a box that includes the words “I agree.” If the offeree clicks on the box to indicate acceptance, a binding contract is created.

Courts normally have enforced the terms of click-on agreements in the same way as the terms of other contracts. Under the common law of contracts, a binding contract can be created by conduct—including clicking on an online box—that indicates consent to the terms of the agreement.

Click-on agreements frequently include forum-selection clauses. These clauses normally state that disputes involving a contract have to be litigated in a specific geographic location. For instance, when you agree to the terms of use for Facebook, you are agreeing to a forum-selection clause stating that all disputes will be resolved in a court in Santa Clara County, California.

click-on agreement

An agreement entered into online when a buyer indicates acceptance of an offer by clicking on a button that reads “I agree.”

Real Case



Rebecca Bextel developed a business plan to sell online greeting cards for the benefit of charitable organizations. She hired Tekstir, Inc., to develop the website for her venture, called Ecocards. Several months later Bextel filed suit against Tekstir in a Wyoming state court, claiming that the company had failed to meet its contractual obligations. Tekstir argued that the contract with Bextel included a forum-selection clause requiring any disputes to be litigated in Orange County, California.

Was the forum-selection clause valid? Yes. In *Ecocards v. Tekstir, Inc.*, the Supreme Court of Wyoming determined that the forum-selection clause was reasonable and enforceable. Thus, all claims and disputes arising under the forum-selection clause effectively bound Ecocards and Tekstir.

—459 P.3d 1111 (2020)

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Code Tech Corporation agrees to provide technical services and support for Standing Stone Brewery’s website. Claiming nonpayment, Code Tech later files a lawsuit against Standing Stone. In an effort to resolve their dispute, the parties exchange e-mails outlining essential terms to a settlement contract.

A Do the e-mails create a binding settlement agreement? Yes. The parties’ e-mail exchanges contain the essential terms of the settlement offer and demonstrate voluntary acceptance by both parties. The messages constitute a complete and unambiguous statement of the parties’ intent to be bound by the terms. All that remains is for the contract terms to be performed.

9–4c The Uniform Electronic Transactions Act

The Uniform Electronic Transactions Act (UETA), which has been adopted in most states, applies to many e-contracts. The UETA does not create new rules for e-contracts. Rather, it supports the application of existing contract rules to electronic transactions.

Before the UETA applies, each party to a transaction must agree to conduct it by electronic means. The agreement may be implied by the conduct of the parties and the circumstances. **Example 9.10** Jonas gives out his business card with an e-mail address on it. Jonas has normally consented to do business electronically. ■

Chapter Summary—Offer and Acceptance

Learning Outcome 1: Identify the elements of an offer.

The elements of an effective offer are (1) the offeror's serious intent to be bound by the offer, (2) terms that are reasonably definite, and (3) communication of the offer to the offeree.

Learning Outcome 2: Recognize a counteroffer.

A counteroffer is a response to an offer in which an offeree rejects the original offer and at the same time makes a new offer.

Learning Outcome 3: Identify the elements of a valid acceptance.

The elements of a valid acceptance are (1) acceptance by the offeree, (2) unequivocal acceptance with no changes in terms, and (3) communication of the acceptance to the offeror.

Learning Outcome 4: Describe a click-on agreement.

A click-on agreement arises when buyers, completing their transactions online, are required to indicate their consent to the terms by clicking on a button or box that says, "I agree."

Straight to the Point

1. How can an offeror or offeree terminate an offer? (See Learning Outcome 1.)
2. In what ways might the law terminate an offer? (See Learning Outcome 2.)
3. What is the mailbox rule? (See Learning Outcome 3.)
4. What is the mirror image rule? (See Learning Outcome 2.)
5. What must occur for the Uniform Electronic Transactions Act (UETA) to apply to a transaction? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Fidelity Corporation offers to hire Ron to replace Gabrielle, who has given Fidelity a month's notice of intent to quit. Fidelity gives Ron a week to decide whether to accept. Two days later, Gabrielle signs an employment contract with Fidelity for another year. The next day, Gabrielle tells Ron of the new contract. Ron immediately sends a formal letter of acceptance to Fidelity. Do Fidelity and Ron have a contract? Why or why not? (See Learning Outcome 1.)
2. While visiting the website of Cyber Investments, Dani encounters a pop-up box that reads, "Our e-mail daily newsletter *E-Profit* is available by subscription at the rate of one dollar per issue. To subscribe, enter your e-mail address below and click on 'SUBSCRIBE.'" Dani enters her e-mail address and clicks on "SUBSCRIBE." Has Dani entered into an enforceable contract? Explain. (See Learning Outcome 4.)

Real Law

9-1. Communication of Acceptance. Mohamad Kutite sought to lease a gas station operated by Majors Management. The closing date for the lease agreement was October 1st. On September 27th, Majors sent Kutite five documents to sign and have notarized before the closing date. Kutite did so and returned the documents on September 28th. Kutite refused, however, to sign a separate document acknowledging that he would continue using the ATM machine that was already at the gas station. On October 2nd, Majors informed Kutite that if he did not sign the ATM agreement, then the deal was off. Kutite sued for breach of contract, claiming that the agreement had been formalized on September 28th. Could Kutite unilaterally establish a valid contract simply by returning the five signed and notarized forms? [*Kutite, LLC v. Excell Petroleum, LLC*, 780 F.Appx. 254 (6th Cir. 2019)] (See Learning Outcome 3.)

9-2. Acceptance. Lucas Contracting, Inc., is a small contractor in Carrollton, Ohio. Altisource Portfolio Solutions, Inc., hired Lucas to work on certain foreclosed properties. When payment for the work was not forthcoming, Lucas filed a suit in an Ohio state court against Altisource. Before the trial, Lucas e-mailed the terms of a settlement. The same

day, Altisource e-mailed a response that did not challenge or contradict Lucas's proposal and indicated agreement to it. Two days later, however, Altisource forwarded a settlement document that contained additional terms. Which e-mail proposal most likely satisfies the element of agreement to establish a contract? Explain. [*Lucas Contracting, Inc. v. Altisource Portfolio Solutions, Inc.*, 2016 WL 529408 (2016)] (See Learning Outcome 3.)

9-3. Offer. While riding her motorcycle, Amy Kemper was seriously injured when Christopher Brown hit her with his vehicle. Kemper wrote to Statewide Claims Services, the administrator for Brown's insurer, asking for "all the insurance money that Mr. Brown had under his insurance policy." In exchange, Kemper agreed to sign a limited release that could not contain "any language saying that [she would] have to pay Mr. Brown or his insurance company any of their incurred costs." Statewide sent a check and a demand that Kemper "place money in an escrow account in regards to any and all liens pending." Kemper refused the demand. Did Statewide and Kemper have an enforceable agreement? Discuss. [*Kemper v. Brown*, 325 Ga.App. 806, 754 S.E.2d 141 (2014)] (See Learning Outcome 1.)

Ethical Questions

9-4. Intent. Should promises of prizes in ads and circulars always be enforced? Discuss. (See Learning Outcome 1.)

9-5. Intention. The Prince Hall Grand Lodge is a fraternal association incorporated in the state of Washington. The Grand Lodge Constitution provides that the Grand Master "shall decide all questions of . . . Masonic law." Grand Master Gregory Wraggs suspended the membership of Lonnie Traylor for "unMasonic conduct." Traylor asked Wraggs to revoke the suspension and prepared a "Memo

of Understanding." Wraggs agreed to talk but declined to revoke the suspension and did not sign the memo. Traylor filed a suit in a Washington state court against the Grand Lodge and Wraggs, alleging that the Grand Master's failure to revoke Traylor's suspension was a breach of contract. On what basis would the court likely hold that there was no contract? Is it unethical of Traylor to assert otherwise? Discuss. [*Traylor v. Most Worshipful Prince Hall Grand Lodge*, 197 Wash.App. 1026 (Div. 2 2017)] (See Learning Outcome 1.)

Chapter 9—Work Set

True-False Questions

- _____ 1. To be effective, an offer must be made with serious intent.
- _____ 2. A contract providing that Joe is to pay Bill “a fair share of the profits” will be enforced.
- _____ 3. A simple rejection of an offer will terminate it.
- _____ 4. Offers that must be kept open for a period of time include advertisements.
- _____ 5. The mirror image rule is an old rule that no longer applies.
- _____ 6. If an offeree is silent, the offeree can never be considered to have accepted an offer.
- _____ 7. An offer terminates when the time specified in the offer has passed and the offeror has given one last chance to the offeree to accept.
- _____ 8. Anyone who is aware of an offer can accept it and create a binding contract.
- _____ 9. Acceptance is timely if it is made before an offer terminates.

Multiple-Choice Questions

- _____ 1. Julio offers to sell Christine a used iPad for \$200. Which of the following replies would constitute an acceptance?
 - a. “I accept. Please send a written contract.”
 - b. “I accept if you send a written contract.”
 - c. “I accept if I can pay in monthly installments.”
 - d. None of the above.
- _____ 2. Vern offers to sell his car to Lee, stating that the offer will stay open for thirty days. Vern
 - a. cannot revoke the offer for thirty days.
 - b. can revoke the offer after any reasonable period of time.
 - c. can revoke the offer any time before Lee accepts.
 - d. can revoke the offer any time within thirty days, even after Lee accepts.
- _____ 3. Digit Electronics places an ad announcing a sale of its inventory at public auction. At the auction, Digit’s auctioneer points to a new seventy-five-inch 8K TV and asks, “What am I bid for this item?” Which of the following is true?
 - a. The first bid is an acceptance if no other bid is received.
 - b. Each bid is an acceptance if no higher bid is received.
 - c. Each bid is an offer that may be accepted or rejected.
 - d. Each bid is an offer that must be accepted if no higher bid is received.
- _____ 4. Ed sends to Sax, Inc., a written order for software to be specially designed, offering a certain amount of money. If Sax does not respond, it can be considered to have accepted the offer
 - a. after a reasonable time has passed.
 - b. if Ed knows that Sax accepts all offers unless it sends notice to the contrary.
 - c. only when Sax begins the work.
 - d. in none of the above situations.

- _____ 5. Pierre makes an offer to Lynn in a written purchase order, saying nothing about how her acceptance should be sent. Lynn indicates her acceptance by signing and returning the purchase order. Lynn's acceptance is effective
- when Lynn decides to accept.
 - when Lynn sends the signed purchase order.
 - when Pierre receives the signed purchase order.
 - in none of the above situations.
- _____ 6. Nintendo of America, Inc. contacts Play 2 Win Games and offers to sell "one to twenty-five new gaming systems for \$75 each. State number desired in acceptance." Play 2 Win agrees to buy twenty systems. This is
- a counteroffer.
 - an enforceable contract.
 - an invitation to negotiate.
 - a revocable offer.
- _____ 7. Garfield Company agrees to sell software to Holly from its website. To complete the deal, Holly clicks on a button that, with reference to certain terms, reads, "I agree." The parties have
- a binding contract that does not include the terms.
 - a binding contract that includes only the terms to which Holly later agrees.
 - a binding contract that includes the terms.
 - no contract.
- _____ 8. Icon Properties, Inc., makes an offer to Bob to sell a certain lot for \$30,000, with the offer to stay open for thirty days. Bob would prefer to pay \$25,000 if Icon would sell at that price. What should Bob reply to Icon to leave room for negotiation without rejecting the offer?
- "I will not pay \$30,000."
 - "Will you take \$25,000?"
 - "I will pay \$25,000."
 - "I will pay \$27,500."

Answering More Legal Problems

1. Nils bargains with the city of Fargo, North Dakota, concerning a contract to design a waste-to-energy incinerator that is to double as a tourist attraction. Integrated into the structure will be a ski slope with areas for skiers of all skill levels. On January 12, the city sends a written offer that states, "Acceptance of this offer must be made by registered or certified mail and received no later than January 22." Nils eventually responds with a note accepting the offer. Nils uses an overnight delivery service. The city receives the note January 23.

Do Nils and Fargo have a contract? No. Fargo received Nils's note one day after its deadline had expired. For this reason, his response to the city's offer is a counteroffer—a new _____. When an offeror specifies a date for acceptance, an offer automatically _____

on that specified date. This _____ the offeree's power to accept the offer. An attempted acceptance after the expiration constitutes a new offer.

2. The University of Connecticut offers Jordana an assistant coaching position on its women's basketball team. The offer states that it will expire thirty days from May 1. Jordana rejects the offer on May 12.

Can Jordana change her mind and accept the offer within what remains of the thirty days? Jordana can change her mind, but she _____ accept the school's offer. An offer is terminated when, within its terms, the _____ rejects it. An attempt to accept an offer after its termination is not an acceptance, but a new _____ to enter into a contract.

10 | Consideration

Conflict Presented

Antonio says to his son, “If you will paint the garage, I will buy you a brand new smartphone.” Antonio’s son paints the garage. The act of painting the garage is the consideration that creates the contractual obligation of Antonio to buy his son a new smartphone.

Q If, instead, Antonio had said to his son, “In consideration of the fact that you are not as wealthy as your brothers, I will buy you a new smartphone,” would this promise have been enforceable?

Just because a party has made a promise does not mean the promise is enforceable. In every legal system, there are promises that will be enforced and promises that will not be enforced. Under the common law, a primary basis for the enforcement of promises is **consideration**. This term is usually defined as the value (such as money) given in return for a promise (in a bilateral contract) or in return for a performance (in a unilateral contract).

10–1 Elements of Consideration

Often, consideration is broken down into two elements:

1. Something of legally sufficient value must be given in exchange for the promise.
2. There must be a bargained-for exchange.

10–1a Legally Sufficient Value

To be legally sufficient, consideration must be something of value in the eyes of the law. The “something of legally sufficient value” may consist of any of the following:

1. A promise to do something that one has no prior legal duty to do (to pay on receipt of certain goods, for instance).
2. The performance of an action that one is otherwise not obligated to undertake (such as providing accounting services).
3. The refraining from an action that one has a legal right to undertake (called a **forbearance**).

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 List the elements of consideration.
- 2 State the preexisting duty rule.
- 3 Name two ways to settle a legal claim.
- 4 Understand the concept of promissory estoppel.

consideration

The value given in return for a promise or performance.

Learning Outcome 1

List the elements of consideration.

forbearance

Refraining from an action that one has a legal right to undertake.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Antonio said to his son, “If you will paint the garage, I will buy you a new smartphone.” Antonio’s son paints the garage. This act is the consideration that creates Antonio’s obligation to buy the smartphone.

A If Antonio had instead said to his son, “In consideration of the fact that you are not as wealthy as your brothers, I will buy you a new smartphone,” would this promise have been enforceable? No. Antonio’s son would not have given any consideration for it. Antonio would simply have stated his motive for giving his son a new phone. Using the word consideration in an agreement does not, alone, create consideration.

Legal sufficiency is distinct from adequacy of consideration, which refers to “how much” consideration is given. Essentially, adequacy of consideration concerns the fairness of the bargain. In general, courts do not question the adequacy of consideration. Under the doctrine of freedom of contract, parties are usually free to bargain as they wish. If people could sue merely because they entered into an unwise contract, the courts would be overloaded with frivolous suits.



Highlighting the Point

On his sixteenth birthday, Kyle gets his driver’s license. Within six months, he receives three speeding tickets and rear-ends another car at a traffic stop. James, Kyle’s uncle, promises that he will pay Kyle \$5,000 if Kyle refrains from driving until he reaches the age of eighteen. Kyle agrees. Six months after his eighteenth birthday, Kyle e-mails his uncle to let him know that he has not driven a car for the past two years, fulfilling his end of their agreement. They agree that James will invest the \$5,000 for Kyle.

When James dies unexpectedly three years later, the executor of James’s estate refuses to pay Kyle the \$5,000. The executor contends that the contract is invalid. He argues that there is no consideration because James received nothing of value from Kyle, and Kyle is the only one who benefitted.

Does James and Kyle’s contract include consideration? Yes. On the strength of his uncle’s promise, Kyle stopped his driving. This performance is the consideration that makes the contract. On the faith of the agreement, Kyle refrained from doing something that he was otherwise entitled to do (a forbearance). The contract is enforceable, and the money belongs to Kyle.

10–1b Bargained-for Exchange

The second element of consideration is that it must provide the basis for the bargain between the contracting parties. The item of value must be given or promised by the promisor (offeror). In return, the promisee must make a promise or perform.

Real Case



Richard (Rick) Baarlaer contacted Jay Bakhshi and asked Jay to build a local bar. Before a written contract was signed, Rick gave Jay a check for \$36,000 and then another check for \$22,000 for supplies and to hire subcontractors. An actual contract was eventually signed for a total price of almost \$200,000. Rick also signed a promissory note and security agreement to pay Jay \$40,000 for “value received” in monthly installments. In an ensuing lawsuit, Rick, among other things, claimed that the \$40,000 promissory note was never deducted from the monies owed to Jay.

Was there any valid consideration for the promissory note? No. The Appeals Court of Ohio for the second appellate district pointed out that “consideration, meaning that which is bargained for and given in exchange for a promise, is a necessary element of a binding contract, and the absence of consideration precludes a formation of a valid contract.” In this case, the consideration was not apparent from the note. The note only indicated that Rick agreed to pay \$40,000 to Jay in installments. The obligation’s meaning was ambiguous. There was therefore a failure of consideration.

—*Bakhshi v. Baarlaer*, 2021-Ohio-13 (2nd Appellate District, 2021)

10-2 The Lack of Consideration

Sometimes, one of the parties (or both parties) to an agreement may think that consideration has been exchanged when, in fact, it has not. Situations in which agreements lack consideration include those involving preexisting duty, past consideration, and illusory promises.

10-2a Preexisting Duty

Under most circumstances, a promise to do what one already has a legal duty to do is not legally sufficient consideration, because no legal detriment or benefit has been incurred. This is the preexisting duty rule. The duty may be imposed by law or may arise out of a previous contract.

For instance, a sheriff cannot collect a reward for information leading to the capture of a criminal if the sheriff already has a legal duty to capture the criminal. Thus, if a party is already bound by contract to perform a certain duty, that duty cannot serve as consideration for a second contract.

Learning Outcome 2

State the preexisting duty rule.

Highlighting the Point



Bowman, Inc., begins construction on a seven-story office building. After three months, Bowman demands an extra \$75,000 payment on its contract. If the extra \$75,000 is not paid, the company will stop working. Richard, the owner of the land, finding no one else to complete construction, agrees to the extra \$75,000.

If Richard later refuses to pay the extra \$75,000, could Bowman successfully sue to enforce the agreement? No. The agreement is not enforceable, because it is not supported by consideration. Bowman had a preexisting duty to complete the building under the original contract with Richard.

In the interest of fairness, the courts sometimes allow exceptions to the preexisting duty rule. These exceptions include unforeseen difficulties and rescission.

Unforeseen Difficulties A court may decide not to apply the preexisting duty rule when a party to a contract confronts extraordinary difficulties that were totally unforeseen at the time the contract was formed. **Example 10.1** Straight Edge Construction contracts with Jacob to build a house. Straight Edge runs into extraordinary difficulties—it finds an underground tank full of hazardous materials. Jacob then agrees to pay extra compensation to cover the cost of the clean-up. A court may enforce the agreement to pay more under these circumstances. ■

If the difficulties are the types of risks ordinarily assumed in business, however, the court will likely assert the preexisting duty rule (and not enforce the agreement to pay more).

rescission

A remedy whereby a contract is terminated, and the parties are returned to the positions they had before the contract was made.

Rescission and New Contract The law recognizes that two parties can mutually agree to rescind their contract, at least to the extent that it is executory—that is, still to be performed. **Rescission** is defined as the unmaking of a contract so as to return the parties to the positions they occupied before the contract was made.

Sometimes, parties rescind a contract and make a new contract at the same time. When this occurs, it is often difficult to determine whether there was consideration for the new contract or whether the parties had a preexisting duty under the previous contract. If a court finds there was a preexisting duty, then the new contract normally will be invalid because there was no consideration.

10–2b Past Consideration

Promises made in return for actions or events that have already taken place are unenforceable. These promises lack consideration because the element of bargained-for exchange is missing. In short, you can bargain for something to take place now or in the future, but not for something that has already taken place. Therefore, **past consideration** is no consideration.

past consideration

A past act that cannot be consideration for a later promise.

Sometimes, an employer will ask an employee to sign a noncompete agreement. Under such an agreement, the employee agrees not to compete with the employer for a certain period after their employment relationship ends. When a current employee is required to sign a noncompete agreement, their employment is not sufficient consideration for the agreement because the individual is already employed. To be valid, the agreement requires new consideration.

10–2c Illusory Promises

If the terms of the contract express such uncertainty of performance that the promisor has not definitely promised to do anything, the promise is illusory. Such a promise is without consideration and unenforceable.

Option-to-cancel clauses in contracts for specified time periods sometimes present problems in regard to consideration. **Example 10.2** Abe contracts to hire Chris for one year at \$5,000 per month, reserving the right to cancel the contract at any time. Abe has not actually agreed to hire Chris, because Abe can cancel Chris's employment without liability at any time and has not given up the possibility of hiring someone else. This contract is therefore illusory. ■

Exhibit 10.1 presents some common situations in which there is a lack of consideration.

Exhibit 10.1 Examples of Agreements That Lack Consideration**Preexisting Duty**

When a person already has a legal duty to perform an action, there is no legally sufficient consideration.

Example: A firefighter cannot receive a cash reward from a business owner for putting out a fire in a downtown commercial district. As a city employee, the firefighter had a duty to extinguish the fire.

Past Consideration

When a person makes a promise in return for actions or events that have already taken place, there is no consideration.

Example: A real estate agent sold a friend's house without charging a commission, and in return, the friend promises to give the agent \$1,000. The friend's promise is simply an intention to give a gift.

Illusory Promises

When a person expresses contract terms with such uncertainty that the terms are not definite, the promise is illusory.

Example: A storeowner promises a \$500 bonus to each employee who works Christmas Day, as long as the owner feels that they did their jobs well. The owner's promise is just a statement of something she may or may not do in the future.

10-3 Settlement of Claims

Businesspersons and others often enter into contracts to settle legal claims. An accord and satisfaction is one such agreement. A release is another. It is important to understand the nature of consideration given in these kinds of settlement agreements, or contracts.

Learning Outcome 3

Name two ways to settle a legal claim.

10-3a Accord and Satisfaction

In an **accord and satisfaction**, a debtor offers to pay, and a creditor accepts, a lesser amount than the creditor originally claimed was owed. The accord is the agreement. Satisfaction is the performance (usually payment) that takes place after the accord is reached.

A basic rule governing such agreements is that there can be no satisfaction unless there is first an accord. In addition, for accord and satisfaction to occur, the amount of the debt must be in dispute.

accord and satisfaction

Settling a claim by the debtor offering to pay less than the creditor claims to be owed.

10-3b Release

A **release** is an agreement in which one party gives up the right to pursue a legal claim against another party. The release bars any recovery other than that specified in its terms. Releases are generally binding if they are (1) given in good faith, (2) stated in a signed writing, and (3) accompanied by consideration.

release

An agreement in which one party gives up the right to pursue a legal claim against another party.

Highlighting the Point



Serena is involved in an automobile accident caused by Raoul's negligence. Raoul offers to give Serena \$4,000 if she will release him from further liability resulting from the accident. Serena believes that this amount will cover her damages, so she agrees to the release. Later, Serena discovers that it will cost \$5,000 to repair her car.

Can Serena collect the balance from Raoul? The answer is normally no. Serena is limited to the \$4,000 specified in the release. Serena and Raoul agreed to the bargain, and sufficient consideration was present. The consideration was the legal detriment Serena suffered—by releasing Raoul from liability, Serena forfeited her right to sue to recover further damages.

10-4 Promissory Estoppel

Learning Outcome 4

Understand the concept of promissory estoppel.

promissory estoppel

A doctrine used to enforce promises when the promisees justifiably relied on them to their detriment.

Sometimes, individuals rely on promises, and such reliance may form a basis for contract rights and duties. Under the doctrine of **promissory estoppel** (also called detrimental reliance), a person who has reasonably relied on the promise of another can often obtain some measure of recovery. When this doctrine is applied, the promisor is estopped, or barred, from revoking the promise. For the doctrine of promissory estoppel to be applied, a number of elements are required:

1. There must be a clear and definite promise.
2. The promisee must justifiably rely on the promise.
3. The reliance normally must be of a substantial and definite character.
4. Justice will be better served by the enforcement of the promise.

Example 10.3 Bailey, the owner of a local machine shop, employs six employees. As part of their employment, Bailey orally promises to pay each of them \$2,000 per month for the remainder of their lives after they retire. Hernandez, one of Bailey's employees, retires. Hernandez receives the \$2,000 monthly amount for two years, but after that, Bailey stops paying Hernandez. Under the doctrine of promissory estoppel, Hernandez can sue Bailey in an attempt to enforce Bailey's promise. ■

Chapter Summary—Consideration

Learning Outcome 1: List the elements of consideration.

The two elements of consideration are (1) something of legally sufficient value given in exchange for a promise and (2) a bargained-for exchange.

Learning Outcome 2: State the preexisting duty rule.

A promise to do what already one has a legal duty to do is not legally sufficient consideration. This is because no new legal detriment or benefit has been incurred.

Learning Outcome 3: Name two ways to settle a legal claim.

A businessperson can settle a legal claim through (1) an accord and satisfaction or (2) a release.

Learning Outcome 4: Understand the concept of promissory estoppel.

Promissory estoppel is a doctrine that applies when (1) there is a clear and definite promise, (2) the promisee justifiably relies on the promise, (3) the reliance is of a substantial and definite character, and (4) justice is better served by enforcing the promise.

Straight to the Point

1. What is "something of legally sufficient value"? (See Learning Outcome 1.)
2. How can something be the basis of a bargain? (See Learning Outcome 1.)
3. Identify two situations in which agreements lack consideration. (See Learning Outcome 2.)
4. What is a release? (See Learning Outcome 3.)
5. When might reliance form the basis for contract rights and duties despite a lack of consideration? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. In September, Sharon agrees to work for Cole Productions, Inc., at \$700 a week for a year beginning January 1. In October, Sharon is offered the same work at \$800 a week by Quintero Shows, Ltd. When Sharon tells Cole about the other offer, they tear up their existing contract and agree that Sharon will be paid \$775. Is the new contract binding? Why or why not? (See Learning Outcome 2.)
2. Before Maria starts her first year of college, Fred promises to give her \$5,000 when she graduates. She goes to college, borrowing and spending far more than \$5,000. At the beginning of the spring semester of her senior year, she reminds Fred of the promise. Fred sends her a note that says, "I revoke the promise." Is Fred's promise binding? Explain. (See Learning Outcome 4.)

Real Law

10-1. Illusory Consideration. David Zigler was an employee of Featherstone Foods. Joel Schonfeld was Zigler's employer. The two exchanged e-mails in which Zigler sought assurance that he would have a right of first refusal to purchase Featherstone. Zigler contended that Schonfeld granted Zigler this right of first refusal in exchange for Zigler's "continued efforts as an employee of [Featherstone] related to the acquisition of a Featherstone competitor." Schonfeld and Zigler eventually executed a one-sentence agreement that stated that "[Schonfeld] will give [Zigler] right of first refusal to purchase Featherstone Foods, Sesame Distribution, Caraway, and any related entities." Later, Schonfeld decided to sell his business to a private equity firm. Zigler sued for violating the right of first refusal to buy the business. Schonfeld and other defendants moved to dismiss the complaint in its entirety. The defendants argued that the right of first refusal agreement lacked consideration and was therefore unenforceable. Should the court dismiss the complaint? [*Zigler v. Featherstone Foods, Inc., et al.*, 2021 WL149259, (U.S. District Court for the Southern District of New York)] (See Learning Outcome 2.)

10-2. Bargained-for Exchange. On Brenda Snizek's first day of work for the Kansas City Chiefs Football Club, she signed a document that compelled arbitration of any disputes that she might have with the Chiefs. In the document, Snizek promised that on the arbitrator's decision, she would release the Chiefs from any related claims. Nowhere in the document did the Chiefs agree to do anything in return for Snizek's promise. Was there consideration for the arbitration provision? Explain. [*Snizek v. Kansas City Chiefs Football Club*, 402 S.W.3d 580 (Mo.App. W.D. 2013)] (See Learning Outcome 1.)

10-3. Rescission. Farrokh and Scheherezade Sharabianlou agreed to buy a building owned by Berenstein Associates for \$2 million. They deposited \$115,000 toward the purchase. Before the deal closed, an environmental assessment of the property indicated the presence of chemicals used in dry cleaning. This substantially reduced the property's value. Do the Sharabianlous have a good argument for the return of their deposit and rescission of the contract? Explain. [*Sharabianlou v. Karp*, 181 Cal.App.4th 1133, 105 Cal.Rptr.3d 300 (1 Dist. 2010)] (See Learning Outcome 2.)

Ethical Questions

10-4. Legally Sufficient Value. Can a moral obligation satisfy the requirements of consideration? Why or why not? (See Learning Outcome 1.)

10-5. Elements of Consideration. Carmen White signed a lease with Sienna Ridge Apartments in San Antonio, Texas. The lease required White to reimburse Sienna Ridge for any damage to the apartment not caused by the landlord's negligence or fault. After moving in, White received a new washer and dryer from her parents. She did not read the instruction manual before overloading the dryer with bedding, including

an unwashed pillow, which started a fire. Sienna Ridge filed a claim for the resulting damage with Philadelphia Indemnity Insurance Company. Philadelphia paid the claim and filed a suit in a Texas state court against White, alleging that she had breached the lease by failing to reimburse Sienna Ridge for the damage. White argued that the lease was unenforceable for lack of consideration. Is White correct? Is it unethical for her to resist payment? Discuss. [*Philadelphia Indemnity Insurance Co. v. White*, 2017 WL 32899 (Tex.App.—San Antonio 2017)] (See Learning Outcome 1.)

Chapter 10—Work Set

True-False Questions

- _____ 1. Ordinarily, courts evaluate the adequacy or fairness of consideration even if the consideration is legally sufficient.
- _____ 2. A promise to do what one already has a legal duty to do is not legally sufficient consideration under most circumstances.
- _____ 3. Promises made with consideration based on events that have already taken place are fully enforceable.
- _____ 4. Rescission is the unmaking of a contract so as to return the parties to the positions they occupied before the contract was made.
- _____ 5. A promise has no legal value as consideration.
- _____ 6. A release is an agreement in which one party gives up the right to pursue a legal claim against another party.
- _____ 7. Consideration is the value given in return for a promise.
- _____ 8. Promissory estoppel may prevent a party from using lack of consideration as a defense.
- _____ 9. The doctrine of promissory estoppel requires a clear and definite promise.

Multiple-Choice Questions

- _____ 1. Damba offers to buy a book owned by Lee for \$40. Lee accepts and hands the book to Damba. The transfer and delivery of the book constitutes performance. Is this performance consideration for Damba's promise?
 - a. Yes because performance always constitutes consideration.
 - b. Yes because Damba sought it in exchange for his promise, and Lee gave it in exchange for that promise.
 - c. No because performance never constitutes consideration.
 - d. No because Lee already had a duty to hand the book to Damba.
- _____ 2. Malina agrees to supervise a construction project for Al for a certain fee. In midproject, without an excuse, Malina removes the plans from the site and refuses to continue. Al promises to increase Malina's fee. Malina returns to work. Is going back to work consideration for the promise to increase the fee?
 - a. Yes because performance always constitutes consideration.
 - b. Yes because Al sought it in exchange for his promise.
 - c. No because performance never constitutes consideration.
 - d. No because Malina already had a duty to supervise the project.
- _____ 3. Shannon contracts with Dan to build two houses on two lots. After the first house is finished, they decide to build a garage instead of a house on the second lot. Under these circumstances,
 - a. they must build the second house—a contract must be fully performed.
 - b. they can rescind their contract and make a new contract to build a garage.
 - c. the contract to build two houses is illusory.
 - d. none of the above is true.
- _____ 4. Kingston has a cause to sue Mary in a tort action but agrees not to sue her if she will pay for the damage. If she fails to pay, Kingston can bring an action against her for breach of contract. This is an example of
 - a. promissory estoppel.
 - b. a release.
 - c. a bargained-for exchange.
 - d. an unenforceable contract.

- _____ 5. John's car is hit by Ben's truck. A doctor tells John that he will be disabled only temporarily. Ben's insurance company offers John \$15,000 to settle his claim. John accepts and signs a release. Later, John learns that he is permanently disabled. John sues Ben and the insurance company. John will
- win because John did not know when he signed the release that the disability was permanent.
 - win because Ben caused the accident.
 - lose because John signed a written release—no fraud was involved, and consideration was given.
 - do none of the above.
- _____ 6. Mike promises that next year he will sell Valeria a certain house. Meanwhile, he allows her to live in the house. Valeria completely renovates the house, repairs the heating system, and entirely landscapes the property. The next year, Mike tells Valeria he's decided to keep the house. Who is entitled to the house?
- Valeria under the doctrine of promissory estoppel.
 - Valeria because Mike's decision to keep the house is an unforeseen difficulty.
 - Mike because his promise to sell Valeria the house was illusory.
 - Mike because he initially stated only his intention to sell.
- _____ 7. Deb owes Jim \$5,500. In need of the money, Jim threatens to foreclose on the debt. Deb offers to pay \$5,000 immediately to settle Jim's claim. Jim agrees. This is
- promissory estoppel.
 - a release.
 - an accord and satisfaction.
 - an unenforceable contract.
- _____ 8. Green Energy Company files a suit against First Bank, claiming that the consideration for a contract between them was inadequate. The court likely will not evaluate the adequacy of consideration unless it is
- somewhat unbalanced.
 - grossly inadequate.
 - legally sufficient.
 - willfully unfair.

Answering More Legal Problems

1. RiotGear contracts with Standard Transit, Inc., to distribute RiotGear's "Occupy Earth/Global Movement" line of apparel to retail outlets for a certain price. With the goods in transit, RiotGear receives this tweet from Standard: "Price increase of 99 percent or no delivery." RiotGear agrees and pays, but later sues Standard for the increase over the original price.

Is RiotGear entitled to the difference in price? Yes. Under the _____ rule, if a party is already bound by contract to perform a certain duty, that duty cannot serve as _____ for a second contract. A party to a contract is not bound to a modification of the contract unless there is additional consideration for the change. In this set of facts, there is no new consideration, so RiotGear's agreement to the change is _____.

2. RiotGear promises to donate a share of the proceeds from the sale of the "Occupy Earth/Global Movement"

line to The Cause, a charitable organization dedicated to supporting those who seek social and economic change through protest. In reliance on the expected donation, The Cause contracts for medical and other supplies. When Standard increases the distribution cost, RiotGear tells The Cause that there will be no donation.

Can The Cause enforce RiotGear's original promise despite the lack of consideration? Yes. Under the doctrine of _____, a party who makes a promise can be estopped from revoking it. For the doctrine to be applied, (1) there must be a _____, (2) the promisee must reasonably rely on it, (3) the reliance must be substantial and definite, and (4) justice must be better served by the enforcement of the _____. It is reasonable to expect that a charitable organization will incur obligations in reliance on a _____ of a donation. Failing to enforce it would be unjust.

11 Capacity

Conflict Presented

Sierra, a sixteen-year-old minor, applies for a job at Fast Burgers. As part of her pre-employment paperwork, her employer requests that she sign an agreement to resolve any future dispute through arbitration. She signs and begins work. Later, Sierra is injured on the job and quits. Her mother, Marissa, files a lawsuit on Sierra's behalf against Fast Burgers to recover for the injury. To avoid the lawsuit, Fast Burgers files a motion to compel arbitration.

Q Can Sierra avoid the agreement to arbitrate?

The first two requirements for a valid contract are agreement and consideration. The third requirement is **contractual capacity**—the legal ability to enter into a contractual relationship.

Courts generally presume the existence of contractual capacity. In some situations, however, capacity is lacking or questionable. For instance, a person adjudged by a court to be mentally incompetent cannot form a legally binding contract with another party. In other situations, a party may have the capacity to enter into a valid contract but also have the right to avoid liability under it.

In this chapter, we look at the effects of youth, intoxication, and mental incompetence on contractual capacity.

11-1 Minors

Minors—or infants, as they are commonly referred to in the law—usually are not legally bound by contracts. In most states, the **age of majority** for contractual purposes is eighteen years. Thus, in these states, after someone turns eighteen, they are no longer considered a minor. Some states provide for the termination of minority when a minor gets married. Minority status may also be terminated by a minor's emancipation from their parents (discussed shortly).

The general rule is that a minor can enter into any contract an adult can, provided that the contract is not one prohibited by law for minors. **Example 11.1** Jamie, who is a freshman in high school, cannot enter into a contract with a local winery to buy a case of white wine. It is against the law for minors to buy alcoholic beverages. ■

Subject to certain exceptions, however, the contracts entered into by a minor are voidable (nullified) at the option of that minor. The minor can ratify (accept) the contract and thus make it enforceable. Or a minor can disaffirm (avoid) the contract and set aside all legal obligations.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Understand a minor's right to disaffirm a contract.
- 2 Identify obligations that minors cannot avoid.
- 3 Explain how intoxication can affect a contract.
- 4 Discuss how mental incompetence can affect a contract.

contractual capacity

The legal ability to enter into a contractual relationship.

age of majority

The age when a person is no longer a minor.

Learning Outcome 1

Understand a minor's right to disaffirm a contract.

disaffirmance

The repudiation (avoidance) of a contractual obligation.

11–1a Disaffirmance

Disaffirmance is the legal avoidance, or setting aside, of a contractual obligation. Public policy permits minors normally to disaffirm, and thereby void, their contracts. It is also a well-settled principle that a court should act to protect a minor's best interests. This includes financial interests.

For minors to exercise the option to disaffirm contracts, they need only show an intention not to be bound by it. Words or conduct may serve to show this intent.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Sierra, a sixteen-year-old minor, is hired by Fast Burgers. At the employer's request, Sierra signs an agreement to resolve any dispute through arbitration. Sierra is injured on the job and quits. Her mother files a lawsuit against Fast Burgers on Sierra's behalf to recover for the injury. The employer files a motion to compel arbitration.

A Can Sierra avoid the agreement to arbitrate? Yes. Minors can disaffirm contracts at their option. Sierra opted to disaffirm the agreement to arbitrate by quitting her job and filing a lawsuit against Fast Burgers.

Disaffirmance Within a Reasonable Time A minor can ordinarily disaffirm a contract at any time during minority or for a reasonable time after coming of age. It is important that disaffirmance be timely.



Real Case

Ian Norred was a 17-year-old minor when he started working as a server at a Cotton Patch Café in Texas. Norred electronically signed a document titled "Notice to Employees" that contained a mutual arbitration agreement for all disputes arising out of his employment. Seven months later, Norred turned 18. Ten months after that, Norred left his job and then filed a compensation lawsuit against Cotton Patch alleging violations of federal labor law. At the same time, Norred attempted to disaffirm the terms of his original contract.

Can Norred legally disaffirm his employment contract? No. Norred took too long to disaffirm and was therefore bound by the arbitration agreement. In *Norred v. Cotton Patch Café, LLC*, the United States District Court for the Northern District of Texas cited Texas caselaw from 1889 to reach its decision. Norred did not convey his repudiation of the employment contract to Cotton Patch within a reasonable time after reaching the age of majority.

—2019 WL 5425479 (Dist. Ct. N.D. TX)

A Minor's Obligations on Disaffirmance All states' laws permit minors to disaffirm contracts, including fully executed (performed) contracts. States differ, though, on the extent of a minor's obligations after disaffirmance. In most states, courts hold that the minor need only return the goods (or other consideration) subject to the contract, provided the goods are in the minor's possession or control.

A few states place an additional duty on the minor—the duty of **restitution**. In these states, courts may hold a minor responsible for damage, ordinary wear and tear, and depreciation of goods that the minor used before disaffirming a contract. This duty of restitution recognizes the legitimate interests of those who enter into agreements with minors. The theory is that the adult parties should be returned to the position they held before the contract was made with the minor. If minors disaffirm a contract, they must disaffirm the entire contract. Minors cannot decide to keep part of the contracted goods and return the rest.

Certain exceptions apply to a minor's obligations on disaffirmance. These are discussed next.

Disaffirmance and Misrepresentation of Age Ordinarily, minors can disaffirm contracts even when they have misrepresented their age. **Example 11.2** Ellery applies for a job at Pacific Jewelry. She tells Kirk, the owner, that she is twenty-one years old. In reality, she is seventeen years old and a senior in high school. Kirk hires her to work evenings. If an employment dispute arises between Kirk and Ellery, Ellery can disaffirm any legal obligation she has under the contract. ■

A growing number of states, in contrast, have enacted laws to prohibit a minor's disaffirmance in certain situations. In short, the right to disaffirm a contract is to protect minors. If, instead, a minor uses the right to disaffirm for unfair personal gain, then that protection may be dismissed in certain states.

restitution

A remedy that restores a person to the position held before a contract.

Highlighting the Point



Jennifer, a minor, contracts to purchase a new car from Haydocy Pontiac. She tells the salesperson that she is twenty-one. Jennifer finances most of the purchase price. Immediately following delivery of the car, she turns it over to her boyfriend and thereafter never has possession. She makes no further payments on the contract and attempts to disaffirm the contract. She makes no offer to return the car. Haydocy sues Jennifer for the balance owed.

Can Haydocy recover the balance, even though Jennifer is a minor who misrepresented her age? Yes. If Jennifer lives in a state that prohibits disaffirmance by minors who misrepresent their age for unfair personal gain, Haydocy can attempt to recover the remaining balance of the contract. Jennifer's misrepresentation of her age in this instance was done to intentionally benefit herself and her boyfriend.

Disaffirmance and Necessaries A minor who enters into a contract for necessities may disaffirm the contract but remains liable for the reasonable value of the goods. **Necessaries** include whatever is reasonably needed to maintain the minor's standard of living. In general, food, clothing, shelter, and medical services are necessities. What is a necessary for one minor, however, may be a luxury for another, depending on the minors' customary living standard.

Disaffirmance and Business Contracts In many states, certain business contracts entered into by minors cannot be disaffirmed. In those states, if minors do business or engage in employment in the manner of adults, their related contracts are fully enforceable.

Example 11.3 Miguel is seventeen years old and a gifted computer science student. While in high school, he creates a new app called "Taking Care of Business." The app links personal to-do lists, maps, downtown building directories, and other useful data to connected social media and contact networks. Using attorneys to negotiate a sales agreement, Miguel sells the app to Wilson Tech. Later, another

Learning Outcome 2

Identify obligations that minors cannot avoid.

necessaries

Necessities required for a standard of living, such as food and shelter.

large corporation offers Miguel a better price, but he cannot disaffirm his agreement with Wilson Tech. Miguel has done business in the manner of an adult, and in his state, that means his contract cannot be disaffirmed. ■

Can Minors Avoid Their Obligations Under Smart Contracts? Everyone has heard about virtual and cybercurrency, such as Bitcoin. Bitcoin involves the anonymity of the sellers and buyers of that cybercurrency. When buying or selling virtual currency, smart contracts are used. Smart contracts can also be used as a type of automated purchasing system to buy a particular item at a certain price.

Can minors avoid their decisions to enter into such contracts? This is a complicated issue because the parties to smart contracts are unknown to each other. There is a risk that a party who has attained the age of majority may inadvertently enter into a contract with a minor because of the anonymity of the internet. While some automated smart contracts used for the purchase of necessities would rule out disaffirmance by a minor, it is hard to imagine that the purchase of a cybercurrency, such as Bitcoin, would be declared as buying necessities.

11–1b Ratification

ratification

Accepting and giving legal force to an obligation that previously was not enforceable.

In contract law, **ratification** is the act of accepting and giving legal force to an obligation that previously was not enforceable. A minor who has reached the age of majority can ratify a contract expressly or impliedly. Express ratification occurs when the individual, on reaching the age of majority, states orally or in writing that they intend to be bound by the contract. Implied ratification takes place when the minor, on reaching the age of majority, indicates an intent to abide by the contract.



Highlighting the Point

Lindsay posts an ad on Craigslist offering to sell her grandmother's Yamaha Grand Piano for \$6,000. Axel, who is seventeen years old, agrees to purchase the piano by making monthly payments of \$200 over the next two and a half years. Axel does not disaffirm the contract, and six months into the agreement, he turns eighteen (the age of majority in his state). When Axel stops by Lindsay's house to make his seventh payment, he states, "I love the piano and will continue making payments."

Has Axel expressly ratified the contract with Lindsay? Yes. His oral statement to Lindsay to continue making payments on the piano is an express ratification of their contract. He can no longer disaffirm it. If Axel never expressly tells Lindsay he will continue making payments but continues to do so well after reaching the age of majority, he has implied the contract's ratification.

11–1c Parents' Liability

As a general rule, parents are not liable for contracts made by their minor children when the children are acting on their own. That is why businesses ordinarily require parents to sign any contract made with a minor. The parents then become personally obligated under the contract to perform the conditions of the contract, even if their child avoids liability. (See the Linking Business Law to Your Career feature at the end of this chapter.)

11–1d Emancipation

emancipation

The release of a minor from parental control.

The release of minors by their parents is known as **emancipation**. Emancipation involves completely relinquishing the right to the minor's control, care, custody, and earnings. It is a repudiation of parental obligations. Emancipation may be

express or implied, absolute or conditional, total or partial. A number of jurisdictions permit minors to petition for emancipation themselves.

In addition, a minor may petition a court to be treated as an adult for business purposes. If the court grants the minor's request, it removes the lack of contractual capacity, and the minor no longer has the right to disaffirm business contracts.

11–1e Minors' Rights in Digital Assets

Minors own many digital assets, including e-mail accounts, social networking accounts, digital photos, text messages, virtual assets associated with online games, and other forms of digital media. To be sure, minors have the ability to use these digital assets with a fluidity unrivaled by older generations.

What happens when a minor dies, though? Under current law, minors have no right to decide what happens to their digital property at death. Minors have the right to contract with online businesses, to marry, to seek and gain employment, but they are currently denied a basic right of property ownership—the right to pass their digital property to their heirs in a manner that they wish. More generally, minors do not have the right of succession—they are legally incapable of deciding how any of their property is distributed at death.

11–2 Intoxicated Persons

A contract entered into by an intoxicated person can be either voidable or valid. If the person was sufficiently intoxicated to lack mental capacity, the transaction is voidable at the option of the intoxicated person, even if the intoxication was purely voluntary. For the contract to be voidable, it must be proved that the intoxicated person's reason and judgment were impaired to the extent that they did not comprehend the legal consequences of entering into the contract. If the person was intoxicated but understood these legal consequences, the contract is enforceable. Under any circumstances, an intoxicated person is liable for the reasonable value of any necessities they receive.

Problems often arise in determining whether a party was sufficiently intoxicated to avoid legal duties. Many courts prefer looking at factors other than the intoxicated party's mental state (for example, whether the other party fraudulently induced the person to become intoxicated).

Example 11.4 Bill offers to buy Portside Warehouse, a prime commercial property, from Blanda. Blanda refuses to sell. Bill encourages Blanda to quickly down a couple of strong alcoholic drinks “to celebrate your resolve.” Bill then persuades Blanda to sell the property. If a court finds that Bill fraudulently induced Blanda to become intoxicated, and that Blanda was sufficiently intoxicated to lack mental capacity, Blanda can avoid the sale. ■

Learning Outcome 3

Explain how intoxication can affect a contract.

11–3 Mentally Incompetent Persons

Contracts made by mentally incompetent persons can be void, voidable, or valid.

11–3a When a Contract Is Void

If a person has been adjudged mentally incompetent by a court of law and a guardian has been appointed, any contract made by the mentally incompetent person is void—no contract exists. Only the guardian can enter into a binding legal duty on the person's behalf.

Example 11.5 Delilah has a rare form of amnesia as a result of a head injury suffered in a car accident ten years ago. Ronald is her legal guardian. When Lisa offers to buy Delilah's house for a good price, Delilah agrees and signs the sales contract. This contract is void due to Delilah's amnesia. Lisa, however, could create a valid contract with Ronald to buy Delilah's house, if Ronald agrees. ■

Learning Outcome 4

Discuss how mental incompetence can affect a contract.

11–3b When a Contract Is Voidable

The situation is somewhat different when mentally incompetent persons who have not been adjudged incompetent by a court enter into contracts. Such contracts are voidable if the incompetent persons did not know they were entering into the contracts or they lacked the mental capacity to comprehend the contracts' subject matter, nature, and consequences. In such situations, the contracts are voidable at the option of the mentally incompetent person but not the other party.

As with minors, voidable contracts made by mentally incompetent persons may be disaffirmed or ratified. Ratification must occur after the person is mentally competent or after a guardian is appointed and ratifies the contract. Like intoxicated persons, mentally incompetent persons are liable for the reasonable value of any necessities they receive.

11–3c When a Contract Is Valid

A contract entered into by a mentally incompetent person may also be valid. A person can understand the nature and effect of entering into a certain contract yet simultaneously lack capacity to engage in other activities. In such situations, the contract is valid because the person is not legally mentally incompetent for contractual purposes.



Highlighting the Point

Rhonda is diagnosed with bipolar disorder, but a court has not declared her mentally incompetent. One afternoon, wearing shabby clothes and with her hair uncombed, she arrives at Classic Automotive. After two hours of negotiations, she trades in her Honda Civic and signs a three-year lease for a BMW. She does not test-drive the new car, she has difficulty removing the Civic's keys from her key ring, and the payments on the BMW are more than she can afford.

Can Rhonda disaffirm the lease agreement because of mental incompetence? No. A party cannot avoid a contract on the ground of mental incompetence unless at the time of the contract's execution, the person did not reasonably understand the nature and terms of the contract. In this situation, nothing—including Rhonda's disheveled appearance, her difficulty with the keys, her failure to test-drive the car, or its price—indicates that she did not understand she was executing an auto lease. After all, she negotiated more than two hours with Classic Automotive.



Linking Business Law to Your Career

Contracts With Minors

Some of you have been or will be involved in retail careers at the managerial level. Sometimes, sales personnel must deal with minors, who have limited contractual capacity. As a sales manager, you should introduce your employees to the law governing contracts with minors.

Contracts With Minors

If your business involves selling consumer durables, such as appliances, furniture, or automobiles, your employees must be careful in forming contracts with minors. The employees should heed the adage "When in doubt, check."

Remember that a contract signed by a minor (unless it is for necessities) normally is voidable by the minor. Employees should demand proof of legal age when they have any doubt about whether a customer is a minor. If the customer is a minor, employees should insist that an adult (such as a parent) be the purchaser or at least the co-signer on any sales contract.

Because the law governing minors' rights varies from state to state, you should check with an attorney concerning the laws governing disaffirmance in your state. You should know, for instance, what the consequences are if minors disaffirm sales or misrepresent their age in forming a sales contract. Similarly, you need to find out whether a minor, on disaffirming a contract, can be required to pay for damage to goods sold under the contract.

Chapter Summary—Capacity

Learning Outcome 1: Understand a minor's right to disaffirm a contract.

Contracts with minors are voidable at the option of the minor. Disaffirmance can take place (in most states) at any time during minority and within a reasonable time after the minor has reached the age of majority. If a minor disaffirms a contract, the entire contract must be disaffirmed. When disaffirming an executed contract, the minor has a duty of restitution to return the received goods if they are still in the minor's control and (in some states) to pay for any damage to the goods.

Learning Outcome 2: Identify obligations that minors cannot avoid.

Minors who have misrepresented their age will be denied the right to disaffirm by some courts. A minor may disaffirm a contract for necessities but remains liable for the reasonable value of the goods. In some states, if minors do business or engage in employment in the manner of adults, their related contracts are fully enforceable.

Learning Outcome 3: Explain how intoxication can affect a contract.

A contract entered into by an intoxicated person is voidable at the option of the intoxicated person if the person was sufficiently intoxicated to lack mental capacity, even if the intoxication was voluntary. A contract with an intoxicated person is enforceable if, despite being intoxicated, the person understood the legal consequences of entering into the contract.

Learning Outcome 4: Discuss how mental incompetence can affect a contract.

A contract made by a person adjudged by a court to be mentally incompetent is void. A contract made by a mentally incompetent person not adjudged by a court to be mentally incompetent is voidable at the option of the mentally incompetent person. A contract made by a mentally incompetent person who nevertheless understands the nature and effect of entering into the contract is valid.

Straight to the Point

1. Can a minor enter into any contract that an adult can? (See Learning Outcome 1.)
2. Are minors legally bound to every contract that they enter into? (See Learning Outcome 1.)
3. When a contract has been fully executed, what must a minor do to disaffirm it? (See Learning Outcome 1.)
4. How does ratification affect the right of minors to avoid their contracts? (See Learning Outcome 1.)
5. In what circumstance can an intoxicated person avoid a contract even if the intoxication was purely voluntary? (See Learning Outcome 3.)
6. How does ratification affect the right of mentally incompetent persons to avoid their contracts? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Joan, who is sixteen years old, moves out of her parents' home and signs a one-year lease for an apartment at Kenwood Apartments. Joan's parents tell her that she can return to live with them at any time. Unable to pay the rent, Joan moves to her parents' home two months later. Can Kenwood enforce the lease against Joan? Why or why not? (See Learning Outcome 1.)
2. Cedric, a minor, enters into a contract with Diane. How might Cedric effectively ratify this contract? (See Learning Outcome 1.)

Real Law

11-1. Disaffirmance by Minors. Millions of individuals, including millions of minors, play Epic Games' "Fortnite." One unidentified minor, known in this case as Johnny Doe, filed a federal lawsuit claiming that "Epic collects millions of dollars... by luring [children] to download bait Apps and then spend vast sums on Game Currency without parental knowledge or permission." Part of the suit reads that "these games are highly addictive, designed deliberately so, and tend to compel children playing them to make purchases." None of these purchases allow for refunds. At the early stages of this litigation, a federal district court had to rule whether a minor sufficiently conveyed his intent to repudiate end-user license agreements (EULAs) and therefore could disaffirm any expressed or implied contract. On the question of disaffirmance, should the court rule in favor of the minor's request to disaffirm? [*Doe v. Epic Games, Inc.*, 435 F.Supp.3d 1024 (U.S. Dist. Court for Northern District of California, 2020)] (See Learning Outcome 1.)

11-2. Minors. Bonney McWilliam's father deeded a house in Norfolk County, Massachusetts, to Bonney and her daughter, Mechelle. Each owned a one-half interest. Described as "an emotionally troubled teenager," Mechelle had a history

of substance abuse and a fractured relationship with her mother. At age sixteen, in the presence of her mother and her mother's attorney, Mechelle signed a deed transferring her interest in the house to Bonney. Later, still at odds with her mother, Mechelle learned that she did not have a right to enter the house to retrieve her belongings. Bonney claimed sole ownership. Mechelle filed a lawsuit in a Massachusetts state court against her mother to declare the deed void. Could the transfer of Mechelle's interest be disaffirmed? Explain. [*McWilliam v. McWilliam*, 46 N.E.3d 598 (Mass. App.Ct. 2016)] (See Learning Outcome 1.)

11-3. Mental Incompetence. William Zurenda was disabled by post-traumatic stress disorder (PTSD) but had not been adjudged mentally incompetent. During divorce proceedings, he agreed to pay his spouse \$5,000 within six months. The settlement was read aloud in court, and the judge asked William if he understood that the settlement was binding. He answered that he did. Later, he argued that he should not have to pay the \$5,000, because the stress of the divorce had made his PTSD worse. Is the settlement void on the basis of mental incompetence? Explain. [*Zurenda v. Zurenda*, 85 A.D.3d 1283, 925 N.Y.S.2d 221 (3 Dept. 2011)] (See Learning Outcome 4.)

Ethical Questions

11-4. Minors. Should the goal of protecting minors from the consequences of unwise contracts ever outweigh the goal of encouraging minors to behave in a responsible manner? Discuss. (See Learning Outcome 1.)

11-5. Minors. Sky High Sports Nashville Operations, LLC, operated a trampoline park in Nashville, Tennessee. During a dodgeball tournament at Sky High, Jacob Blackwell, a minor, suffered a torn tendon and a broken tibia. His mother, Crystal, filed a lawsuit on his behalf in a Tennessee state court against Sky High. She alleged negligence

and sought \$500,000 to cover Jacob's medical and other expenses. Sky High asserted that the claim was barred by a waiver of liability in a contract between the parties, which the defendant asked the court to enforce. The waiver released Sky High from liability for any "negligent acts or omissions." What might Sky High argue as a reason for enforcing the waiver? Would it be unethical to allow Jacob to recover? Discuss. [*Blackwell v. Sky High Sports Nashville Operations, LLC*, 523 S.W.3d 624 (Tenn.App. 2017)] (See Learning Outcome 1.)

Chapter 11—Work Set

True-False Questions

- _____ 1. When persons reach the age of majority, they can no longer disaffirm a contract.
- _____ 2. When a minor disaffirms a contract, whatever the minor transferred as consideration (or its value) normally must be returned.
- _____ 3. Persons who are so intoxicated as to lack mental capacity when they enter into a contract must perform the contract.
- _____ 4. Emancipation has no effect on a minor's contractual capacity.
- _____ 5. If an individual who has not been judged mentally incompetent understands the nature and effect of entering into a certain contract, the contract is normally valid.
- _____ 6. In many states, certain business contracts entered into by minors cannot be disaffirmed.
- _____ 7. Some states' statutes restrict minors from avoiding certain contracts, including for necessities.
- _____ 8. Generally, parents are liable for contracts made by their minor children.
- _____ 9. In most cases, persons, to disaffirm contracts entered into when they were intoxicated, must return any consideration received.

Multiple-Choice Questions

- _____ 1. Troy, a minor, sells his collection of sports memorabilia to Vern for \$250. On his eighteenth birthday, Troy learns that the collection may have been worth at least \$2,500. Troy
 - a. can disaffirm because the contract has not been fully performed.
 - b. can disaffirm if he does so within a reasonable time after attaining majority.
 - c. cannot disaffirm because he has already attained majority.
 - d. cannot disaffirm because the contract has been fully performed.
- _____ 2. Doug has been drinking heavily. Joe offers to buy Doug's farm for a fair price. Believing the deal is a joke, Doug writes and signs an agreement to sell and gives it to Joe. Joe believes the deal is serious. The contract is
 - a. enforceable if the circumstances indicate that Doug understands what he did.
 - b. enforceable because Joe believes that the transaction is serious.
 - c. unenforceable because the intoxication permits Doug to avoid the contract.
 - d. unenforceable because Doug thinks it is a joke.
- _____ 3. Kanna is adjudged mentally incompetent. Irwin is appointed to act as Kanna's guardian. Irwin signs a contract to sell some of Kanna's property to pay for Kanna's care. On regaining competency, Kanna
 - a. can disaffirm because he was mentally incompetent.
 - b. can disaffirm because he is no longer mentally incompetent.
 - c. cannot disaffirm because Irwin could enter into contracts on his behalf.
 - d. cannot disaffirm because he may become mentally incompetent again.
- _____ 4. Adam, a sixteen-year-old minor, enters into a contract for necessities, which his parents could provide but do not. Adam disaffirms the contract. Adam's parents
 - a. must pay the reasonable value of the goods.
 - b. must pay more than the reasonable value of the goods.
 - c. can pay less than the reasonable value of the goods.
 - d. do not have to pay anything for the goods.

- _____ 5. First Bank loans money to Kosum, a sixteen-year-old minor. Kosum must repay the loan
- if the loan is made for the express purpose of buying necessities.
 - if First Bank makes sure the money is spent on necessities.
 - if both a and b are true.
 - in none of the above circumstances.
- _____ 6. Eve, a fifteen-year-old minor, buys a smartphone app from EZ Spyware. The contract is fully executed. Eve now wants to disaffirm it. In most states, Eve
- must return only the app to EZ.
 - must return the smartphone with the app to EZ.
 - must return just the smartphone to EZ.
 - need do none of the above.
- _____ 7. Neal is adjudged mentally incompetent, and a guardian is appointed. Neal later signs an investment contract with Delfina. This contract is
- valid.
 - voidable.
 - void.
 - none of the above.
- _____ 8. Jeff, a fifteen-year-old minor, contracts with Online, Inc., for internet access services. Considering that Jeff is a minor, which of the following is true?
- Online can disaffirm the contract.
 - Jeff can disaffirm the contract.
 - Both a and b are true.
 - None of the above are true.

Answering More Legal Problems

1. After sipping half a small glass of wine at a meeting with Vineyard Valley Adventures, Esmé buys a discounted tour package. The time of the trip is approaching, and Vineyard's costs to provide the package have doubled. Vineyard tries to avoid honoring the agreement with Esmé on the ground that she was intoxicated when the agreement was made.

Can Vineyard avoid the contract on the basis of Esmé's lack of capacity? No. A contract entered into by an intoxicated person is _____ if the person was sufficiently intoxicated to lack mental capacity. But the transaction is _____ only at the option of the _____ person. Furthermore, if the person was intoxicated but understood the legal consequences, the contract is enforceable. Vineyard cannot avoid the contract.

2. Lucrezia is diagnosed with chronic, severe schizoaffective psychosis. Experiencing hallucinations, she

is hospitalized in a psychiatric ward and placed on medication. On a furlough a month later, she signs an agreement at the insistence of her spouse, Cesare. The agreement states that Cesare has exclusive rights to all of their finances and property, and Lucrezia has the sole duty to pay all of their debts. Cesare files for divorce.

Can Lucrezia avoid this agreement? Yes. When a mentally incompetent person not previously so adjudged by a court enters into a contract, the contract is _____ if that person lacks the capacity to comprehend its subject matter, nature, and consequences at the time of the _____. At the time of this agreement, Lucrezia had been diagnosed with schizoaffective psychosis. She was experiencing hallucinations, and she was on medication. Based on these facts, she lacked the mental capacity to manage her own affairs and to make decisions in her own best interest.

12 | The Legality of Agreements

Conflict Presented

Each of five coworkers receives a free lottery ticket from a customer. The coworkers orally agree to split the jackpot if one of the tickets turns out to be the winning one. When one of the tickets is a winner, its holder decides not to share the proceeds. The other coworkers file a suit to collect.

Q Is the agreement to split the lottery winnings among the coworkers enforceable?

Up to this point, we have discussed three of the requirements for a valid contract to exist—agreement (offer and acceptance), consideration, and contractual capacity. Legality is the fourth requirement.

12–1 Contracts Contrary to Statute

Statutes often set forth rules affecting the terms of contracts. Statutes may specify clauses that must be included in certain contracts, for instance, or may prohibit certain contracts based on their subject matter.

In this section, we examine several ways in which contracts may be contrary to statute and thus illegal.

12–1a Contracts to Commit a Crime

Any contract to commit a crime is contrary to statute and unenforceable. **Example 12.1** Lawrence Industrial Works contracts with Dusty's Transportation to take its industrial waste to a local landfill. The waste is considered hazardous, and federal environmental laws require that it be disposed of at a special facility in another city. This contract's purpose violates federal law. As a result, the contract is void and unenforceable from the outset. ■

Sometimes, the object or performance of a contract is rendered illegal by a statute after the parties have already entered into the contract. When this happens, the contract is discharged (terminated) by law.

12–1b Usury

Almost every state has a statute that sets the maximum rate of interest that can be charged for different types of transactions, including ordinary loans. A lender who makes a loan at an interest rate above the lawful maximum commits **usury**.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Identify contracts contrary to statute.
- 2 Describe an enforceable covenant not to compete.
- 3 Identify contracts contrary to public policy.
- 4 Explain the consequences of an illegal agreement.

Learning Outcome 1

Identify contracts contrary to statute.

usury
Charging an illegal rate of interest.

12–1c Gambling

Any scheme that involves the distribution of property by chance among persons who have paid valuable consideration for the opportunity to receive the property is gambling. Traditionally, the states considered gambling contracts illegal and thus void.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, five coworkers agreed to split the winnings from their individual lottery tickets, but a worker with a winning ticket later refused to share the proceeds.

A **Is the coworkers' agreement enforceable?** No. At first glance, this agreement might seem entirely legal. The contract here, however, is an exchange of promises to share winnings from the parties' individually owned lottery tickets in the uncertain event that one of the tickets wins. Consequently, the agreement is founded on a gambling consideration and is therefore void.

Today, many states allow (and regulate) certain forms of gambling, such as horse racing, video poker machines, and charity-sponsored bingo. In addition, nearly all states allow state-operated lotteries and gambling on Native American reservations. Even in states that permit certain types of gambling, though, courts often find that gambling contracts are illegal.

12–1d Licensing Statutes

All states require members of certain professions—including physicians, lawyers, real estate brokers, architects, electricians, and stockbrokers—to have licenses. Some licenses require extensive schooling and examinations, which indicate to the public that a special skill has been acquired. Others require only that the particular person be of good character and pay a fee.

Generally, licenses provide a means of regulating and taxing certain businesses and protecting the public against actions that could threaten the general welfare. **Example 12.2** Nita is a stockbroker in New York City. In New York—as in nearly all states—Nita must be licensed and file a bond (a promise obtained from a professional bonding company to pay a certain amount of money if Nita commits theft). The bond is filed with the state to protect the public from Nita's performing fraudulent stock transactions. ■

When a person enters into a contract with an unlicensed individual, the contract may still be enforceable depending on the nature of the licensing statute. If the licensing statute's purpose is to protect the public from unauthorized practitioners, a contract involving an unlicensed individual is illegal and unenforceable. Some states expressly provide that the lack of a license in certain occupations bars the enforcement of work-related contracts. If a state's statute does not expressly affirm the barring of a contract's enforceability, it is then necessary to look to the underlying purpose of the licensing requirements for a particular occupation.

12–1e Contracts in Restraint of Trade

Restraint of trade involves interfering with free competition. Contracts in restraint of trade usually adversely affect the public (which favors competition in the economy) and typically violate one or more federal or state statutes.

An exception is recognized when the restraint is reasonable and an integral part of a contract. Many such exceptions involve a type of restraint called a **covenant not to compete**.

covenant not to compete

A promise to refrain from competing in business with another.

Covenants Not to Compete and the Sale of an Ongoing Business Covenants not to compete are often contained in contracts concerning the sale of an ongoing business. Such agreements enable the seller to sell, and the purchaser to buy, the “goodwill” and “reputation” of an ongoing business.

Example 12.3 For more than twenty years, Ryan has been operating his specialty art supply store, Blue Moon Art Shop, in Ashville. Customers come from other cities to shop at Blue Moon. He decides to sell the business to Shanice, who includes a provision in the sales agreement stating that Ryan will not open an art store within one hundred miles of Ashville. Shanice is protecting her investment in Blue Moon’s goodwill and reputation with its loyal customers. ■

Learning Outcome 2

Describe an enforceable covenant not to compete.

Covenants Not to Compete in Employment Contracts Agreements not to compete can also be contained in employment contracts. Often, middle- and upper-level managers agree not to work for competitors or not to start a competing business for a specified period of time after terminating employment. Such agreements generally are legal so long as the specified period of time is not excessive in duration and the geographical restriction is reasonable. Basically, the restriction on competition must be reasonable—that is, no greater than necessary to protect a legitimate business interest.

Highlighting the Point



Brown Insurance Agency hires Tami to provide marketing analysis. Before her first day of work, Tami signs a covenant not to compete. This agreement prohibits Tami from working with a Brown competitor for ten years after she leaves her position with Brown. After six months, Tami leaves Brown for medical reasons. Three years later, she takes a job with The Langley Group, a Brown competitor. Brown sues Tami for breach of contract.

Is Brown’s covenant not to compete enforceable? No. Brown’s time requirement of waiting ten years after leaving a job with the company is unreasonable. Tami can work for The Langley Group and is not liable under the Brown covenant not to compete.

Covenants Not to Compete and Reformation On occasion, when a covenant not to compete is unreasonable in its essential terms, the court may reform the covenant, converting its terms into reasonable ones. This practice is called contract **reformation**. In such a situation, the court reasons that the parties intended their contract to contain reasonable terms and changes the contract so that this intent can be enforced. A court usually will reform a contract only when it is necessary to prevent undue burdens or hardships.

reformation

A court-ordered correction of a written contract to reflect the parties’ true intentions.

Highlighting the Point



Patricia is a master barber for The Shave. She agreed in her terms of employment that if she left The Shave, she would not work in the men’s grooming industry within a three-mile radius of any The Shave location for two years. She quit The Shave. She then opened a new men’s salon within two miles of The Shave. The Shave sued her. She

(Continues)

claimed that the geographic description in the noncompete clause was “unreasonable and uncertain.” A trial court limits the geographic scope of the provision to a three-mile radius of The Shave’s current location.

Did Patricia violate a legal covenant-not-to-compete restriction? Yes. If the court did not support The Shave’s noncompete provision, then The Shave would unreasonably lose customers to Patricia’s new business location.

12–2 Contracts Contrary to Public Policy

Learning Outcome 3

Identify contracts contrary to public policy.

Although contracts involve private parties, some are not enforceable because of the negative impact they would have on society. These contracts are said to be contrary to public policy.

12–2a Unconscionable Contracts or Clauses

Ordinarily, a court does not look at the fairness, or equity, of a contract. Persons are assumed to be reasonably intelligent, and the court does not come to their aid just because they have made a foolish bargain.

In certain circumstances, however, bargains are so oppressive that the courts relieve innocent parties of part or all of their duties. Such a bargain may be evidenced by an **unconscionable contract or clause**. (Unconscionable means grossly unethical or unfair.) An unconscionable contract is one in which the terms of the agreement are so unfair as to “shock the conscience” of the court.

unconscionable contract or clause

A contract or clause that is so unfair that it is rendered void.



Real Case

Sometimes legal waivers for inherently dangerous activities are deemed by courts to be unconscionable contracts. When minors are involved, the contracts are subject to different legal standards. In *Miller v. House of Boom Kentucky, LLC*, Kathy Miller signed a liability waiver that warned of the risk of serious injury, paralysis, or death when she bought a ticket for her eleven-year-old daughter to visit House of Boom, a trampoline park. Miller’s daughter broke her ankle in an accident involving another girl. Miller sued to recoup the costs of the injury. House of Boom relied on the signed liability waiver and moved for dismissal of the case.

Should the case be dismissed? No. The Supreme Court of Kentucky in *Miller v. House of Boom Kentucky, LLC*, allowed the case to proceed. It refused to dismiss it because it found that liability waivers between a parent and a for-profit entity involving the actions of a child are unenforceable. The court relied on two factors in making this decision. First, in Kentucky, parents have no right to enter into contracts on behalf of their children. Second, liability waivers in these cases are unacceptable in terms of public policy because they negate business’ incentives to “take reasonable precautions to protect the safety of minor children.”

—575 S.W.3d 656 (Ky: S. Ct, 2019)

Court decisions have distinguished between procedural and substantive unconscionability.

Procedural Unconscionability Procedural unconscionability has to do with how a term (a provision or clause) becomes part of a contract. It relates to factors bearing on a party's lack of knowledge or understanding of the contract.

Procedural unconscionability may involve print that is hard to see or notice or language that is hard to understand (legalese). It may also involve a lack of opportunity to read the contract or to ask questions about its meaning. Finally, it may reflect disparate, or unequal, bargaining power between the parties.

In addition, contracts entered into because of one party's vastly superior bargaining power may be deemed unconscionable. These situations usually involve an **adhesion contract**. This type of contract is drafted by one party (such as a dishonest retail dealer) and then presented to another (such as an uneducated consumer) on a take-it-or-leave-it basis.

adhesion contract

A contract in which the stronger party dictates the terms.

Highlighting the Point



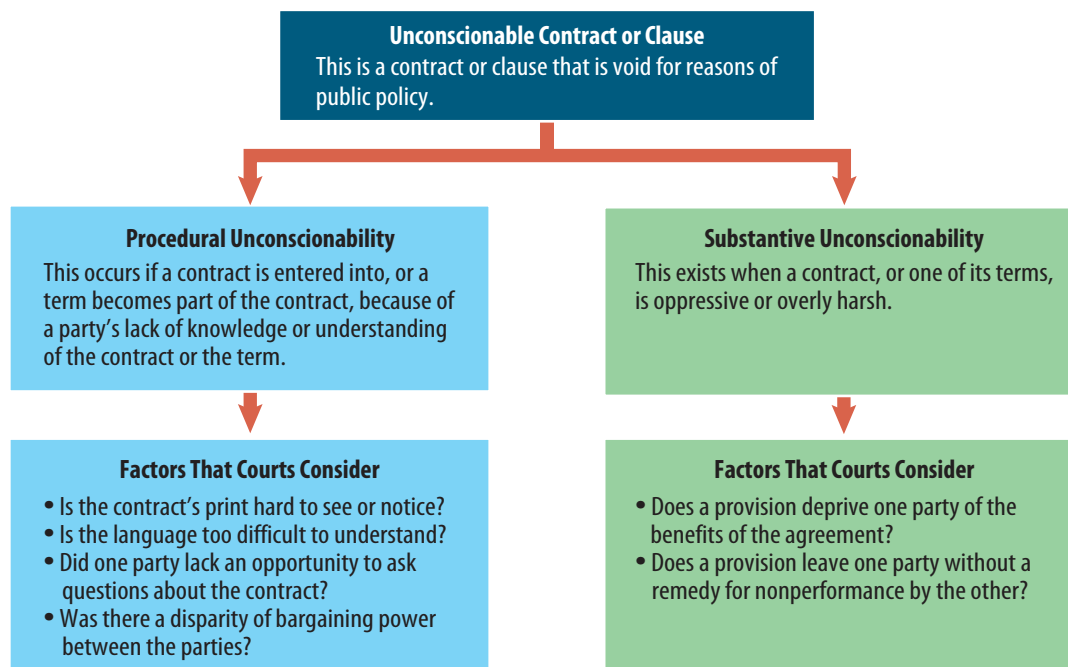
Gerald, a part-time janitor with a fourth-grade education, agrees to purchase a seventy-five-inch 8K Smart TV from USA Electronics for \$3,000. This TV usually sells for \$1,500. Gerald signs a two-year contract agreeing to make minimum monthly payments of \$100. After ten payments, Gerald refuses to pay more, and USA Electronics sues to collect the remaining balance.

Is Gerald required to pay the remaining balance owed to USA Electronics? No. This contract is considered unconscionable because of Gerald's lack of education (which may prevent him from fully understanding the terms of the contract) and the obvious disparity of bargaining power between the parties.

Substantive Unconscionability Substantive unconscionability describes contracts, or portions of contracts, that are oppressive or overly harsh. When determining substantive unconscionability, courts generally focus on provisions that deprive one party of the benefits of the agreement or leave that party without a remedy for nonperformance by the other party.

Procedural and substantive unconscionability are summarized in Exhibit 12.1.

Exhibit 12.1 Procedural and Substantive Unconscionability



exculpatory clause

A contract clause that releases a party from liability for wrongful acts.

12-2b Exculpatory Clauses

Closely related to the concept of unconscionability are **exculpatory clauses**. These are clauses that release a party from liability in the event of monetary or physical injury, no matter who is at fault. (Exculpatory means tending to avoid blame.) Indeed, some courts refer to such clauses in terms of unconscionability.

Exculpatory clauses are often held to be unenforceable. For instance, exculpatory clauses that relieve a party from liability for harm caused by simple negligence normally are unenforceable when they are asserted by an employer against an employee.



Highlighting the Point

Madison Manufacturing Company asks Juan, a new employee, to sign a contract that includes a clause absolving Madison from liability for harm caused “by accidents or injuries in the factory, or which may result from defective machinery or carelessness or misconduct of the employee or any other employee in service of the employer.”

If Juan is injured in a factory accident, can Madison use the clause to avoid responsibility? Probably not. The provision attempts to remove Madison’s potential liability for injuries occurring to employees, and it would ordinarily be held contrary to public policy.

12-3 The Effect of Illegality

Learning Outcome 4

Explain the consequences of an illegal agreement.

In general, an illegal contract is void. If a contract is executory (not yet fulfilled), neither party can enforce it. If it is executed (fully performed), there can be no recovery.

The major justification for this hands-off attitude is that a plaintiff who has broken the law by entering into an illegal bargain should not be able to get help from the courts. Another justification is the hoped-for deterrent effect of this general rule. A plaintiff who suffers a loss because of an illegal bargain should presumably be deterred from entering into similar illegal bargains.

Some persons are excluded from the general rule that neither party to an illegal bargain can sue for breach or recover for performance rendered. These exceptions involve (1) justifiable ignorance of the facts, (2) members of protected classes, and (3) withdrawal from an illegal agreement.

12-3a Justifiable Ignorance of the Facts

Sometimes, one of the parties to a contract has no reason to know that the contract is illegal and thus is relatively innocent. This party can often obtain restitution (recovery of benefits conferred) in a partially executed contract. The courts do not enforce the contract but do allow the parties to return to their original positions. It is also possible for an innocent party who has fully performed under the contract to enforce the contract against the guilty party.



Highlighting the Point

Debbie contracts with Tucker to purchase ten crates of goods that legally cannot be sold or shipped. Tucker hires Silverstone Trucking Company to deliver the shipment to Debbie. Tucker agrees to pay Silverstone the normal shipping fee of \$500. He does not,

however, tell Silverstone that the goods in the crates are illegal to sell or ship. Silverstone delivers the goods as agreed, but Tucker fails to pay the company.

Can Silverstone recover the \$500 shipping fee from Tucker? Yes. Although the law specifies that the shipment and sale of the goods are illegal, Silverstone, being an innocent party, can legally collect the \$500 from Tucker.

12–3b Members of Protected Classes

When a statute protects a certain class of people, a member of that class can enforce a contract in violation of the statute even though the other party cannot. **Example 12.4** Valinda, a commercial airline pilot, is prohibited by statute from working more than twenty hours in a two-day period. Valinda works twenty-five hours in two days. As a member of a protected class, she can recover (get paid) for those extra hours of service, despite the illegality of the contract. ■

Most states also have statutes regulating the sale of insurance. If an insurance company violates a statute when selling insurance, the purchaser can nevertheless enforce the policy and recover from the insurer.

12–3c Withdrawal from an Illegal Agreement

If the illegal part of a bargain has not yet been performed, the party tendering performance can withdraw from the bargain and recover the performance or its value.

Highlighting the Point



Martha and Francisco decide to wager (illegally) on the outcome of a boxing match. Each deposits money with a stakeholder, who agrees to pay the winner of the bet. Before the boxing match is held, Francisco changes his mind about the bet.

Can Francisco get his money back? Yes. At this point, each party has performed part of the agreement, but the illegal part of the agreement will not occur until the money is paid to the winner. Before such payment occurs, either party is entitled to withdraw from the agreement by giving notice to the stakeholder.

Chapter Summary—The Legality of Agreements

Learning Outcome 1: Identify contracts contrary to statute.

Any contract to commit a crime is contrary to statute. It is also illegal to make a loan at an interest rate that exceeds the maximum rate established by state law. Gambling contracts that violate state statutes are illegal. A contract entered into by a person who does not have a license, when one is required by statute, is not enforceable if the underlying purpose of the statute is to protect the public from unlicensed practitioners. Contracts in restraint of trade are generally prohibited by statute unless the restraint is reasonable.

Learning Outcome 2: Describe an enforceable covenant not to compete.

A covenant not to compete is enforceable if its terms are reasonable as to time and area of restraint. Covenants not to compete are often contained in contracts for the sale of an ongoing business and in certain employment contracts.

Learning Outcome 3: Identify contracts contrary to public policy.

Contracts that have a negative impact on society are contrary to public policy. A contract or clause that is so unfair to one party can be deemed unconscionable by a court and will be unenforceable.

Learning Outcome 4: Explain the consequences of an illegal agreement.

An illegal contract is void, and the courts will aid neither party when both parties are equally at fault. If the contract is executory, neither party can enforce it. If it is executed, neither party can recover for its breach.

Straight to the Point

1. How do statutes affect the terms of contracts? (See Learning Outcome 1.)
2. What is the purpose of a business license? (See Learning Outcome 1.)
3. When a person contracts with an unlicensed individual, in what circumstance is the contract enforceable? (See Learning Outcome 1.)
4. When is a contract in restraint of trade enforceable? (See Learning Outcome 1.)
5. What is the definition of unconscionable? (See Learning Outcome 3.)
6. In what situation can a party to an illegal contract enforce it against the other party? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Diane bets Tex \$1,000 that the Green Bay Packers will win the Super Bowl. A state law prohibits gambling. Do Diane and Tex have an enforceable contract? Explain. (See Learning Outcome 1.)
2. Potomac Airlines prints on the backs of its tickets that it is not liable for any injury to a passenger caused by Potomac's negligence. Haruto buys a ticket and boards the plane. On takeoff, the plane crashes, and Haruto is injured. If the cause of the accident is found to be Potomac's negligence, can Potomac use the clause as a defense to liability? Why or why not? (See Learning Outcome 3.)

Real Law

12-1. Unconscionable Contracts. Lianna Saribekyan placed diamonds, gold, and other collectibles in her safe deposit box at the Bank of America's (BANA's) Universal City, California, branch. When this branch was slated for closure, bank employees drilled open her deposit box and placed its contents in unsecured storage for several days. Millions of dollars' worth of items went missing, including four bags of diamonds inventoried by BANA as "beads" and a container full of gold that had been replaced with pennies. At trial, the court found BANA liable but limited its compensation to \$2,460 because the bank's Safety Deposit Rules and Regulations limited damages for negligence to 10 times the safety deposit box's annual rental fee. Should an appellate court reverse the trial court's decision? Why or why not?

[*Saribekyan v. Bank of America, N.A.*, 2020 WL 38676 (Second Dist. Div. 3 Cal., 2020)] (See Learning Outcome 3.)

12-2. Exculpatory Clauses. Sue Ann Apolinar hired a guide through Arkansas Valley Adventures, LLC, for a rafting excursion on the Arkansas River. At the outfitter's office, Apolinar signed a release that detailed potential hazards and risks, including overturning, unpredictable currents, obstacles in the water, and drowning. The release clearly stated that her signature discharged Arkansas Valley from liability for all claims arising in connection with the trip. On the river, while attempting to maneuver around a rapid, the raft capsized. The current swept Apolinar into a logjam where, despite efforts to save her, she drowned. Her son, Jesus Espinoza, Jr., filed a lawsuit in a federal district court

against the rafting company, alleging negligence. What are the arguments for and against enforcing the release that Apolinar signed? Discuss. [*Espinoza v. Arkansas Valley Adventures, LLC*, 809 F.3d 1150 (10th Cir. 2016)] (See Learning Outcome 3.)

12-3. Adhesion Contracts. David Desgro hired Paul Pack to inspect a house that Desgro wanted to buy. Pack had Desgro sign a contract that included a twelve-month limit for claims

based on the agreement. Pack reported that the house had no major problems, but after Desgro bought it, he discovered issues with the plumbing, insulation, heat pump, and floor support. Thirteen months after the inspection, Desgro filed a suit in a Tennessee state court against Pack. Was Desgro's complaint filed too late, or was the contract's twelve-month limit unenforceable? Discuss. [*Desgro v. Pack*, 2013 WL 84899 (Tenn.Ct.App. 2013)] (See Learning Outcome 3.)

Ethical Questions

12-4. Gambling. How can states enforce gambling laws in the age of the internet? (See Learning Outcome 1.)

12-5. Covenant Not to Compete. Surya Challa worked for TransUnion Risk and Alternative Data Solutions, Inc. (TRADS), a data fusion company. Under a covenant not to compete, Challa agreed to not work for any TRADS competitor for one year after the end of his employment. Challa quit his job at TRADS, and without informing TRADS, he went to work for IDI, Inc., a competitor. TRADS filed a lawsuit in a federal district against him, alleging breach of

their agreement. TRADS argued that Challa's "presence at IDI created an irreparable injury." Challa testified that he worked in a different capacity at IDI, relying on publicly available information and skills that he developed before working for TRADS. He was also careful not to reveal TRADS's proprietary information. From an ethical perspective, is Challa effectively avoiding a conflict of interest? Discuss. [*TransUnion Risk and Alternative Data Solutions, Inc. v. Surya Challa*, 2017 WL 117128 (11th Cir. 2017)] (See Learning Outcome 1.)

Chapter 12—Work Set

True-False Questions

- _____ 1. An exculpatory clause may or may not be enforced.
- _____ 2. An adhesion contract will never be deemed unconscionable.
- _____ 3. An illegal contract is valid unless it is executory.
- _____ 4. If the purpose of a licensing statute is to protect the public from unlicensed practitioners, a contract entered into with an unlicensed practitioner is unenforceable.
- _____ 5. Covenants not to compete are never enforceable.
- _____ 6. Usury is charging an illegal rate of interest.
- _____ 7. Even in states that permit certain types of gambling, courts often find that gambling contracts are illegal.
- _____ 8. All states have statutes that regulate gambling.

Multiple-Choice Questions

- _____ 1. At the start of the football season, Bob and Murray make a bet about the results of the next Super Bowl. Adam holds their money. Just as the divisional playoffs are beginning, Bob changes his mind and asks for his money back. Gambling on sports events is illegal in their state. Can Bob be held to the bet?
 - a. Yes. It would be unconscionable to let Bob back out so late in the season.
 - b. Yes. No party to the contract is innocent, and thus no party can withdraw.
 - c. No. If an illegal agreement is still executory, either party can withdraw.
 - d. No. The only party who can be held to the bet is Murray.
- _____ 2. Sukarno sells his business to Dan and, as part of the agreement, promises not to engage in a business of the same kind within thirty miles for three years. Competition within thirty miles would hurt Dan's business. Sukarno's promise
 - a. violates public policy because it is part of the sale of a business.
 - b. violates public policy because it unreasonably restrains Sukarno from competing.
 - c. does not violate public policy because it is no broader than necessary.
 - d. does none of the above.
- _____ 3. Luke practices law without an attorney's license. The state requires a license to protect the public from unauthorized practitioners. Clark hires Luke to handle a legal matter. Luke cannot enforce their contract because
 - a. it is illegal.
 - b. Luke has no contractual capacity.
 - c. Luke did not give consideration.
 - d. none of the above.
- _____ 4. Antonella contracts to buy Kim's business. Kim agrees not to compete with Antonella for one year in the same county. Six months later, Kim opens a competing business six blocks away. Antonella
 - a. cannot enforce the contract because it is unconscionable.
 - b. cannot enforce the contract because it is a restraint of trade.
 - c. can enforce the contract because all covenants not to compete are valid.
 - d. can enforce the contract because it is reasonable in scope and duration.

- _____ 5. Sam signs an employment contract that contains a clause absolving the employer of any liability if Sam is injured on the job. If Sam is injured on the job due to the employer's negligence, the clause will
- protect the employer from liability.
 - likely not protect the employer from liability.
 - likely be held unconscionable.
 - do both b and c.
- _____ 6. Fred signs a covenant not to compete with his employer, General Sales Corporation. This covenant is enforceable if it
- is not connected with the sale of an ongoing business.
 - is reasonable in terms of geographic area and time.
 - is supported by consideration.
 - requires both parties to obtain business licenses.
- _____ 7. Ann contracts with Gamal, a financial planner, who is required by the state to have a license. Gamal does not have a license. Their contract is enforceable if
- the purpose of the statute is to protect the public from unlicensed practitioners.
 - the purpose of the statute is to raise government revenue.
 - Gamal does not know that he is required to have a license.
 - Ann does not know that Gamal is required to have a license.
- _____ 8. A contract that is full of hard-to-read print and hard-to-understand language and that is presented to someone who is not given an opportunity to read it is
- always unenforceable.
 - always enforceable.
 - unenforceable under some circumstances.
 - void.
- _____ 9. In an exculpatory clause, which of the following statements is true?
- One party agrees that the other party is not mentally incompetent.
 - One party releases the other party from liability in the event of monetary or physical injury, no matter who is at fault.
 - One party is able to sue the other party based on the clear fault of the other party.
 - Both parties agree to use arbitration, not adjudication, to settle any disputes arising under the contract containing the clause.

Answering More Legal Problems

1. To protect professional boxers, California law requires that their managers be licensed by the state. José, who was not licensed by the state, assumed the management of Marco, a professional boxer. José negotiated a contract for Marco with Everlast Promotions, Inc. José helped Marco resolve three lawsuits and unrelated tax problems so that he could continue boxing. When Marco stopped talking to José, the latter filed a suit in a California court.
2. Roberto, who did not speak or read English, visited Dart Dodge, a car dealership. Aware that Roberto was monolingual, Dart's staff transacted a deal in Spanish. They explained the English-language contract, except for one clause. This clause limited the buyer's right to seek damages in court to less than \$5,000 but did not limit Dart's right to ask for damages. Roberto bought a Dodge Ram truck and signed the contract.

Is this management contract enforceable? No. A contract with an unlicensed practitioner is not enforceable if the underlying purpose of the state's licensing statute is to protect the _____ from unauthorized _____. Here, the manager of a professional boxer must be licensed by the state. The purpose is to protect boxers. The state did not license José as a boxing manager, yet he conducted himself as the manager of a professional boxer. Because he acted without a _____, the alleged contract with Marco is _____.

Is the damages clause in this contract enforceable? No. The clause is unconscionable. _____ unconscionability concerns the manner in which a contract is entered into. _____ unconscionability can occur when a contract unfairly limits one party's remedy for the other's breach. Having undertaken to explain the contract in Spanish, Dart's staff was obliged to do so accurately so Roberto would have a meaningful opportunity to bargain. The failure to do so made the contract _____ unconscionable. The unfair limit to the buyer's damages was _____ unconscionable.

13 | Voluntary Consent

Conflict Presented

Lucinda negotiates with Maurice to buy a car wash that is not currently operating. Maurice tells Lucinda that the property has been winterized, which he guarantees later in an e-mail. After the sale, Lucinda enters the building and clearly sees that all the equipment is frozen. Lucinda files a lawsuit against Maurice, claiming fraud.

Q Did Lucinda reasonably rely on Maurice's representation that the car wash had been winterized?

An otherwise valid contract may still be unenforceable if the parties have not genuinely agreed to its terms. This lack of **voluntary consent** can be used as a defense to the contract's enforceability. Voluntary consent may be lacking if one or more of the parties is mistaken about an important fact concerning the subject matter of the contract. Parties also lack voluntary consent if they have entered into a contract as a result of fraudulent misrepresentation, undue influence, or duress.

13-1 Mistakes

We all make mistakes, and it is not surprising that mistakes are made when contracts are formed. In certain circumstances, contract law allows a contract to be avoided on the basis of mistake. It is important to distinguish between mistakes of fact and mistakes of value, however. Only a mistake of fact makes a contract voidable.

13-1a Mistakes of Fact

Mistakes of fact can occur in two forms—unilateral and bilateral (mutual). These two types of mistakes are illustrated in Exhibit 13.1. In either instance, the mistake must involve a material fact. A material fact is a fact that is important and central to the subject matter of the contract, such as the identity of the parties.

Unilateral Mistakes A **unilateral mistake** is made by only one of the parties. In general, a unilateral mistake does not give the mistaken party any right to avoid the contract. In other words, the contract normally is enforceable against the mistaken party.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 State the difference between mistakes of fact and of value.
- 2 List the elements of fraud.
- 3 Contrast misrepresentations of a material fact and of law.
- 4 Recognize the difference between undue influence and duress.

voluntary consent

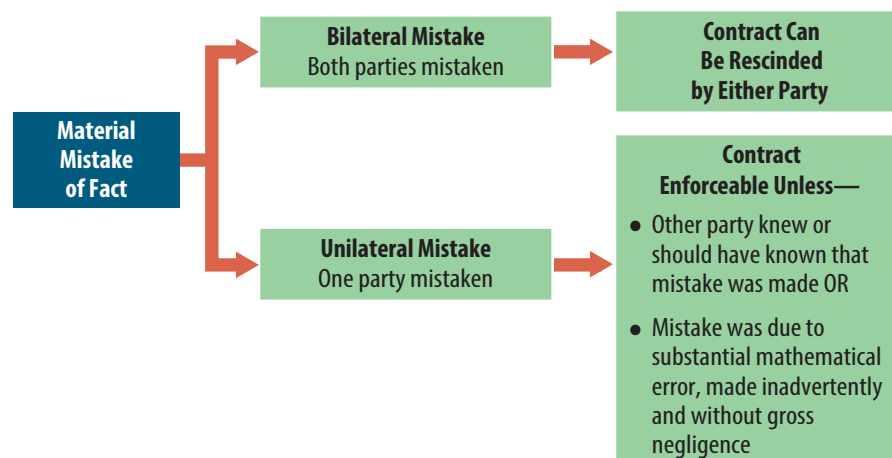
Knowledge of and genuine assent to the terms of a contract.

Learning Outcome 1

State the difference between mistakes of fact and of value.

unilateral mistake

A mistake that occurs when one party to a contract is mistaken about a material fact.

Exhibit 13.1 Mistakes of Fact

Example 13.1 Elena intends to sell her personal jet ski for \$6,500. When she learns that Derek is interested, she sends him a text offering to sell the jet ski to him. When writing the text, she mistakenly keys in the price of \$5,600. Derek immediately accepts her offer. Elena has made a unilateral mistake and is bound by the contract to sell the jet ski to Derek for \$5,600. ■

There are at least two exceptions to this rule. The contract may not be enforceable if:

1. The other party to the contract knows or should have known that a mistake was made.
2. The error was due to a substantial mathematical mistake in addition, subtraction, division, or multiplication and was made accidentally and without intentional carelessness. If, for instance, a contractor's bid was significantly low because the contractor made a mistake when adding up the total estimated costs, any contract resulting from the bid normally may be rescinded.

Of course, in both situations the mistake must still involve some material fact.

bilateral mistake

A mistake that occurs when both parties are mistaken about a material fact.

Bilateral (Mutual) Mistakes When both parties are mistaken about the same material fact, a **bilateral mistake** has occurred. In this situation, the contract can be rescinded by either party, though it is usually the adversely affected party that takes that step. That is to say, usually the contract is voidable by the adversely affected party. Again, the mistake must be about a material fact.

One type of bilateral mistake can occur when a word or term in a contract is subject to more than one reasonable interpretation. In that situation, if the parties to the contract attach materially different meanings to the term, their mutual misunderstanding may allow the contract to be rescinded.

Contract May Be Reformed Rather than rescind a contract flawed by a bilateral mistake, judges often prefer to reform the agreement. Reformation allows a court, using its powers of equity, to restore the original goals of the parties who entered into the contract.

**Real Case**

Jason Allen was injured in a work-related automobile accident. His employer had workers' compensation insurance with Accident Fund Insurance Company of America. After a series of disputes and negotiations, Allen and Accident Fund entered into a voluntary

payment agreement (VPA) under which the insurance company consented to pay Allen \$264.53 per week for 54.2 weeks. Neither side noticed, however, that the arithmetic of the VPA was wrong. Accident Fund should have been paying Allen the amount agreed upon per week for 131.7 weeks, rather than for only 54.2 weeks.

Should the court simply throw out the agreement? No. In *Allen v. Charlevoix Abstract & Engineering Company*, a Michigan appellate court found that the faulty calculations had escaped the notice of both parties. To correct this bilateral mistake, the court ordered that the VPA be reformed with the correct figures, reflecting the intentions of Allen and Accident Fund at the time of their agreement.

—326 Mich.App. 658 (Ct. of Appeals, Mich.)

13–1b Mistakes of Value

If a mistake concerns the future market value or quality of the object of the contract, the mistake is one of value, and the contract normally is enforceable. Mistakes of value can be bilateral or unilateral. Either way, they do not serve as a basis for avoiding a contract.

Example 13.2 Carlos buys a violin from Beverly for \$250. Although the violin is very old, neither party believes that it is valuable. Later, however, an antiques dealer informs Carlos and Beverly that the violin is rare and worth thousands of dollars. A bilateral mistake has been made, but it is a mistake of value rather than a mistake of fact. Therefore, Beverly cannot cancel the contract. ■

The reason that mistakes of value or quality have no legal significance is that value is variable. Depending on the time, place, and other factors, the same item may be worth considerably different amounts.

When parties form a contract, their agreement establishes the value of the object of their transaction—for the moment. Both parties are considered to have assumed the risk that the value will change in the future or prove to be different from what they thought. Without this rule, almost any parties who did not receive what they considered a fair bargain could argue mistake.

13–2 Fraudulent Misrepresentation

Although fraudulent misrepresentation is a tort, the presence of fraud also affects the authenticity of the innocent party's consent to the contract. When an innocent party consents to a contract with fraudulent terms, the contract usually can be avoided because the innocent party has not voluntarily consented to the terms. Normally, the innocent party can either cancel the contract or enforce it and seek damages.

Typically, fraud has three elements:

1. A misrepresentation of a material fact must occur.
2. There must be an intent to deceive.
3. The innocent party must justifiably rely on the misrepresentation.

To recover damages, the innocent party must also suffer an injury.

Learning Outcome 2

List the elements of fraud.

13–2a Misrepresentation Has Occurred

The first element of proving fraud is to show that misrepresentation of a material fact has occurred. This misrepresentation can occur through words or conduct.

Misrepresentation by Words A misrepresentation of a material fact can be expressly made through a person's words or writings. **Example 13.3** Waylan, an art gallery owner, clearly tells Eva, a wealthy customer, that a painting is a Renoir. Waylan knows that the painting is a forgery, however. Waylan's statement to Eva regarding the fake Renoir painting is an express misrepresentation. If Eva buys the painting and later discovers the fraud, she can prove misrepresentation of a material fact. ■

A statement of opinion cannot be used in a claim of fraud. A fact is objective and verifiable, whereas an opinion usually is subject to debate. **Example 13.4** Oro, a financial adviser, says to Tanya, "The investment in Silver Ridge Technologies will be worth twice as much next year." Oro is only stating an opinion. His statement cannot be verified and is only speculation. ■

The distinction between "seller's talk" and facts allows sellers to tout their products and services without being liable for fraud. Contracting parties should recognize this difference and should not rely on any statement of opinion.

Misrepresentation by Conduct A misrepresentation need not be expressly made through the words or writings of another. It can also occur by conduct. **Example 13.5** Tom contracts to buy a horse named Zorro from Dolores. By showing Tom health records of another horse and injecting Zorro with pain medication, Dolores leads Tom to believe that Zorro is fit to be ridden in jumping competitions. In reality, Zorro suffers from a medical condition that makes him unsuitable for competition. Wrongfully concealing Zorro's condition is a misrepresentation by conduct. ■

Misrepresentation by conduct can also involve denial. **Example 13.6** Tom asks Dolores whether Zorro has visited a veterinarian recently. Dolores says no. Dolores knows her statement is untrue. Her denial is another misrepresentation by conduct. ■

Misrepresentation of Law Misrepresentation of law does not ordinarily entitle the party to avoid a contract. People are assumed to know the law.

Learning Outcome 3

Contrast misrepresentations of a material fact and of law.



Highlighting the Point

Mercedes has a parcel of property that she is trying to sell to Fadely. Mercedes knows that a local ordinance prohibits building anything higher than three stories on the property. Nonetheless, she tells Fadely, "You can build an office building fifty stories high if you want to." Fadely buys the land and later discovers that Mercedes's statement is false.

Can Fadely avoid the contract? No. Fadely normally cannot avoid the contract. Under the common law, people are assumed to know easily researched state and local laws. Today, these laws are readily available on the internet.

In general, a person should not rely on a nonlawyer's statement about a point of law. Exceptions to this rule occur when the misrepresenting party is in a profession known to require greater knowledge of the law than the average citizen possesses.

Misrepresentation by Silence Ordinarily, neither party to a contract has a duty to come forward and disclose facts. Generally, a contract will not be set aside because certain pertinent information is not volunteered. **Example 13.7** Norah does

not have to tell potential buyers that a car she is selling has been in an accident unless they ask. ■

If a seller knows of a serious potential problem that the buyer cannot reasonably be expected to discover, however, the seller may have a duty to speak. **Example 13.8** River City is accepting bids for a new sewer system. City officials know that subsoil conditions in the area will make it very expensive to construct the system. If River City fails to disclose the conditions to bidders, the city is guilty of fraud. ■

13–2b Intent to Deceive

The second element of fraud is knowledge on the part of the misrepresenting party that facts have been falsely represented. This element, called **scienter** (pronounced sy-en-ter) or “guilty knowledge,” signifies that there was an intent to deceive.

Scienter clearly exists if a party knows that a fact is not as stated. **Example 13.9** Robert applies for a position as a business law professor. He says that he has been a corporate president for several years and has taught business law at another college. Neither claim is true. After he is hired, his probation officer alerts the school to his criminal history. The school immediately fires him. Robert sues for breach of his employment contract. Robert is unlikely to win his suit because he clearly engaged in an attempt to deceive the college. Furthermore, the college justifiably relied on his misrepresentations. ■

Scienter also exists if a party makes a statement that they believe not to be true or makes a statement recklessly, without regard to whether it is true or false. Finally, this element is met if a party says or implies that a statement is made on some basis, such as personal knowledge or personal investigation, when it is not.

scienter

A party's knowledge that material facts have been falsely represented with an intent to deceive.

Innocent Misrepresentation If someone makes a statement that they believe to be true and actually represents material facts, that person is guilty of **innocent misrepresentation**. When an innocent misrepresentation occurs, the aggrieved party can rescind the contract, but usually cannot seek damages. **Example 13.10** Jeanine applies for no-fault automobile insurance with State Farm in which she declares that she has not received any traffic citations for three years. State Farm accepts the application and Jeanine pays the premium. Soon thereafter, State Farm discovers that twenty months earlier, Jeanine had been cited for operating a vehicle while impaired (drunk driving). Even if Jeanine's misrepresentation on the application is an innocent mistake, State Farm can void the insurance contract and return the premium because the misrepresentation is material. ■

innocent misrepresentation

A misrepresentation that occurs when a person makes a false statement of fact that they believe is true. They are guilty of an innocent misrepresentation but not fraud.

13–2c Reliance on the Misrepresentation

The third element of fraud is reasonably justifiable reliance on the misrepresentation of fact. The deceived party must have a justifiable reason for relying on the misrepresentation. The misrepresentation must also be an important factor (but not necessarily the sole factor) in inducing the party to enter into the contract.

Reliance is not justified if the innocent party knows the true facts or relies on obviously extravagant statements. If the defects in a piece of property are obvious, the buyer cannot justifiably rely on the seller's misrepresentations concerning those defects. **Example 13.11** Dylan, a used car salesman, tells Shelby, “This old Chevy Trailblazer SUV will get more than seventy miles per gallon.” Shelby cannot justifiably rely on Dylan's statement, because the statement is obviously not accurate. ■

If the defects are latent (hidden), however, the buyer is justified in relying on the seller's statements.

Conflict Resolved

In the Conflict Presented feature at the beginning of the chapter, Lucinda and Maurice negotiate the sale of a car wash. Maurice tells Lucinda that the car wash has been winterized and guarantees this fact in an e-mail. After the sale, Lucinda learns that the property has not been properly winterized. She files a lawsuit against Maurice, claiming fraud.

A Did Lucinda reasonably rely on Maurice's representation that the car wash had been winterized? Yes. One element of fraud is a person's reasonably justifiable reliance on a misrepresentation by another. Here, Lucinda's reliance on Maurice's misrepresentation about the winterizing of the car wash was reasonable. Maurice told her personally that the car wash was safe from freezing temperatures and later repeated that guarantee in an e-mail.



Highlighting the Point

Michael is the president of a small family company called North Country Industries. Michael induces Reyna to invest in the company by saying, "We will be launching a new genetically modified corn seed in the spring that will increase our profits substantially." Michael's statement is false, however. The company has no modified corn seed in production to help increase its profits. Reyna invests \$50,000 in North Country based on Michael's statement. Later, North Country is forced into bankruptcy, and Reyna loses her entire investment. To recover her losses, Reyna sues Michael, claiming fraud.

Can Reyna claim that she justifiably relied on Michael's misrepresentation of North Country to make her investment decision? Yes. Reyna, as the innocent party, does not know the status of the corn seed production at the company. In addition, she has no way to discover this information. Reyna may proceed with her claim of fraud against Michael.

13-2d Injury to the Innocent Party

For a person to recover damages based on fraud, proof of an injury is required. The measure of damages is ordinarily equal to the property's value had it been delivered as represented, less the actual price paid for the property.

In actions based on fraud, courts also often award punitive damages. These damages are often used to punish a defendant or set an example for similar wrongdoers.

13-3 Undue Influence and Duress

Learning Outcome 4

Recognize the difference between undue influence and duress.

undue influence

Persuasion that induces a person to act according to the will of the dominating party.

A contract lacks voluntary consent if undue influence or duress is present. If a contract lacks voluntary consent, it is voidable.

13-3a Undue Influence

Undue influence arises from relationships in which one party can greatly influence another party, thus overcoming that party's free will. Minors and elderly people are often under the influence of guardians. Undue influence also can arise from a

number of confidential relationships or relationships founded on trust. Examples include attorney-client and physician-patient relationships.

Highlighting the Point



Susan has been Erel's in-home caregiver for several years. Erel is nearly eighty years old and in frail health. One afternoon, Susan convinces Erel to review his will. Together, they rework the will so that Susan will receive a large portion of Erel's estate. Susan convinces Erel that she deserves the money more than Erel's two sons. Additionally, Susan implies that she will quit her caregiver job if she cannot be a beneficiary of Erel's will.

Are Susan's actions considered undue influence? Yes. Susan has used undue influence to make Erel act in a way that he would not have done ordinarily. Erel's two sons can claim the revised will agreement is unenforceable because of Susan's excessive undue influence.

13-3b Duress

Consent to the terms of a contract is not voluntary if one of the parties is forced into the agreement. Recognizing this, the courts allow that party to rescind the contract. Forcing a party to enter into a contract under the fear of threats is legally defined as **duress**. The party on whom the duress is exerted can choose to carry out the contract or to avoid the entire transaction. (The wronged party usually has this choice when consent is not voluntary.)

duress

Threats made to force a party to enter into a contract.

Chapter Summary—Voluntary Consent

Learning Outcome 1: State the difference between mistakes of fact and of value.

A mistake of fact involves a material fact—one that is important to the subject matter of the contract. Only a mistake of fact can give a party the right to avoid a contract. A mistake of value concerns the future market value or quality of the object of the contract. This type of mistake normally does not serve as a basis for avoiding a contract.

Learning Outcome 2: List the elements of fraud.

The elements of fraud are (1) a misrepresentation of a material fact, (2) an intent to deceive, and (3) an innocent party's reliance on the misrepresentation. To recover damages, the innocent party must suffer an injury.

Learning Outcome 3: Contrast misrepresentations of a material fact and of law.

A material fact is objective and verifiable. A misrepresentation of a material fact can serve as the basis to avoid a contract. A misrepresentation of law usually does not entitle a party to avoid a contract. People are assumed to know the law.

Learning Outcome 4: Recognize the difference between undue influence and duress.

Undue influence arises from relationships in which one party can greatly influence another party, thus overcoming that party's free will. Duress involves forcing a party to enter into a contract under the fear of threats. This pressure causes a party to do what they would not do otherwise. A contract entered into under undue influence or duress is voidable due to a lack of voluntary consent.

Straight to the Point

1. What is the difference between a unilateral mistake and a bilateral mistake? (See Learning Outcome 1.)
2. How does the presence of fraud affect an innocent party's consent to a contract? (See Learning Outcome 2.)
3. When can a contract be set aside because the seller has not volunteered certain pertinent information? (See Learning Outcome 2.)
4. What is the definition of *scienter*? (See Learning Outcome 2.)
5. When is a party's reliance on another's misrepresentation not justifiable? (See Learning Outcome 2.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Brad, an accountant, files Dina's tax returns. When the Internal Revenue Service assesses a large tax against Dina, she retains Brad to contest the assessment. The day before the deadline for replying to the IRS, Brad tells Dina that unless she pays a higher fee, he will withdraw. If Dina agrees to pay, is the contract enforceable? Explain your answer. (See Learning Outcome 4.)
2. In selling a house, Matt tells Ann that the wiring, fixtures, and appliances are of a certain quality. Matt knows nothing about the quality, but it is not as specified. Ann buys the house. On learning the true quality, Ann confronts Matt. He says he wasn't trying to fool her, he was only trying to make a sale. Can she rescind the deal? Why or why not? (See Learning Outcome 2.)

Real Law

13-1. Fraudulent Misrepresentation. Chris and Erika Shannon purchased a house for \$275,000. After they took possession, there was significant water intrusion in the basement. Similar water intrusions occurred three more times. The Shannons discovered that there had been extensive water damage prior to their purchasing the house. They filed suit against the sellers for, among other things, fraudulent misrepresentation. The prior owners signed a disclosure document before selling the house in which they indicated that there had only been a sump pump problem. A neighbor, however, had witnessed the prior owners draining water from the basement on at least four different occasions, each time occurring after a heavy rainfall. At trial, an Ohio court granted summary judgment in favor of the defendants. The Shannons appealed. Should an appellate court reverse the trial court's granting of summary judgment? Why or why not? [*Shannon v. Fischer*, 2020-Ohio-5567 (Ct. of App., 12th Appellate Dist. of Ohio, 2020)] (See Learning Outcome 2.)

13-2. Fraudulent Misrepresentation. Vianna Stibal owns and operates the ThetaHealing Institute of Knowledge (THIK) in Idaho Falls, Idaho. ThetaHealing is Stibal's "self-discovered" healing method. To induce people to take THIK classes, Stibal claimed that she had been diagnosed with cancer and had cured herself using

ThetaHealing. This was false, and Stibal knew it. Her medical records did not confirm a cancer diagnosis. Believing Stibal's claim, Kara Alexander traveled from New York to Idaho to pay for, and attend, classes in ThetaHealing. Later, Alexander filed a lawsuit in a state court against Stibal, alleging fraud. What are the elements of a cause of action for fraudulent misrepresentation? Do the facts in this situation meet these requirements? Discuss your answer. [*Alexander v. Stibal*, 368 P.3d 630 (2016)] (See Learning Outcome 2.)

13-3. Fraudulent Misrepresentation. Joy Pervis and Brenda Pauley worked together as talent agents in Georgia. When Pervis "discovered" actress Dakota Fanning, Pervis sent Fanning's audition tape to Cindy Osbrink, a talent agent in California. Osbrink agreed to represent Fanning in California and to pay 3 percent of Osbrink's commissions to Pervis and Pauley, who agreed to split the payments equally. Six years later, Pervis told Pauley that their agreement with Osbrink had expired and there would be no more payments. Nevertheless, Pervis continued to receive payments from Osbrink. Each time Pauley asked about commissions, however, Pervis replied that she was not receiving any. Do these facts evidence fraud? Explain. [*In re Pervis*, 512 Bankr. 348 (N.D.Ga. 2014)] (See Learning Outcome 2.)

Ethical Questions

13–4. Fraudulent Misrepresentation. Is honesty an implicit duty of every employee? Discuss. (See Learning Outcome 2.)

13–5. Fraudulent Misrepresentation. Data Consulting Group contracted with Weston Medsurg Center—a health care facility in North Carolina—to install, maintain, and manage Weston’s computers and software. At about the same time, Ginger Blackwood began to work for Weston as a medical billing and coding specialist. Soon, she was submitting false time reports and converting Weston documents and data to

her own purposes. On her request, Data’s manager, Nasko Dinev, removed evidence of her actions from her work computer. What should Weston do when it learns of these activities? With respect to this situation, what is the firm’s primary ethical dilemma? Suppose that despite Dinev’s efforts, Weston is later able to recover the data that was removed from Blackwood’s work computer. How might this affect Weston’s choices? Discuss. [*Weston Medsurg Center v. Blackwood*, 795 S.E.2d 829 (N.C.App. 2017)] (See Learning Outcome 2.)

Chapter 13—Work Set

True-False Questions

- _____ 1. A contract involving a mistake of fact can sometimes be avoided.
- _____ 2. When both parties to a contract are mistaken as to the same material fact, the contract cannot be rescinded by either party.
- _____ 3. To commit fraudulent misrepresentation, one party must intend to mislead another.
- _____ 4. In an action to rescind a contract for fraudulent misrepresentation, proof of injury is required for damages to be awarded.
- _____ 5. The essential feature of undue influence is that the party taken advantage of does not exercise free will.
- _____ 6. If a person makes a statement that they believe to be true, they cannot be held liable for misrepresentation.
- _____ 7. A seller has no duty to disclose a defect that is known to the seller but could not reasonably be suspected by the buyer.
- _____ 8. When both parties make a mistake as to the future market value of the object of their contract, the contract can be rescinded by either party.
- _____ 9. A contract entered into under duress is voidable.

Multiple-Choice Questions

- _____ 1. Metro Transport asks for bids on a construction project. Metro estimates that the cost will be \$200,000. Most bids are about \$200,000, but EZ Construction bids \$150,000. In adding a column of cost figures, EZ mistakenly omitted a \$50,000 item. Because Metro had reason to know of the mistake
 - a. Metro can enforce the contract.
 - b. EZ can increase the price and enforce the contract at the higher price.
 - c. EZ can avoid the contract.
 - d. none of the above can be done.
- _____ 2. To induce Sam to buy a lot in Mel's development, Mel tells Sam that he intends to add a golf course. The terrain is suitable, and there is enough land, but Mel has no intention of adding a golf course. Sam is induced by the statement to buy a lot. Sam's reliance on Mel's statement is justified because
 - a. Mel is the owner of the development.
 - b. Sam does not know the truth and has no way of finding it out.
 - c. Sam did not buy the golf course.
 - d. the golf course had obviously not been built yet.
- _____ 3. Li Jang agrees to sell ten shares of Black Bear Corporation stock to Pam. Neither party knows whether the stock will increase or decrease in value. Pam believes that it will increase in value. If she is mistaken, her mistake will
 - a. justify voiding the contract.
 - b. not justify voiding the contract.
 - c. justify a refund to her from Li Jang of the difference.
 - d. justify a payment from her to Li Jang of the difference.
- _____ 4. In an e-mail offering to sell amplifiers to Gina for her theater, Richard describes the 120-watt amplifiers as "210 watts per channel." This is fraudulent misrepresentation if
 - a. the number of watts is a material fact.
 - b. Richard intends to deceive Gina.
 - c. Gina relies on the description.
 - d. all of the above are true.

- _____ 5. Ken, who is not a real estate broker, sells Global Associates some land. Which of the following statements by Ken, with the accompanying circumstance, would be a fraudulent misrepresentation in that sale?
- "This acreage offers the most spectacular view of the valley." From higher up the mountain, more of the valley is visible.
 - "You can build an office building here." The county requires the property to be exclusively residential, but neither Ken nor Global knows that.
 - "This property includes ninety acres." Ken knows it includes only eighty acres.
 - "The value of this property will triple in five years." Ken does not know whether the value of the property will triple in five years.
- _____ 6. Adam persuades Chiya to contract for his company's services by telling her that his employees are "the best and the brightest." Adam's statement is
- duress.
 - fraud.
 - opinion.
 - undue influence.
- _____ 7. In selling a warehouse to A&B Enterprises, Ray does not disclose that the foundation was built on unstable pilings. A&B may later avoid the contract on the ground of
- misrepresentation.
 - undue influence.
 - duress.
 - none of the above.

Answering More Legal Problems

1. Trulov.com is an online dating site. Trulov allows subscribers to create profiles, browse other profiles, take a relationship test, use the site's computerized matching system, and exchange messages. Browsing through profiles, Sophia, a subscriber, notices that many use the same phrases and photos. She files a suit against Trulov, alleging that the site created and posted false profiles of nonexistent "potential matches" to attract subscribers.
2. Lionel, a Trulov subscriber, browses other profiles and contacts some of the subscribers. He discovers that the profiles many of the members created for themselves exaggerate their physical appearance, intelligence, experiences, accomplishments, and occupations. Trulov's policy is to remove a subscriber's profile when such deception is revealed.

Has Trulov committed fraudulent misrepresentation? Yes. Fraud requires (1) a _____ of a material fact, (2) an intent to deceive, and (3) an innocent party's justifiable reliance on the _____. To recover damages, the innocent party must also suffer an injury. Trulov created and posted bogus user profiles to entice new subscribers and retain old ones. This constituted _____ of material facts with an intent to deceive. Some new subscribers and some renewing subscribers relied on Trulov's _____. Damages include the expense of initiating or continuing subscriptions.

Is Trulov liable for fraud in these circumstances? No. Fraud requires a _____ of a material fact, as well as an intent to deceive. The intent is knowledge on the part of the _____ party that facts have been falsely represented. There is clearly _____ in these circumstances. It occurred through the exaggerated profiles created and posted by individual subscribers. Unless Trulov knew that the profiles were false and allowed them to remain despite its stated policy, however, there is no _____ nor intent to deceive on its part.

14

Contracts That Must Be in Writing

Conflict Presented

Regional Community College forms a contract with Yolanda to teach three courses in business law during the next academic year (September 15 through June 15). Janine enters into a contract to provide security for the college's student center as long as the college needs the service.

Q Do these two contracts have to be in writing to be enforceable? Why or why not?

A contract may be unenforceable if it is not in the proper **form**. Certain types of contracts are required by law to be in writing. If there is no written evidence of the contract, it may not be enforceable.

In this chapter, we examine the kinds of contracts that require a writing under what is called the Statute of Frauds. We conclude the chapter with a discussion of the parol evidence rule.

14-1 The Statute of Frauds— Writing Requirement

Every state has a statute that specifies what types of contracts must be in writing. Such a statute is referred to as the **Statute of Frauds**. The Statute of Frauds does not apply to fraud. Rather, it denies enforceability to certain contracts that do not comply with its requirements. The primary purpose of the statute is to prevent harm to innocent parties by requiring written evidence of agreements concerning important transactions.

Essentially, the Statute of Frauds requires certain contracts to be in writing or be evidenced by a written memorandum. A written memorandum can consist of any signed confirmation, invoice, check, sales slip, or e-mail.

The Statute of Frauds varies from state to state, but all states require the following contracts to be in writing (or evidenced by a written memorandum):

1. Contracts involving interests in land.
2. Contracts that cannot by their terms be performed within one year from the day after the contract's formation.
3. Collateral contracts, such as promises to answer for the debt or duty of another.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Identify contracts that must be in writing.
- 2 Describe what satisfies the writing requirement.
- 3 State the parol evidence rule.
- 4 Differentiate between an integrated and a partially integrated contract.

form

The manner observed in creating a legal agreement, as opposed to the substance of the agreement.

Statute of Frauds

A statute under which certain contracts must be in writing to be enforceable.

Learning Outcome 1

Identify contracts that must be in writing.

4. Promises made in consideration of marriage.
5. Under the Uniform Commercial Code, contracts for the sale of goods priced at \$500 or more.

14–1a Contracts Involving Interests in Land

Under the Statute of Frauds, a contract involving an interest in land must be in writing. Land is also called real property. A contract for the sale of land ordinarily involves the entire interest in the real property, including buildings, growing crops, vegetation, timber, and fixtures. A fixture is personal property attached to real property in such a way that it is part of that real property. Examples include carpeting, water faucets, and ceiling fans.

A contract calling for the sale of land is not enforceable unless it is in writing or evidenced by a written memorandum. **Example 14.1** Lewis is a party to an oral contract with Maria involving a vineyard. Neither Lewis nor Maria can force the other to buy or sell the land that is the subject of their contract. The Statute of Frauds is a defense to the enforcement of this contract. ■

14–1b The One-Year Rule

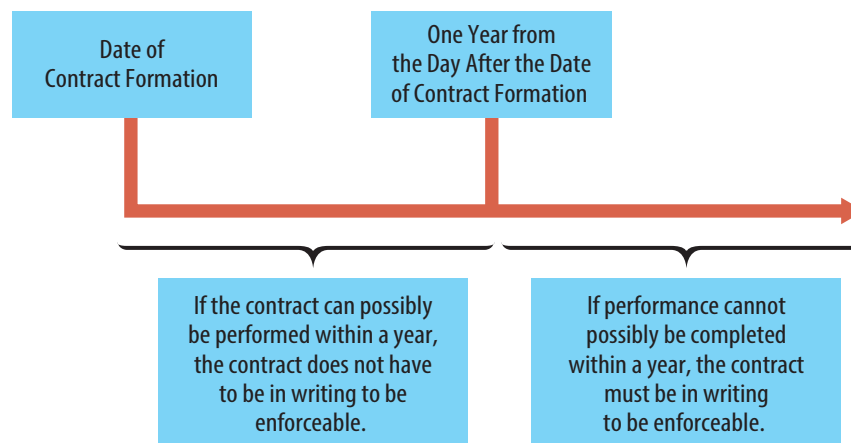
A contract that cannot, by its own terms, be performed within one year from the day after the contract is formed must be in writing to be enforceable. The one-year period begins to run the day after the contract is made. The idea behind the one-year rule is that a witness's memory is not to be trusted for longer than a year.

Example 14.2 Isabella enters into a contract with Diamond Auto Body & Paint in August. She states that she will provide accounting services to Diamond during the firm's coming fiscal year, which begins October 1 and continues until September 30. Because the contract is formed in August, it must be in writing to be enforceable—because it cannot be performed within one year. ■

Exhibit 14.1 graphically illustrates the one-year rule.

If Performance Is Objectively Impossible Note that for a particular contract to fall under the one-year rule, contract performance must be objectively impossible to complete within a year. For instance, a contract to provide five crops of tomatoes to be grown on a specific farm in Illinois would be impossible to perform within a year. It is impossible to grow five crops of tomatoes on the same farmland in a single year in Illinois.

Exhibit 14.1 The One-Year Rule



If Performance Is Possible If the contract, by its terms, makes performance within the year possible (even if not probable), the contract does not fall within the Statute of Frauds and need not be in writing. **Example 14.3** Jason agrees to provide office-cleaning services for Omar's Imports for as long as the company needs his services. This means the contract could be fully performed within a year because Omar's could go out of business within twelve months. Thus, the contract need not be in writing to be enforceable. ■

Conflict Resolved

In the Conflict Presented feature set out at the beginning of this chapter, Regional Community College contracted with Yolanda to teach courses in business law during the next academic year, which ends June 15, and with Janine to provide security for the student center as long as the college needs it.

A Do these two contracts have to be in writing to be enforceable? Under the Statute of Frauds, a contract that cannot, by its own terms, be performed within one year from the day after the contract is formed must be in writing to be enforceable. Thus, if Yolanda's contract was formed before June 14 of the preceding year, it must be in writing to be enforceable, because it cannot be performed within one year.

If the contract was formed after June 14, however, it does not need to be in writing, because it can be performed within one year. Similarly, Janine's contract does not need to be in writing, because it could conceivably be performed within one year. Although the college's need for her services could continue indefinitely, it could also run out within twelve months.

14-1c Collateral Promises

A **collateral promise** is secondary to a principal transaction or primary contractual relationship. Basically, a collateral promise is made by a third party to assume the debts—that is, the obligations to pay money—of a primary party to a contract if that party does not perform. Any collateral promise of this nature falls under the Statute of Frauds and must be in writing to be enforceable.

collateral promise

A secondary promise made by one person to pay the debts of another if that second party fails to perform.

Primary Versus Secondary Obligations To understand collateral promises, it is important to distinguish between primary and secondary promises and obligations. An unconditional promise to pay another person's debt is a primary obligation. A promise to pay another person's debt only if that person fails to pay is a secondary obligation.

Highlighting the Point



Pablo contracts with Dr. Joanne Leong to have his daughter's wisdom teeth pulled the following week. Pablo promises to pay for the dental work when he receives the bill from Leong's dental office. On the same day, Pablo's daughter borrows \$10,000 from the Medford Bank to remodel her kitchen. Pablo promises the bank that he will pay the \$10,000 if his daughter does not repay the loan on time.

(Continues)

Which of these promises must be in writing to be enforceable under the Statute of Frauds? In contracting for the dental work, Pablo incurs a primary obligation. Under the Statute of Frauds, this contract does not have to be in writing to be enforceable. If Pablo fails to pay Leong and she sues him for payment, Pablo cannot claim that the contract is unenforceable because it was not in writing.

Pablo's promise to repay his daughter's debt to Medford Bank, however, is a secondary obligation. This promise must be in writing to be enforceable. Pablo, in this situation, becomes a guarantor of the loan—meaning that he guarantees that he will pay back the loan if his daughter fails to do so.

An Exception—The “Main Purpose” Rule An oral promise to answer for the debt of another need not be in writing if the guarantor's main purpose in accepting secondary liability is to secure a personal benefit. This exception is known as the “main purpose” rule. The assumption is that a court can infer from the circumstances whether the promisor's “leading objective” was to secure a personal benefit.



Highlighting the Point

Fiona contracts with Cartwright Manufacturing Company to have some machines made to detailed specifications for her factory. She promises Allrite Supply Company, Cartwright's supplier, that if Allrite continues to deliver materials to Cartwright, Fiona will guarantee payment.

Under the Statute of Frauds, does Fiona's promise need to be in writing to be enforceable? No. Fiona's promise need not be in writing, because her main purpose is to secure a benefit for herself.

Another typical application of the so-called main purpose rule occurs when one creditor guarantees a debtor's debt to another creditor to prevent litigation. This allows the debtor to remain in business long enough to generate profits sufficient to pay both creditors.

14–1d Promises Made in Consideration of Marriage

A unilateral promise to pay a sum of money or to give property in consideration of a promise to marry must be in writing. **Example 14.4** Ralph promises to pay Stewart \$10,000 if Stuart agrees to marry Ralph's daughter, Taylor. This promise must be in writing. ■

The same rule applies to **prenuptial agreements**. These agreements are made before marriage and define each partner's ownership rights in the other partner's property. Prenuptial arrangements made in consideration of marriage must be in writing to be enforceable.

Example 14.5 Before they marry, Helen and Josiah enter into a prenuptial agreement. Helen, an international supermodel, agrees that if they divorce, she will pay Josiah \$100,000 for every year of the marriage, unless he uses drugs. If he uses drugs, Josiah will receive nothing from Helen. This agreement must be in writing. ■

prenuptial agreements

An agreement entered into in contemplation of marriage, specifying the rights and ownership of the parties' property.

14–1e Contracts for the Sale of Goods

The Uniform Commercial Code (UCC) is a body of law that governs commercial transactions within the United States. Commercial transactions occur in the business environment between merchants and involve contracts for the sale (or lease) of goods.

Like each state's Statute of Frauds, the UCC has its own Statute of Frauds provisions that require written evidence or an electronic record of a contract. Under these provisions, sales contracts for goods priced at \$500 or more must be in writing to be enforceable.

To satisfy the UCC requirement, a writing—including e-mail or another type of electronic record—need only state the quantity term. Other terms need not be stated “accurately” in the writing, as long as they adequately reflect both parties’ intentions. The contract will not be enforceable for any quantity greater than that set forth in the writing. In addition, the writing must have been signed by the person who refuses to perform or the one being sued.

14–1f Exceptions to the Writing Requirement

Exceptions to the writing requirement are made in certain situations. These include partial performance, admissions, and promissory estoppel.

Partial Performance An oral contract that should be in writing to be enforceable under the Statute of Frauds may be enforceable if it has been partially performed. When a contract has been partially performed, and the parties cannot be returned to their positions before the contract was made, a court may grant specific performance. Specific performance is an equitable remedy (court-ordered relief that does not usually involve money) that requires performance of the contract according to its precise terms. The parties must prove that an oral contract existed, of course.

In cases involving oral contracts for the transfer of interests in land, for instance, courts usually look at whether justice is better served by enforcing the oral contract when partial performance has taken place.

Highlighting the Point



Liza orally agrees to buy a small piece of vacant land from James for \$8,000. Liza gives James a \$4,000 down payment and begins making monthly payments on the remaining balance. During this time, she improves the land for a community garden. Liza has several truckloads of fertile soil delivered, and she constructs several raised planting beds on the land. After four months, James claims their agreement is not enforceable and wants his land back.

Is the oral contract enforceable because of partial performance? Yes. Liza has paid more than half the purchase price for the land and has made substantial improvements. It would be impossible to return James and Liza to their original positions before the oral contract was formed. A court will most likely grant specific performance, allowing Liza to finish paying for the land and creating her community garden.

Admissions In some states, if a party against whom enforcement of an oral contract is sought “admits” under oath that a contract for sale was made, the contract will be enforceable. If a party admits to a contract subject to the UCC, the contract is enforceable, but only to the extent of the quantity admitted.

Example 14.6 Rachel, the president of Bistro Corporation, admits under oath that an oral agreement was made with Commercial Kitchens, Inc., to buy certain equipment for \$10,000. A court will enforce the agreement only to the extent admitted (\$10,000), even if Commercial Kitchens claims that the agreement involved \$20,000 worth of equipment. ■

Promissory Estoppel In some states, an oral contract that would otherwise be unenforceable under the Statute of Frauds may be enforced under the doctrine of promissory estoppel. If a promisor makes a promise on which the promisee justifiably relies to their detriment, a court may estop (prevent) the promisor from denying that a contract exists. In these circumstances, an oral promise can be enforceable if two requirements are met:

1. The person making the promise must foresee that the promisee will rely on it.
2. There must be no way to avoid injustice except to enforce the promise.

14–2 The Sufficiency of the Writing

Learning Outcome 2

Describe what satisfies the writing requirement.

Either a written contract or a written memorandum signed by the party against whom enforcement is sought will satisfy the Statute of Frauds.

14–2a Memorandums

As mentioned earlier, a written memorandum can consist of any confirmation, invoice, sales slip, check, or e-mail. Any one of these items may constitute a writing that satisfies the Statute of Frauds.

In addition, a written contract need not consist of a single document to constitute an enforceable contract. One document may incorporate another document by expressly referring to it. Several documents may form a single contract if they are physically attached by staple, paper clip, or glue, or even if they are only placed in the same envelope.

14–2b Essential Terms

A memorandum evidencing an oral contract must contain the essential terms of the contract. Under the UCC, for a sale of goods the writing need only name the quantity term and be signed by the party being charged. Under most provisions of the Statute of Frauds, the writing must name the parties, subject matter, consideration, and quantity.

Contracts for the sale of land must state the essential terms of the contract (such as location and price) and describe the property with sufficient clarity to allow the terms to be determined from the memo, without reference to any outside sources.

Example 14.7 Celia orally agrees to sell land to Abbott Properties. Celia gives Abbott an unsigned memo that contains a legal description of the property. Abbott gives Celia an unsigned first draft of their real estate contract. Celia sends Abbott a signed letter that refers to the memo and to the first and final drafts of the contract. Abbott sends Celia an unsigned copy of the final draft of the contract with a signed check stapled to it. Together, the documents can constitute a writing sufficient to satisfy the writing requirement and to bind both parties to the terms of the contract. ■

14–2c Signatures

A party's signature can be anywhere in the writing and does not need to be placed at the end. Also, a signature can even be initials rather than the full name.

E-Signatures An **e-signature** is “an electronic sound, symbol, or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record,” according to the Uniform Electronic Transactions Act (UETA). A party’s name typed at the end of an e-mail note, for instance, meets this signature requirement. An e-signature is as valid as a signature on paper, and an e-document is as enforceable as a paper one. (See the Linking Business Law to Your Career feature at the end of the chapter.)

e-signature

An electronic sound, symbol, or process used as a signature.

Enforcement of a Signature Only the party against whom enforcement is sought must have signed the writing. Therefore, a contract may be enforceable by one of its parties but not by the other. **Example 14.8** Troy and Wilma make an oral agreement. Troy writes and signs a memo setting out the essential terms of the agreement. Wilma can now hold him to these terms. Troy cannot enforce the contract against Wilma, however, because she has signed nothing. ■

14–3 The Parol Evidence Rule

Sometimes, a written contract does not include—or contradicts—an oral understanding. When a dispute arises in such situations, the courts look to a common law rule governing the admissibility of oral evidence in court, or parol evidence in court. Parol evidence is testimony or other evidence of communications between the parties not contained in the written contract.

Under the **parol evidence rule**, if a court finds that the parties intended their written contract to be a complete and final statement of their agreement, then it will not allow either party to present parol evidence. As a result, evidence of the parties’ prior negotiation or oral agreements cannot be introduced to a court if that evidence contradicts the terms of the written contract.

Learning Outcome 3

State the parol evidence rule.

parol evidence rule

A rule governing the admissibility of oral evidence in court.

Real Case



Stephanie McNelly attempted to rent an apartment owned by Ivan Conde. McNelly was not allowed to see the apartment because it was occupied, but Conde showed her his own apartment and claimed that the apartment she would be renting was a mirror image of his own apartment. McNelly paid one month’s rent, plus a security deposit. When she went to move in, she discovered that the apartment was uninhabitable because it was “filthy, with water behind the walls, leakage, mold all over, and exposed wires in the kitchen and attic, which were a safety hazard.” At trial, McNelly prevailed and was awarded damages. Conde appealed, arguing that the parol evidence rule precluded any information about discussions prior to McNelly seeing the actual apartment.

In this situation, can McNelly use the parol evidence rule to argue in her favor? Yes. In *McNelly v. Conde*, the Court of Appeals of Ohio, 2d Dist., upheld the trial court’s decision. McNelly claimed that she was induced into renting the apartment based on misrepresentations by Conde. Even though there might be a valid contract, the parol evidence rule does not prevent claims based on fraud, misrepresentation, or unconscionability.

—2021-Ohio-146 (Ct. App. OH, 2d Dist.)

14–3a Exceptions to the Parol Evidence Rule

Because of the rigidity of the parol evidence rule, courts make several exceptions. These exceptions are discussed next.

Contracts Subsequently Modified Evidence of a subsequent modification of a written contract can be introduced into court. Keep in mind that an oral modification may not be enforceable if it comes under the Statute of Frauds. This could occur, for instance, if the oral modification increased the price of the goods in a sales contract to \$500 or more. Also, oral modifications will not be enforceable if the original contract provides that any modification must be in writing.

Voidable or Void Contracts Oral evidence can be introduced to show that the contract was voidable or void (for example, induced by mistake or fraudulent misrepresentation or was illegal). If deception led one of the parties to agree to the terms of a written contract, oral evidence attesting to fraud should not be excluded. Courts frown on bad faith and are quick to allow such evidence when it establishes fraud.

Ambiguous Terms When the terms of a written contract are ambiguous or not clear, evidence is admissible to show the meaning of the terms.

Example 14.9 Odina buys a home from Samuel by taking out a loan with a bank. Odina's contract with Samuel states that Odina will make payments on the loan until it is paid in full. "The house" will then become Odina's. The agreement also stipulates that Odina will obtain insurance on "the property." The house is destroyed in a hurricane, and the insurance proceeds pay the balance of Odina's loan. Samuel claims the land, however, arguing that he sold only the house to Odina. A court finds that the contract's references to "the house" and "the property" are ambiguous. The court admits parol evidence to show that the parties intended to transfer ownership of both the house and the land. ■

Incomplete Contracts Evidence is admissible when the written contract is incomplete in that it lacks one or more of the essential terms. Courts often allow outside evidence to "fill in the gaps."

Customary Practices When buyers and sellers deal with each other over extended periods of time, certain customary practices develop. The parties often overlook these practices when writing a contract. So, courts allow the introduction of evidence to show how the parties have acted in the past. Under the UCC, evidence can be introduced to explain or supplement a written contract by showing a prior dealing, course of performance, or usage of trade.



Highlighting the Point

Elise, an architect, agrees to design a house for Tala. Their contract outlines her services and states that Tala is to pay Elise "a 10 percent fee of the house's cost." The contract is silent as to the style of the house and related particulars, including the maximum cost. Elise prepares the design and solicits bids for construction. The lowest bid is \$400,000. Tala rejects it and refuses to proceed, contending that they agreed that the maximum cost would not exceed \$250,000. Elise files a lawsuit to recover her \$40,000 fee (which is 10 percent of the lowest bid of \$400,000).

Is the contract incomplete enough to allow the court to admit parol evidence? Yes. At trial, the court finds the written contract to be incomplete and admits parol evidence.

This parol evidence shows that at the time of contract formation, Tala told Elise that the cost of the house could not be more than \$250,000. The evidence also reveals that Elise replied, “My fee will be \$25,000.” The court orders Tala to pay \$25,000, not \$40,000, to Elise.

An Orally Agreed-on Condition The parol evidence rule does not apply if the existence of the entire written contract is subject to an orally agreed-on condition. Proof of the condition does not alter or modify the written terms but involves the enforceability of the written contract.

Example 14.10 A lease between the city of Cheddar Bay and Romano, the owner of Monterey Corporate Office Suites, is subject to the approval of the city council. This approval is a condition required for the formation of the lease. If a dispute arises over the lease, the parol evidence rule will not apply. Oral evidence will be admissible only to show whether the council has approved the terms and thus whether the lease is enforceable. ■

Obvious Errors When an obvious clerical error exists that clearly would not represent the agreement of the parties, parol evidence is admissible to correct the error. For instance, a written lease provides for monthly rent of \$300 rather than the \$3,000 orally agreed to by the parties. Parol evidence will be admissible to correct the obvious mistake.

14–3b Integrated Contracts

In determining whether to allow parol evidence, courts consider whether the written contract is intended to be a complete and final statement of the terms of the agreement. If it is, the contract is referred to as an **integrated contract**, and outside evidence is excluded.

To be considered an integrated contract, a contract must be completely integrated. That is, it must contain all of the terms of the parties’ agreement. If, instead, the contract contains only some of the agreed-on terms, it is partially integrated. If the contract is only partially integrated, evidence of consistent additional terms is admissible to supplement the written agreement.

Courts allow parol evidence only to add to the terms of a partially integrated contract. For both completely and partially integrated contracts, courts exclude any evidence that contradicts the writing of the contract. Exhibit 14.2 illustrates the relationship between integrated contracts and the parol evidence rule.

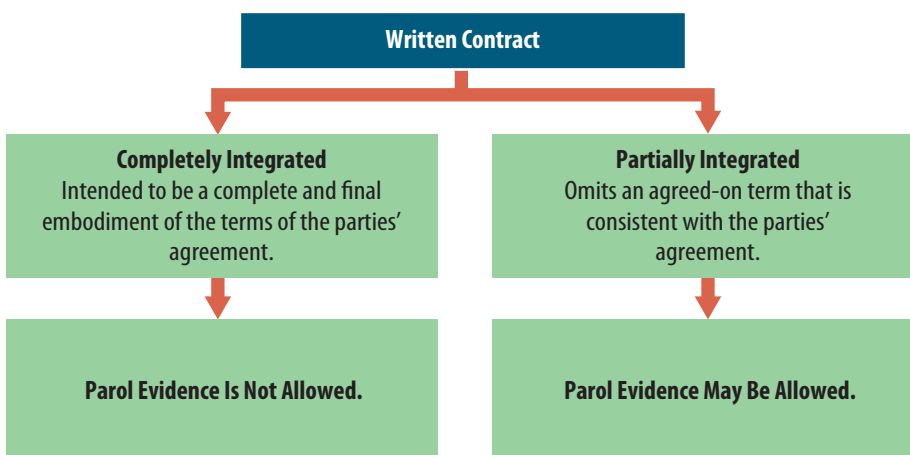
integrated contract

A written contract that constitutes the final expression of the parties’ agreement.

Learning Outcome 4

Differentiate between an integrated and a partially integrated contract.

Exhibit 14.2 The Parol Evidence Rule





Linking Business Law to Your Career

Enforceable E-Mail and Text Contracts

At any point in your business career, you may represent yourself or your company in contract negotiations. These negotiations may involve oral and written contracts, including communication online.

Sufficiency of the Writing

A series of e-mail or text exchanges can comprise a writing that constitutes a contract. In other words, five e-mail or text messages between two parties may collectively form a single contract. If the e-mails or texts name the parties, identify the subject matter, and state the consideration, a court normally will hold that they satisfy the writing requirement under the Statute of Frauds.

Precise Language

E-mail and especially text messages are media that may increase the possibility for ambiguities. After all, we often compose e-mails and texts quickly and use casual language

that may be imprecise. When e-mailing or texting business contacts, therefore, you should:

1. **Include an informative subject line.** Specify the subject exactly—such as “Change in Delivery Date for XYZ Portable Generators.”
2. **Repeat the subject within the body of the message.** That way, if the recipient skips reading the subject line, the message will still be clear.
3. **Focus on a limited number of subjects.** Send separate e-mails or texts to discuss different topics.
4. **Be clear.** If you do not phrase your communication carefully to say what you intend, you may create an enforceable contract without intending to do so.
5. **Proofread your writing.** Reviewing your e-mails or texts before you send them may be the most important step in avoiding misinterpretations.

Chapter Summary—Contracts That Must Be in Writing

Learning Outcome 1: Identify contracts that must be in writing.

Contracts that must be in writing to be enforceable under the Statute of Frauds include the following:

- (1) Contracts involving interests in land.
- (2) Contracts that cannot by their terms be performed within one year from the day after the contract's formation.
- (3) Collateral contracts, such as promises to answer for the debt or duty of another.
- (4) Promises made in consideration of marriage.
- (5) Contracts for sales of goods priced at \$500 or more.

Learning Outcome 2: Describe what satisfies the writing requirement.

To constitute an enforceable contract under the Statute of Frauds, a writing must be signed by the party against whom enforcement is sought and state with reasonable certainty the essential terms of the contract. Generally, it must name the parties, subject matter, consideration, and quantity. A contract for the sale of land must also describe the property. A contract for a sale of goods is not enforceable beyond the quantity of goods stated.

Learning Outcome 3: State the parol evidence rule.

The parol evidence rule prohibits the introduction at trial of oral statements that contradict or change the terms of the contract itself. The written contract is assumed to be the complete and final embodiment of the parties' agreement.

Learning Outcome 4: Differentiate between an integrated and a partially integrated contract.

An integrated contract is a writing that is intended to be a complete and final embodiment of the terms of an agreement between contracting parties. A partially integrated contract omits an agreed-on term that is consistent with the parties' agreement.

Straight to the Point

1. What is the primary purpose of the Statute of Frauds? (See Learning Outcome 1.)
2. When does the one-year period of the one-year rule begin? (See Learning Outcome 1.)
3. What is a collateral promise? (See Learning Outcome 1.)
4. At what price does a sale of goods require a writing? (See Learning Outcome 1.)
5. What are three exceptions to the Statute of Frauds? (See Learning Outcome 1.)
6. When the terms of a written contract are ambiguous, how can the meaning of the terms be shown? (See Learning Outcome 3.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. GamesCo orders \$800 worth of game pieces from Midstate Plastic, Inc. Midstate delivers, and GamesCo pays for \$450 worth. GamesCo then says it wants no more pieces from Midstate. GamesCo and Midstate have never dealt with each other before and have nothing in writing. Can Midstate enforce a deal for \$350 more? Explain your answer. (See Learning Outcome 1.)
2. Paula orally agrees to work with Next Corporation in New York City for two years. Paula moves her family and begins work. Three months later, Paula is fired for no stated cause. She sues for reinstatement or pay. Next Corporation argues that there is no written contract between them. What will the court say? (See Learning Outcome 1.)

Real Law

14-1. Promises Made in Consideration of Marriage. Sharon Hershkowitz, an independent businesswoman, and Harold Levy, Jr., an experienced attorney, entered into a prenuptial agreement that defined separate property as anything acquired by the parties prior to the marriage. The agreement also defined all earned income during the marriage as marital property. Sharon used the services of a lawyer to review this agreement. Approximately eight years later, the husband and wife redefined separate property as including any and all income or other compensation earned during the marriage. The couple waived any maintenance payments in the event of a divorce. The couple waived the right to insist on financial disclosure as a precondition to signing this postnuptial agreement. About three years later, a divorce proceeding commenced. Harold moved that the postnuptial agreement signed by both parties three years prior to divorce proceedings should be set aside because it was unconscionable, overreaching, fraudulent, and it lacked consideration. A trial court did not agree. Harold filed an appeal. Should the appellate court reverse the trial court's decision? Why or why not? [*Sharon Hershkowitz v. Harold Levy, Jr.*, 221 NY Slip OP 00299 (App. Div. of S. Ct. of NY, 2d Dept., 2021)] (See Learning Outcome 1.)

14-2. Statute of Frauds—Writing Requirement. Madeline Castellotti was the sole shareholder of Whole Pies, Inc.,

which owns Jon's Pizzeria in New York City. Her other assets included an interest in a real estate partnership, a residence on Staten Island, and bank accounts. When Madeline's son Peter was going through a divorce, Madeline wanted to prevent his wife from obtaining any of Madeline's assets. She removed Peter from her will, leaving her daughter Lisa as the sole beneficiary. Lisa orally agreed to transfer half of the assets to Peter after the divorce. In reliance on that promise, Peter agreed to pay the property taxes for the estate. Madeline died and Peter paid the taxes, but Lisa reneged on the deal. Is there a legal theory on which a court might enforce Lisa's promise? [*Castellotti v. Free*, 138 A.D.3d 198, 27 N.Y.S.3d 507 (1 Dept. 2016)] (See Learning Outcome 1.)

14-3. Promises Made in Consideration of Marriage. After twenty-nine years of marriage, Robert and Mary Lou Tuttle were divorced. They admitted in court that before they were married, they had signed a prenuptial agreement and had agreed on its general term that each would keep their own property and anything derived from that property. But a copy of the prenuptial agreement could not be found. Can the court enforce the agreement without a writing? Why or why not? [*In re Marriage of Tuttle*, 2013 WL 164035 (5 Dist. 2013)] (See Learning Outcome 1.)

Ethical Questions

14–4. Prenuptial Agreements. Should prenuptial agreements be enforced if one party did not have the advice of counsel? Discuss. (See Learning Outcome 1.)

14–5. The One-Year Rule. Robert and Lynette Knigge owned a B&L Food Store in Redfield, South Dakota. Robert, diagnosed with brain cancer and given five months to live, entered into an oral contract with his brother, David, to manage the store. Robert died five months after the date of the contract. Lynette terminated David's employment two

months later. David filed a suit in a South Dakota state court against his sister-in-law. He alleged that the oral contract with his brother provided for a severance payment if Lynette ended his employment after her husband's death. Does the one-year rule under the Statute of Frauds apply to these facts? Under what circumstances might Lynette have an ethical duty to honor Robert's promise to his brother? Is David ethically obligated to honor Lynette's decision? Explain. [*David Knigge v. B&L Food Stores, Inc.*, 2017 S.D. 4 (2017)] (See Learning Outcome 1.)

Chapter 14—Work Set

True-False Questions

- _____ 1. Contracts for transfers, other than sales, of interests in land need not be in writing to be enforceable under the Statute of Frauds.
- _____ 2. A contract for a sale of goods of over \$300 must be in writing to be enforceable under the Statute of Frauds.
- _____ 3. An oral contract that should be in writing to be enforceable under the Statute of Frauds may be enforceable if it has been partially performed.
- _____ 4. The only writing sufficient to satisfy the Statute of Frauds is a typewritten form, signed at the bottom by all parties, with the heading “Contract” at the top.
- _____ 5. Under the parol evidence rule, virtually any evidence is admissible to prove or disprove the terms of a contract.
- _____ 6. A promise to answer for the debt of another must be in writing to be enforceable unless the guarantor’s main purpose is to obtain a personal benefit.
- _____ 7. A contract that makes performance within one year possible need not be in writing to be enforceable.
- _____ 8. A promise to pay a sum of money in consideration of a promise to marry must be in writing.
- _____ 9. Under the Statute of Frauds, any contract that is not in writing is void.

Multiple-Choice Questions

- _____ 1. Walt sells his pickup truck to Bob. When Walt starts to remove its camper shell, Bob says, “Wait. We agreed the camper shell was included.” Walt points to their written contract and says, “No, we didn’t.” The contract says nothing about the camper shell. The camper shell is
 - a. part of the deal under the parol evidence rule.
 - b. not part of the deal under the parol evidence rule.
 - c. part of the deal because Bob thought it was.
 - d. not part of the deal because Walt thought it was not.
- _____ 2. On March 1, the chief engineer for the software design division of Uni Products orally contracts to hire Sunan for one year, beginning March 4. Sunan works for Uni for five months. When sales decline, Sunan is discharged. Sunan sues Uni for reinstatement or seven months’ salary. Sunan will
 - a. win because the contract can be performed within one year.
 - b. win because employment contracts need not be in writing to be enforceable.
 - c. lose because the contract cannot be performed within one year.
 - d. lose because employment contracts must be in writing to be enforceable.
- _____ 3. National Properties, Inc., orally contracts for a sale of its lot and warehouse to U.S. Merchants, Inc., but later decides not to go through with the sale. The contract is most likely enforceable against
 - a. both National and U.S. Merchants.
 - b. National only.
 - c. U.S. Merchants only.
 - d. neither National nor U.S. Merchants.

- _____ 4. Hans owes Bell Credit Company \$10,000. Chris orally promises Bell that he will pay Hans's debt if Hans does not. This promise is
- a. not enforceable because it is not in writing.
 - b. enforceable under the "main purpose rule" exception.
 - c. not enforceable because the debt is Hans's.
 - d. enforceable under the partial performance exception.
- _____ 5. Which of the following constitutes a writing that satisfies the Statute of Frauds?
- a. A signed sales slip.
 - b. A blank invoice.
 - c. An empty envelope.
 - d. All of the above.
- _____ 6. Terry signs a letter setting out the essential terms of an oral contract with Adrian. Those terms are most likely enforceable against
- a. both Terry and Adrian.
 - b. Terry only.
 - c. Adrian only.
 - d. neither Terry nor Adrian.
- _____ 7. Kirill orally promises to work for Pat, and Pat orally promises to employ Kirill at a rate of \$500 a week. This contract must be in writing to be enforceable if Kirill promises to work for
- a. his entire life.
 - b. at least five years.
 - c. five years, but either party may terminate the contract on thirty days' notice.
 - d. either a or c.
- _____ 8. Tom orally agrees to be liable for Zala's debt to Ace Loan Company. If Tom's purpose for this guaranty is to obtain a personal benefit, the guaranty is
- a. enforceable whether or not it is in writing.
 - b. enforceable only if it is in writing.
 - c. unenforceable if it is in writing.
 - d. unenforceable.

Answering More Legal Problems

1. On June 1, Mel, the owner of Fresco Organico, asks Ray to deliver Fresco's menu items to customers on State University's campus until June 15, which is the final day of the spring semester. Ray says he'll do it if Mel agrees to pay him a certain hourly wage or \$500 plus tips, whichever is more. Mel agrees. Nothing is put in writing.

Is this oral agreement enforceable? Yes. A contract that is oral when it is required to be in writing will not, as a rule, be enforced by the courts. Mel and Ray's agreement, however, does not fall into any of the categories listed below and is thus enforceable despite the lack of a writing.

The following types of contracts must be in writing or be evidenced by a written memorandum: (1) contracts involving interests in _____, (2) contracts that cannot by their terms be performed within one _____ from the day after the contract's formation, (3) _____ promises, (4) promises made in

consideration of _____, and (5) contracts for the sale of _____ priced at \$500 or more.

2. Sushi Yo! makes ready-to-eat Asian seafood dishes that are sold in grocery stores. Sushi Yo! and Dragonfly Tea Company comarket their products in Milwaukee. Due to their success, the two firms negotiate a new comarketing agreement for Chicago. Sushi Yo! e-mails a proposed multiyear contract to Dragonfly, but Dragonfly does not sign it or respond.

Is this deal enforceable against Dragonfly? No. Under the Statute of Frauds, a contract that cannot, by its own terms, be performed within one _____ from the day after the contract is formed must be in writing to be enforceable. Because Sushi Yo!'s proposed contract could not be performed within a _____, it was not enforceable without a writing _____ by Dragonfly. Because Dragonfly did not _____ the proposal, it was not enforceable.

15 | Third Party Rights

Conflict Presented

Wayne attends Metro Community College. To pay tuition and meet other expenses, Wayne obtains a loan from the First National Bank. Six months later, Wayne receives a letter stating that the bank has transferred its rights to receive Wayne's loan payments to the Educational Loan Collection Agency (ELCA). The letter tells Wayne that when he begins making payments, he should make them directly to the ELCA.

Q What is this transfer called? Should Wayne pay the bank or the ELCA?

A contract is a private agreement between the parties who have entered into it. So, these parties alone should have rights and liabilities under the contract. This is referred to as **privity of contract**. Privity of contract establishes the basic concept that third parties have no rights in contracts to which they are not parties.

Example 15.1 Jean offers to sell Ben her Superbowl ticket, and he accepts. Later, Jean refuses to deliver the ticket to Ben. Although Ben decides to overlook the breach of contract, his mother, Edith, is outraged by Jean's behavior and wants to sue. Edith cannot successfully sue Jean for the breach because Edith is not a party to the contract. ■

In this chapter, we look at some exceptions to the rule of privity of contract. These exceptions include assignments and delegations, as well as third party beneficiary contracts.

15-1 Assignments and Delegations

In some situations, third parties acquire rights or assume duties arising from a contract to which they were not parties. The rights are transferred to them by assignment, and the duties are transferred by delegation. Assignment and delegation occur after the original contract is made.

15-1a Assignments

The transfer of rights to a third person is known as an **assignment**. Assignments are important because they are often used in business and mortgage financing. Lending institutions, such as banks, frequently assign the rights to receive payments under their loan contracts to other firms, which pay for those rights.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Describe a contract assignment.
- 2 Define a contract delegation.
- 3 Identify noncontracting parties with contract rights.
- 4 Explain when a third party beneficiary's rights in a contract vest.

privity of contract

The relationship that exists between contracting parties.

Learning Outcome 1

Describe a contract assignment.

assignment

Transferring one's rights under a contract.

Example 15.2 Dei obtains a loan from Downtown Credit to purchase a car. She may later receive a notice stating that Downtown has transferred (assigned) its rights to receive payments on the loan to another firm and that she should make her payments to that other firm. ■ Billions of dollars change hands daily in the business world in the form of assignments of rights in contracts.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Wayne obtains a student loan from a bank. Later, Wayne is notified that the bank has transferred its right to receive his payments to the Educational Loan Collection Agency (ELCA).

A **What is this transfer called? Should Wayne pay the bank or the ELCA?** The transfer is called an assignment. The ELCA purchased the right to receive Wayne's payments and can insist that Wayne make his payments directly to it.

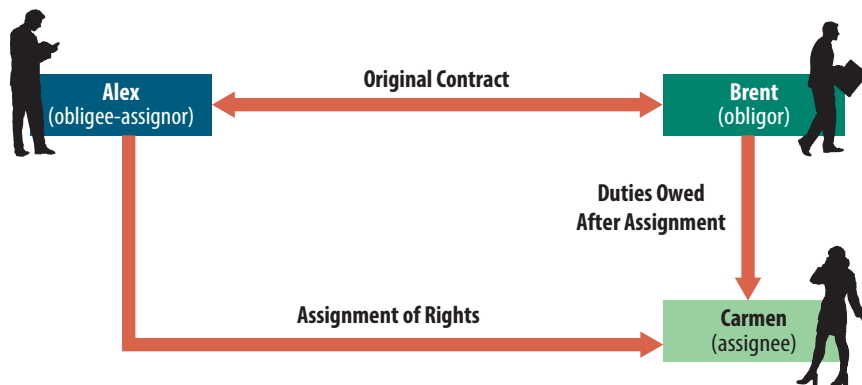
Parties to an Assignment In an assignment, the party assigning the rights to a third party is the assignor. The party receiving the assignment rights is the assignee. Other terms used to describe the parties in assignment relationships are obligee (the person to whom a duty, or obligation, is owed) and obligor (the person who is obligated to perform the duty).

Extinguished Rights When rights under a contract are assigned unconditionally, the rights of the assignor are extinguished. The third party (the assignee) has a right to demand performance from the other original party to the contract (the obligor).

Example 15.3 Brent, the obligor, owes Alex, the obligee, \$1,000. Later, Alex assigns the right to receive the \$1,000 to Carmen. Alex is now the assignor. A valid assignment of a debt exists. Carmen, the assignee, can enforce the contract against Brent, the obligor, if Brent fails to pay the \$1,000. Exhibit 15.1 illustrates this assignment relationship. ■

Defenses The assignee's rights are subject to any defenses that the obligor has against the assignor. In other words, the assignee obtains only those rights that the assignor originally had. **Example 15.4** Alex leases an apartment from Brent for one year but fails to pay the seventh month's rent. If Alex then assigns the lease to Carmen, Brent can evict Alex and Carmen, even though Carmen is innocent of the failure to pay the rent. ■

Exhibit 15.1 Assignment Relationships



Rights That Cannot Be Assigned As a general rule, all rights can be assigned. Exceptions are made, however, under certain circumstances, including the following:

1. The assignment is prohibited by statute. If a statute expressly (clearly) prohibits assignment, the particular right in question cannot be assigned.
2. The contract is personal in nature. Because personal services are unique to the person rendering them, the right to receive those services cannot be assigned.

Example 15.5 Silvia signs a contract to tutor Erik's children. Erik then attempts to assign his right to Silvia's tutoring services to his friend, Corina, who has three daughters in need of a tutor. Corina, however, cannot enforce the contract against Silvia. Tutoring is a specialized personal service, and only Silvia can decide whom she tutors. ■

3. The assignment materially changes a risk or duty. A right cannot be assigned if that assignment will significantly increase or alter the risks to, or the duties of, the obligor.

Example 15.6 Martin takes out a policy with Coast Insurance to insure his hotel. The policy insures against fire, theft, and floods. Martin then attempts to assign his policy to Camille, who owns a hotel by a river. This assignment is ineffective because it may substantially alter Coast's duty of performance and its risk. In short, Coast agreed to insure Martin's hotel, not Camille's. Camille must apply for her own policy with Coast. ■

4. The contract prohibits assignment. If a contract expressly stipulates that the rights cannot be assigned (an anti-assignment clause), then ordinarily they cannot be assigned. Often, how the anti-assignment clause is phrased determines whether it is effective or not. A contract stating that any assignment is void effectively prohibits the assignment of rights.

Highlighting the Point



Shane agrees to build a house for Prima. The contract between Shane and Prima states, "This contract cannot be assigned by Prima without Shane's consent. Any assignment without such consent renders this contract void, and all rights hereunder will thereupon terminate." Later, Prima assigns her rights to Alana without first obtaining Shane's consent.

Is the anti-assignment clause in Shane and Prima's contract enforceable? Yes. The anti-assignment clause is effective. Prima cannot assign her rights without Shane's consent. Alana cannot enforce the contract against Shane.

Notice of Assignment Once a valid assignment of rights has been made to a third party, the third party should notify the original party to the contract (the obligor) of the assignment. This notice is not legally necessary to establish the validity of the assignment, because an assignment is effective immediately. Two major problems emerge, however, when notice of the assignment is not given to the obligor.

1. If the assignor assigns the same right to two different persons, the question arises as to which one has priority—that is, the right to performance by the obligor. The rule most often observed in the United States is that the first assignment in time is the first in right. Some states follow the English rule, however, which basically gives priority to the first assignee who gives notice of assignment.

- Until the obligor has notice of assignment, the obligor can discharge their obligation by performance to the assignor. Performance by the obligor to the assignor constitutes a discharge to the assignee. Once the obligor receives proper notice, only performance to the assignee can discharge the obligor's obligations.



Highlighting the Point

McKenna owes Hugo \$1,000 on a contractual obligation. Hugo assigns this monetary claim to Maria. No notice of assignment is given to McKenna, however. McKenna pays Hugo the \$1,000.

Is the assignment valid? Does McKenna's payment discharge the debt, or does McKenna also have to pay Maria? The assignment is valid. McKenna's payment to Hugo discharges the debt. Maria's failure to give notice to McKenna of the assignment causes Maria to lose the right to collect the \$1,000 from McKenna. If Maria gives McKenna notice, McKenna's payment to Hugo discharges the debt, but Maria has a legal right to require payment from McKenna.

Learning Outcome 2

Define a contract delegation.

delegation

The transfer of a contractual duty to a third party.

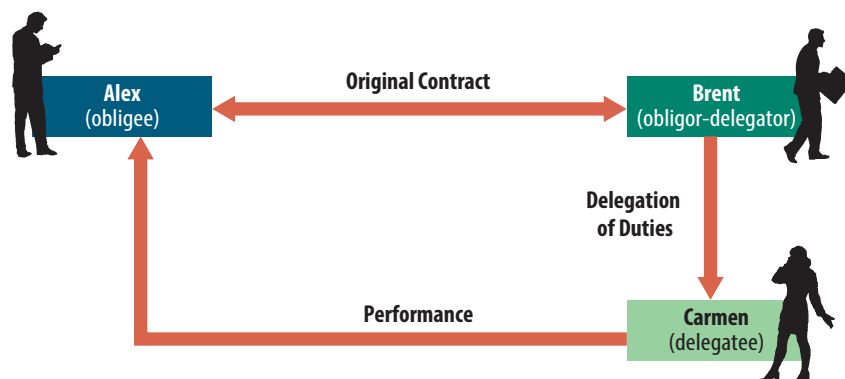
15-1b Delegations

Just as a party can transfer rights through an assignment, a party can transfer duties through a **delegation**. Normally, a delegation of duties does not relieve the party making the delegation (the delegator) of the obligation to perform in the event that the party to whom the duty has been delegated (the delegatee) fails to perform. No special form is required to create a valid delegation of duties. As long as the delegator expresses an intention to make the delegation, it is effective.

Delegation relationships are graphically illustrated in Exhibit 15.2. In the exhibit, Brent delegates his duties under a contract that he made with Alex to a third party, Carmen. Brent thus becomes the delegator and Carmen the delegatee of the contractual duties. Carmen now owes performance of the contractual duties to Alex. Note that a delegation of duties normally does not relieve the delegator (Brent) of liability if the delegatee (Carmen) fails to perform the contractual duties.

Duties That Cannot Be Delegated As a general rule, any duty can be delegated. This rule has some exceptions, however. Delegation is prohibited in the following circumstances:

Exhibit 15.2 Delegation Relationships



1. When the duties are personal in nature. **Example 15.7** Megan is known for her expertise in finance. She is hired to teach the various aspects of financial underwriting and investment banking. Megan's duty cannot be delegated. ■
2. When performance by a third party will vary materially from that expected by the obligee under the contract. **Example 15.8** Jared, a wealthy investor, establishes Heaven Sent, LLC, to provide funds to struggling but potentially successful businesses. Jared contracts with Marilyn, whose judgment Jared trusts to select the recipients. Later, Marilyn delegates this duty to Donald. Jared does not trust Donald's ability to select worthy recipients. This delegation is not effective because it materially alters Jared's expectations under the contract with Marilyn. ■
3. When the contract prohibits delegation. **Example 15.9** Dakota Company contracts with Bella, a certified public accountant, to perform its audits. Because the contract includes a clause that prohibits delegation, Bella cannot delegate the duty to perform the audits to another accountant. ■

Effect of a Delegation If a delegation of duties is enforceable, the obligee must accept performance from the delegatee. The obligee can legally refuse performance from the delegatee only if the duty is one that cannot be delegated. As mentioned, a valid delegation of duties does not relieve the delegator of obligations under the contract. If the delegatee fails to perform, the delegator is still liable to the obligee.

Liability of the Delegatee Can the obligee hold the delegatee liable if the delegatee fails to perform? If the delegatee has made a promise of performance that will directly benefit the obligee, there is an "assumption of duty." Breach of this duty makes the delegatee liable to the obligee.

Highlighting the Point



Leo contracts with Karolina to build a house according to Karolina's blueprint. Leo becomes seriously ill and contracts to have Hal build the house for Karolina. Hal fails to build the house.

Can Karolina sue Leo? Can Karolina sue Hal? Because the delegatee, Hal, contracted with Leo (the obligor) to build the house for the benefit of Karolina (the obligee), Karolina can sue Leo, Hal, or both. Although there are many exceptions, the general rule is that the obligee can sue both the delegatee and the obligor.

15-1c Assignment of "All Rights"

When a contract provides for an "assignment of all rights," this wording may also be treated as providing for an "assumption of duties" on the part of the assignee. So, if general words are used—such as, "I assign the contract" or "I assign all my rights under the contract"—the contract is interpreted as implying both an assignment of rights and a delegation of duties.

(See the Linking Business Law to Your Career feature at the end of this chapter for considerations concerning assignments and delegations.)

15-2 Third Party Beneficiaries

Another exception to the doctrine of privity of contract arises when the contract is intended to benefit a third party. In this situation, the third party becomes a beneficiary of the contract. The law distinguishes between two types of **third party beneficiaries**: intended beneficiaries and incidental beneficiaries. Only intended beneficiaries acquire legal rights in a contract.

Learning Outcome 3

Identify noncontracting parties with contract rights.

third party beneficiary

One who is not a party to a contract but who benefits from the contract.

intended beneficiary

A third party for whose benefit a contract is formed and who can sue the promisor if it is breached.

15–2a Intended Beneficiaries

An **intended beneficiary** can sue the promisor directly for breach of a contract made for the beneficiary's benefit. Who, however, is the promisor? In a bilateral contract, both parties to the contract make promises that can be enforced, so the court has to determine which party made the promise that benefits the third party. That person is the promisor.

Allowing a third party to sue the promisor directly in effect circumvents the “middle person” (the promisee) and thus reduces the burden on the courts. Otherwise, the third party would sue the promisee, who would then sue the promisor.

Creditor Beneficiaries One type of intended beneficiary is a creditor beneficiary. A creditor beneficiary benefits from a contract in which one party (the promisor) promises another party (the promisee) to pay a debt that the promisee owes to a third party (the creditor beneficiary). As an intended beneficiary, the creditor beneficiary can sue the promisor directly to enforce the contract.



Real Case

Sharmalee Goonewardene filed a breach of contract lawsuit against ADP, a company that provided payroll services to her ex-employer, the travel agency Altour. She claimed that ADP was potentially liable for her unpaid wages under the third party beneficiary doctrine. A California appeals court concurred, reasoning that ADP had contracted with Altour to perform the duty—the payment of salary—owed to Goonewardene. Therefore, she could sue ADP as a third party beneficiary. ADP appealed the decision.

Was there an error in the intermediate appellate court's reasoning? Yes. In *Goonewardene v. ADP, LLC*, the California Supreme Court cited a fatal flaw in the lower court's analysis. That is, ADP did not pay Goonewardene's salary. Rather, Altour did. ADP's primary function was to relieve Altour of a time-consuming and complicated task that, if done improperly, can result in significant tax penalties. The contract between Altour and ADP was meant to benefit ADP, not Goonewardene. Thus, she was not a third party beneficiary of that contract, and her suit against ADP could not proceed.

—434 P.3d 124 (S.Ct., Cal.)

Donee Beneficiaries Another type of intended beneficiary is a donee beneficiary. When a contract is made for the express purpose of giving a gift to a third party, the third party (the donee beneficiary) can sue the promisor directly to enforce the promise. The most common donee beneficiary contract is a life insurance contract.

Example 15.10 Anto (the promisee) pays premiums to Standard Life Insurance Company (the promisor). Standard Life promises to pay \$250,000 on Anto's death to Julia, Anto's wife—his donee beneficiary. Under the life insurance policy, Julia, as an intended third party beneficiary, can enforce the promise made by Standard Life to pay her \$250,000 after Anto dies. ■

15–2b Vesting of Intended Beneficiary Rights

vested

The condition in which rights have taken effect.

An intended third party beneficiary cannot enforce a contract against the original parties until the third party rights have **vested**, or taken effect. Until these rights have vested, the original parties to the contract—the promisor and the

promisee—can modify or rescind the contract without the consent of the third party.

When Do Third Party Rights Vest? Generally, the rights of an intended beneficiary vest when one of the following occurs:

1. When the third party demonstrates manifest assent to the contract. Third parties can show manifest assent, for instance, by sending letters or notes consenting to contracts formed for their benefit.
2. When the third parties materially alter their position in detrimental reliance on the contract.

Example 15.11 John and Damien agree that the proceeds of the sale of John's car will be deposited into Yolanda's bank account. In anticipation of receiving this sum of money, Yolanda purchases an expensive new copier machine for her small business. Thus, Yolanda has detrimentally relied on the contract between John and Damien. ■

3. When the conditions for vesting are satisfied. For instance, the rights of a beneficiary under a life insurance policy vest when the insured person dies.

When Can Vested Third Party Rights Change? If the original parties to the contract expressly reserve the right to cancel or modify the contract, the rights of the third party beneficiary are subject to any changes. In other words, the vesting of the third party's rights does not terminate the original contracting parties' rights to alter their legal agreement. In most life insurance contracts, for instance, the policyholder reserves the right to change the designated beneficiary.

15–2c Incidental Beneficiaries

The benefit that an **incidental beneficiary** receives from a contract is unintentional. The incidental beneficiary cannot enforce the contract.

Intended Versus Incidental Beneficiaries In determining whether a third party beneficiary is an intended or an incidental beneficiary, the courts generally use the reasonable person test. Basically, this test asks the following question: Would a reasonable person in the position of the third party beneficiary believe that the promisee intended to confer on the beneficiary the right to enforce the contract?

Factors That Indicate an Intended Beneficiary Several other factors must also be examined to determine whether a party is an intended or an incidental beneficiary. The presence of one or more of the following factors strongly indicates an intended (rather than an incidental) benefit to a third party:

1. Performance is rendered directly to the third party.
2. The third party has the right to control the details of performance.
3. The third party is expressly designated as a beneficiary in the contract.

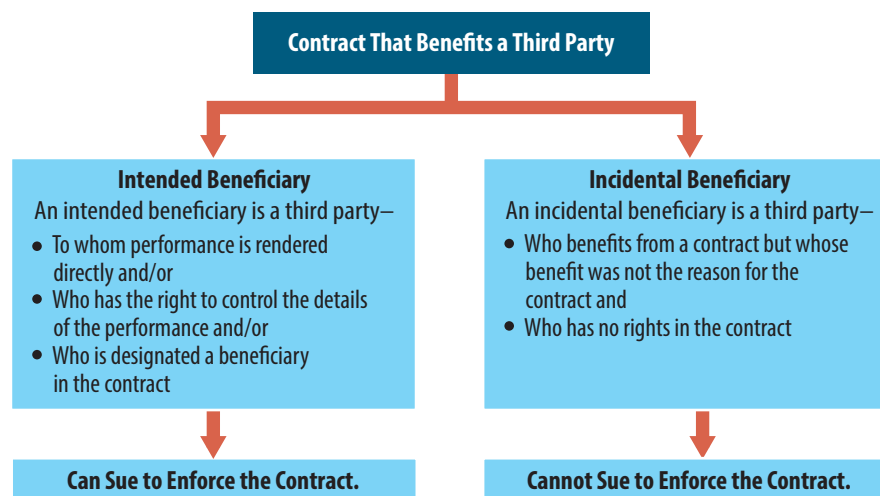
Exhibit 15.3 illustrates the distinction between intended and incidental beneficiaries.

Learning Outcome 4

Explain when a third party beneficiary's rights in a contract vest.

incidental beneficiary

A third party who incidentally benefits from a contract but has no rights in it.

Exhibit 15.3 Third Party Beneficiaries**Highlighting the Point**

New York City (NYC) decides to build a DNA testing laboratory. The Dormitory Authority of the State of New York (DASNY) takes over the project and contracts with Perkins Eastman Architects. That firm hires Sampson Construction to evacuate the site. Sampson's evacuation causes adjacent structures to "settle," resulting in \$37 million in damages.

Can DASNY and NYC sue Perkins and Sampson Construction for breach of contract? The answer depends on whether NYC was a third party beneficiary to the contract between Perkins and Sampson. Ultimately, a reviewing court ruled that NYC was not an intended third party beneficiary of the contracts between DASNY and Perkins or DASNY and Sampson. Generally, construction contracts require expressed contractual language stating clearly the parties' intent to benefit a third party.

**Linking Business Law to Your Career****Assignment and Delegation**

Most sales are based on open accounts. This means that the buyer is obligated to pay, but the seller agrees to accept payment within thirty, sixty, or ninety days, depending on the industry and the parties involved.

During that time, the seller has no cash to show for the sale. To obtain working capital, the seller generally can assign the right to payment to a lender. The assignments of such rights—and the delegations of duties—are common in the business world.

Contract Rights and Duties

Any contract right or duty can be assigned or delegated unless this is prohibited by the contract, a statute, or another

limitation. For instance, a manufacturer can assign or delegate the production of goods to a third party unless prohibited by a buyer's contract. Similarly, without a clause specifying otherwise, a tenant under a lease may assign it to another party.

Contract Restrictions

In certain situations, businesses may wish to prohibit third parties from acquiring contract rights. For instance, a property owner can prohibit the assignment of a lease for the balance of its term without the property owner's consent. Most purchase orders (contracts) have clauses that prohibit the sellers' assignments or delegations of performance with

respect to the subject of the contract without the buyers' consent.

Contract Review

When you are a party to a business contract, be aware of the possibility of its assignment or delegation. With this in mind, you should:

1. **Read the contract.** Review the terms to learn whether you or the other contracting party can assign or delegate rights or duties under the contract to a third party.
2. **Permit or prohibit these rights.** If you do not want your contract rights or duties to be assigned or delegated, insert a clause that prohibits assignment or delegation without your consent.
3. **Identify the terms.** If you or the other party can assign or delegate the contract rights or performance, then pinpoint the benefits and obligations, such as notice to customers.
4. **Follow the requirements.** To avoid unwanted liability and other negative consequences, carefully adhere to the requirements for a contract's assignment or delegation.

Chapter Summary—Third Party Rights

Learning Outcome 1: Describe a contract assignment.

An assignment is the transfer of rights under a contract to a third party. The person assigning the rights is the assignor. The party to whom the rights are assigned—the assignee—has a right to demand performance from the other original party to the contract (the obligor). Generally, any right can be assigned, except in a few special circumstances.

Learning Outcome 2: Define a contract delegation.

A delegation is the transfer of duties under a contract to a third party—the delegatee—who assumes the obligation of performing the duties previously held by the one making the delegation—the delegator. With a few exceptions, any duty can be delegated.

Learning Outcome 3: Identify noncontracting parties with contract rights.

A third party beneficiary benefits from a contract formed by two other parties. An intended beneficiary is a third party for whose benefit the contract was created. When the promisor—the one making the contractual promise that benefits the third party—fails to perform as promised, the third party can sue the promisor directly.

An incidental beneficiary is a third party who indirectly benefits from a contract but for whose benefit the contract was not specifically intended. Incidental beneficiaries have no rights to the benefits received and cannot sue to have the contract enforced.

Learning Outcome 4: Explain when a third party beneficiary's rights in a contract vest.

An intended third party beneficiary's rights vest (1) when the third party demonstrates manifest assent to the contract, (2) when the third party materially alters their position in detrimental reliance on the contract, or (3) when the conditions for vesting are satisfied.

Straight to the Point

1. When the rights under a contract are assigned, what happens to the rights of the assignor? (See Learning Outcome 1.)
2. What is an anti-assignment clause? (See Learning Outcome 1.)
3. What duties cannot be delegated? (See Learning Outcome 1.)
4. When does a third party have contractual rights? (See Learning Outcome 3.)
5. What factors indicate that a third party beneficiary to a contract is an intended beneficiary rather than an incidental beneficiary? (See Learning Outcome 3.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Brian owes Jeff \$100. Ed tells Brian to give him the \$100 and he'll pay Jeff. Brian gives Ed the \$100. Ed never pays Jeff. Can Jeff successfully sue Ed for the \$100? Why or why not? (See Learning Outcome 1.)
2. Fleet Trucking leases a delivery truck to Grocers Express. The lease prohibits Grocers from assigning its rights without Fleet's consent. When the truck needs repair, Grocers leaves it with Harland's Truck Service. Unable to pay for the repair, Grocers assigns its rights to the truck to Harland without obtaining Fleet's consent. Is the assignment enforceable? Explain your answer. (See Learning Outcome 1.)

Real Law

15-1. Creditor Beneficiary. Kenneth Newman attempted to recover allegedly unpaid overtime wages. He claimed that he was implicitly an employee of Plains All American Pipeline, L.P. Plains classified him as an independent contractor. In fact, Newman had only signed an employment agreement with Cypress Energy Management-TIR, LLC. In other words, the defendant Plains All American Pipeline was not a signatory to Newman's employment contract. At trial, the question arose as to whether Newman was a creditor beneficiary to the contract between Plains All American Pipeline and Cypress Energy Management. Newman argued that his employment agreement with Cypress would be for the benefit of Plains. Was Newman a creditor beneficiary or did he only benefit incidentally by the performance of the contract between Plains All American Pipeline and Cypress? [*Newman v. Plains All American Pipeline, L.P.*, 2020 WL 7974298 (U.S. Dist. Ct., W.D., Texas, 2020)] (See Learning Outcome 3.)

15-2. Third Party Beneficiaries. Randy Jones is an agent for Farmers Insurance Company of Arizona. Through Jones, Robert and Marcia Murray obtained auto insurance with Farmers. On Jones's advice, the Murrys increased the policy's limits over the minimums required by the state of

Arizona, except for uninsured/underinsured motorist coverage, for which Jones made no recommendation. Later, the Murrys' seventeen-year-old daughter, Jessyka, was in an accident that involved both an uninsured motorist and an underinsured motorist. She sustained a traumatic brain injury that permanently incapacitated her. Does Jessyka, as a third party to her parents' contract for auto insurance, have standing to bring a claim against Jones and Farmers? Explain. [*Murray v. Farmers Insurance Company of Arizona*, 366 P.3d 117, 239 Ariz. 58 (Ariz. Ct. of App., 2nd Div., 2016)] (See Learning Outcome 3.)

15-3. Third Party Beneficiary. David and Sandra Dess contracted with Sirva Relocation, LLC, to assist in selling their home. In their contract, the Desses agreed to disclose all information about the property on which Sirva "and other prospective buyers may rely in deciding whether and on what terms to purchase the Property." The Kincaids contracted with Sirva to buy the house. After the closing, they discovered dampness in the walls, defective and rotten windows, mold, and other undisclosed problems. Can the Kincaids bring an action against the Desses for breach of their contract with Sirva? Why or why not? [*Kincaid v. Dess*, 48 Kan. App.2d 640, 298 P.3d 358 (2013)] (See Learning Outcome 3.)

Ethical Questions

15-4. Incidental Beneficiaries. Should incidental beneficiaries have any legal recourse against parties who do not perform their contracts? Why or why not? (See Learning Outcome 3.)

15-5. Intended Third Party Beneficiaries. The Health Care Providers Self Insurance Trust (the trust) provided workers' compensation coverage to the employees of its members, including Accredited Aides Plus, Inc. The trust contracted with Program Risk Management, Inc. (PRM), to serve as the program administrator. The contract obligated PRM to reimburse the trust for "claims, losses, and liabilities . . .

arising out of" PRM's acts or omissions. When the trust became insolvent, the state of New York assessed the trust's employer-members for some of its debts. These employer-members filed a suit against PRM for breach of contract. Were the trust's employer-members third party beneficiaries of the trust's contract with PRM? If so, could the employer-members maintain this action against PRM? Did the members have an ethical duty to pursue this claim? Explain. [*Accredited Aides Plus, Inc. v. Program Risk Management, Inc.*, 46 N.Y.S.3d 246 (N.Y.A.D. 3 Dept. 2017)] (See Learning Outcome 3.)

Chapter 15—Work Set

True-False Questions

- _____ 1. Intended beneficiaries have no legal rights under a contract.
- _____ 2. The party who makes an assignment is the assignee.
- _____ 3. All rights can be assigned.
- _____ 4. If a contract contains a clause that prohibits assignment of the contract, then ordinarily the contract cannot be assigned.
- _____ 5. An assignment is not effective without notice.
- _____ 6. No special form is required to create a valid delegation of duties.
- _____ 7. Only intended beneficiaries acquire legal rights in a contract.
- _____ 8. A transfer of duties is called a delegation.
- _____ 9. If a delegatee fails to perform, the delegator must do so.

Multiple-Choice Questions

- _____ 1. Valdis contracts with Dan to buy Dan a new car manufactured by General Motors Corporation (GMC). GMC is
 - a. an intended beneficiary.
 - b. an incidental beneficiary.
 - c. not a third party beneficiary.
 - d. both a and b.
- _____ 2. Bernie has a right to \$100 against Holly. Bernie assigns the right to Tom. Tom's rights against Holly
 - a. include the right to demand performance from Holly.
 - b. are subject to any defenses Holly has against Bernie.
 - c. do not vest until Holly assents to the assignment.
 - d. include both a and b.
- _____ 3. Frank owes Jim \$1,000. Frank contracts with Danylo to pay the \$1,000 and notifies Jim of the contract by e-mail. Jim replies by e-mail that he agrees. After Frank receives Jim's reply, Danylo and Frank send Jim an e-mail stating that they have decided to rescind their contract. Jim's rights under the contract
 - a. vested when Jim learned of the contract and demonstrated manifest assent to it.
 - b. vested when Frank and Danylo formed their contract.
 - c. will not vest because Danylo and Frank rescinded their contract.
 - d. could never vest because Jim is an incidental beneficiary.
- _____ 4. Jenny sells her Value Auto Parts store to Burt and makes a valid contract not to compete. Burt wants to sell the store to Discount Auto Centers and assign to Discount the right to Jenny's promise not to compete. Burt can
 - a. sell the business and assign the right.
 - b. sell the business but not assign the right.
 - c. assign the right but not sell the business.
 - d. neither assign the right nor sell the business.

- _____ 5. Orlando contracts with Jane to mow Jane's lawn. Orlando delegates performance of the duty to Sally with Jane's assent. Who owes Jane a duty to cut her grass?
- Orlando, but not Sally.
 - Sally, but not Orlando.
 - Both Orlando and Sally.
 - Neither Orlando nor Sally.
- _____ 6. Nick contracts with Kathy to paint Nick's portrait. Nick assigns his right to Kathy's painting services to Ronaldo. This assignment to Ronaldo
- cannot be assigned because the contract involves services of a personal nature.
 - can be assigned if the duty to paint the portrait is delegated.
 - can be assigned if Ronaldo pays in advance.
 - can be assigned under any circumstances.
- _____ 7. Fred unconditionally assigns to Liva his rights under a contract with Paul. Fred's rights under the contract
- continue until the contract is fully executed.
 - continue until Paul performs his obligations under the contract.
 - continue until Liva receives Paul's performance.
 - are extinguished.
- _____ 8. Ann has a right to receive payment under a contract with Bill. Without notice, Ann assigns the right first to Carl and then to Diane. In most states, the party with priority to the right would be
- Ann.
 - Bill.
 - Carl.
 - Diane.

Answering More Legal Problems

1. Eli develops and patents the technology behind the VuYu, which allows its users to stream high-definition video from online video services directly to a television set. Eli assigns the rights to Bright Lights, Inc. In exchange, Bright Lights agrees to make and market the device, and assigns a right to receive a percentage of the gross sales revenue to Eli.

Can these rights be assigned? Yes. As a general rule, all rights can be assigned, except in special circumstances. If a _____ expressly prohibits the assignment of a certain right, the right cannot be assigned. When a contract is _____ in nature, the rights in the contract cannot be assigned. A right cannot be assigned if its assignment will significantly _____ the risks to or the duties of the obligor. If a _____ provides that certain rights cannot be assigned, then they cannot be assigned. The rights in this contract do not fall into any of these categories.
2. To begin to manufacture the VuYu, Bright Lights buys equipment from Crest Labs, Inc. Because Bright Lights does not have the funds to finance the purchase, Crest grants the buyer credit in exchange for monthly payments of the amount owed. Later, the owners of Bright Lights sell the firm to Playback, LLC, which agrees in their contract to make the remaining payments to Crest.

If Playback fails to make the payments, can Crest sue Playback directly? Yes. An _____ beneficiary can sue the promisor directly for breach of a contract made for the benefit of the _____. The contract between Bright Lights and Playback includes a provision for the continuation of payments to Crest. This provision is clearly for the benefit of _____. Thus, Crest can sue Playback directly to enforce the contract and obtain payment on the amount owed for the equipment.

16

Termination and Remedies

Conflict Presented

Naomi, a jazz singer, contracts with Primetime, which manages artists and produces recordings. Later, Naomi becomes personally involved with Michael, the president of Primetime. When their personal relationship falls apart, they agree to have contact only through their lawyers. Later, Naomi seeks to cancel her contract with Primetime, arguing that its performance has become impossible.

Q Does Naomi and Michael's agreement to have contact only through their lawyers render the performance of Naomi's Primetime contract impossible?

Parties to a contract need to know when their contract is terminated. In other words, the parties need to know when their contractual duties are at an end. This chapter deals first with the discharge of a contract. Discharge is normally accomplished when both parties have performed the acts promised in the contract but can occur in several other ways.

When it is no longer advantageous for parties to fulfill their contractual obligations, breach of contract may result. A **breach of contract** occurs when a party fails to perform part or all of the required duties under a contract. Once this occurs, the other party—the nonbreaching party—can choose one or more of several remedies.

16–1 Contract Termination

The most common way to terminate, or **discharge**, contractual duties is by **performance** of those duties. In addition to discharge by performance, a contract can be discharged by failure of a condition, by agreement, and by operation of law.

16–1a Discharge by Failure of a Condition

In most contracts, promises of performance are not conditioned. They must be performed, or the party promising the act will be in breach of contract.

Example 16.1 Home Farms contracts to sell Bagels & Bytes a truckload of organic produce for \$1,000. The promises are unconditional. Bagels & Bytes does not have to pay Home Farms if the produce is not delivered. ■

In some situations, however, the duty to perform may be conditioned on the occurrence or nonoccurrence of a certain event. If the condition is not satisfied, the obligations of the parties are discharged. **Example 16.2** Restoration Motors offers

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Explain the difference between complete and substantial performance.
- 2 Describe discharge by agreement.
- 3 Identify different types of damages.
- 4 Define the remedy of rescission and restitution.

breach of contract

Failure to perform the obligations of a contract.

discharge

The termination of one's obligation under a contract

performance

The fulfillment of one's duties arising under a contract.

to buy Charlie's 1960 Cadillac limousine only if an expert appraiser estimates that it can be restored for less than a certain price. Their obligations are conditioned on the outcome of the appraisal. If the condition is not satisfied—if the appraiser deems the cost to be above that price—their obligations are discharged. ■

16–1b Discharge by Performance

tender

A timely offer to pay a debt or perform an obligation.

A contract ends when both parties perform the acts they have promised. Performance can also be accomplished by tender. **Tender** is an unconditional offer to perform by a person who is ready, willing, and able to do so.

For instance, a seller who places goods at the disposal of a buyer has tendered delivery and can demand payment. A buyer who offers to pay for goods has tendered payment and can demand delivery. **Example 16.3** Custom Renovations orders bathroom fixtures from Budget Plumbing. As agreed, Budget places the fixtures on its warehouse loading dock for Custom to pick up on May 1. Budget has tendered delivery and can demand payment from Custom. ■

Once performance has been tendered, the party making the tender has done everything possible to carry out the terms of the contract. It is important to distinguish between complete performance and substantial performance.

Learning Outcome 1

Explain the difference between complete and substantial performance.

Complete Performance When a party performs exactly as agreed, there is no question as to whether the contract has been performed. In this situation, a party's performance is said to be complete.

Normally, conditions expressly stated in the contract must be fully met for complete performance to take place. Any deviation breaches the contract and discharges the other party's duty to perform.

In most contracts, the parties fully discharge their obligations by complete performance. Sometimes, though, a party's performance is incomplete. The issue then arises as to whether the deviating performance was sufficiently substantial to discharge the contractual obligations.

Substantial Performance A party who in good faith performs substantially all of the terms of a contract can enforce the contract against the other party under the doctrine of substantial performance. There are three basic requirements for performance to qualify as substantial performance.

1. The party must have performed in good faith. (Intentional failure to comply with the contract terms is a breach of the contract.)
2. The performance must not vary greatly from the performance promised in the contract. (An omission, variance, or defect in performance is considered minor if it can easily be remedied.)
3. The performance must create substantially the same benefits as those promised in the contract.

Courts decide whether performance was substantial on a case-by-case basis, examining all of the facts of the situation.



Real Case

Magic Carpet Ride (MCR) purchased a used airplane from Rugger Investment Group. The contract required the airplane to be free from any liens (legal claims) against it. In fact, that airplane was burdened with a legal claim against it at the time of the sale. The two sides amended their contract, giving Rugger an additional ninety days to remove the lien or to pay MCR a \$90,000 penalty. Rugger obtained the lien release, but 8 days too late. MCR sued for breach of contract to recover the \$90,000 penalty.

Had Rugger acted in good faith to meet the ninety-day deadline and therefore be able to claim substantial performance under the terms of the amended contract? Yes. In *Magic Carpet Ride, LLC, et al. v. Rugger Investment Group L.L.C.*, a California court of appeal ruled in favor of Rugger. The appellate court asserted that it would be unfair for MCR to obtain the airplane and an additional \$90,000. The eight-day delay did not prevent Rugger from claiming substantial performance under the terms of the amended agreement.

—41 Cal.App. 5th 357 (4th Dist.)

Highlighting the Point



Wilson River Energy Company contracts with O&A Railroad to transport coal to Wilson from mines in Colorado. The contract requires Wilson to notify O&A monthly how many tons of coal it wants to have shipped the next month. The contract states that O&A is to “make good faith reasonable efforts” to meet the schedule. The contract also requires Wilson to supply the railcars. When Wilson does not supply railcars, O&A uses its own railcars and delivers 85 percent of the requested coal. Wilson sues for breach of contract.

Can O&A enforce the contract under the doctrine of substantial performance? Yes. O&A has acted in good faith and has delivered 85 percent of the contracted amount of coal. It has substantially performed and is not in breach of the contract.

Material Breach of a Contract If performance is not substantial, there is a material breach—the nonbreaching party is excused from performance and can sue for damages caused by the breach.

Example 16.4 Clay sells an apartment building in San Francisco to Montgomery. The building’s plumbing does not meet the city’s building code. The contract between Clay and Montgomery provides that Clay will have the plumbing fixed within six months. A year later, the repairs have not been made, the city has fined Montgomery for the code violations, and the building’s tenants are moving out. Clay’s failure to fix the plumbing is a material breach. Montgomery is no longer obligated to make payments under the contract. ■

Performance to the Satisfaction of Another Contracts often state that completed work must personally satisfy one of the parties or a third person. How this requirement is interpreted depends in part on the subject matter of the contract.

When the subject matter is personal, performance must actually satisfy the party whose satisfaction is required. Contracts for works of art and medical or dental work, for instance, are personal. **Example 16.5** Teresa hires Raymond to take a minimum of two hundred photos of her wedding and create an online wedding photo album within two weeks of her wedding day. Teresa’s personal satisfaction with the results of Raymond’s performance is required to successfully complete the contract. ■

Most other contracts need only be performed to the satisfaction of a reasonable person unless they expressly state otherwise. When the subject matter of a contract is mechanical—such as installing a heat pump in a house—courts are likely to find that the performing party has performed satisfactorily if a reasonable person would be satisfied with what was done.

Some contracts require performance to the satisfaction of a third party with superior knowledge or training, such as a supervising engineer. Here, the courts

are divided. A majority of courts require the work to be satisfactory to a reasonable person, but some courts require the personal satisfaction of the third party designated in the contract.

16–1c Discharge by Agreement

Learning Outcome 2

Describe discharge by agreement.

Any contract can be discharged by the agreement of the parties. This agreement can be part of the original contract, or the parties can form a new contract for the express purpose of discharging the original contract.

Mutual Rescission Rescission is a process in which the parties cancel the contract and are returned to the positions they occupied before the contract's formation. For mutual rescission to take place, the parties must make another agreement that also satisfies the legal requirements for a contract—there must be an offer, an acceptance, and consideration.

Ordinarily, if the parties agree to rescind a contract that is executory on both sides, their promises not to perform the acts promised will be the consideration for the second agreement. Contracts that are executed on one side (one party has performed) can be rescinded only if the party who has performed receives consideration for agreeing to call off the deal.

novation

The substitution, by agreement, of a new contract for an old one.

Novation The process of **novation** substitutes a new contract for an old one, terminating the rights under the old contract. A third party takes the place of one of the original parties. The requirements of a novation are as follows:

1. The existence of a previous, valid obligation.
2. Agreement by all the parties to a new contract.
3. The extinguishing of the old obligation (discharge of the prior party).
4. A new, valid contract.



Highlighting the Point

Glasso Corporation contracts to sell its pharmaceutical division to Phillip Pharma. Before the transfer is complete, Glasso, Phillip, and a third company, HealthCare Industries, execute a new agreement to transfer Phillip's contractual rights and duties to HealthCare.

Is the original contract discharged and replaced with the new contract? Yes. As long as the new contract is supported by consideration, the novation will discharge the original contract (between Glasso and Phillip) and replace it with the new contract (between Glasso and HealthCare). Phillip prefers a novation instead of an assignment because the novation discharges all of the liabilities associated with its contract with Glasso.

Accord and Satisfaction As mentioned in an earlier chapter, an accord and satisfaction occurs when the parties to a contract agree to accept performance that is different from the performance originally promised. An accord is an agreement to perform some act to satisfy an existing contractual duty. A satisfaction is the actual performance of the accord. An accord and its satisfaction discharge the original contractual obligation.

Once the accord has been made, the original obligation is suspended. The obligor can discharge the original obligation by performing the obligation agreed to in the accord. Likewise, if the obligor refuses to perform the accord, the obligee can bring an action on the original obligation.

Example 16.6 Shep obtains a judgment against Marla for \$8,000. Later, they agree that the judgment can be satisfied by Marla's transfer of her automobile to Shep. This agreement to accept the car in lieu of \$8,000 is the accord. If Marla transfers her car to Shep, the accord is fully performed, and the \$8,000 obligation is discharged. If Marla refuses to transfer her car, the accord is breached. Because the original obligation is merely suspended, Shep can sue to enforce the judgment for \$8,000. ■ (See this chapter's Linking Business Law to Your Career feature for more on performance and compromise.)

16–1d Discharge by Operation of Law

Under some circumstances, contractual duties may be discharged by operation of law. These circumstances include the ones discussed next.

Statute of Limitations A **statute of limitations** limits the time during which a party can sue on a particular cause of action. After the time has passed, a suit based on that cause can no longer be brought. The statutory period for bringing a suit for breach of a written contract is typically four or five years.

statute of limitations

A statute limiting the time period a certain action can be brought.

Impossibility of Performance After a contract has been made, performance may become impossible in an objective sense. This situation, known as **impossibility of performance**, may discharge a contract. Note that objective impossibility ("It cannot be done") must be distinguished from subjective impossibility ("I'm sorry, I personally cannot do it").

impossibility of performance

A situation in which performance is impossible or totally impracticable in an objective sense.

Certain situations generally qualify under the doctrine of impossibility of performance to discharge contractual obligations:

1. When one of the parties to a personal contract dies or becomes incapacitated before a performance. **Example 16.7** Francis, a famous dancer, contracts with Evergreen Dancing Guild to play a leading role in its new ballet. Before the ballet can be performed, Francis dies. His death discharges the contract. ■
2. When the specific subject matter of the contract is destroyed. **Example 16.8** Ace Farm Equipment agrees to sell Garrett a specific tractor and promises to have it ready for him to pick up on Saturday. On Friday night, the tractor is destroyed beyond repair when a speeding delivery truck crashes into it. The accident renders Ace's performance impossible. ■
3. When a change in the law renders performance illegal.

Conflict Resolved

In the Conflict Presented feature at the beginning of the chapter, Naomi contracts with Primetime, which manages musical artists and produces their recordings. Later, she becomes personally involved with Michael, Primetime's president. When they break up, they agree to have contact only through their lawyers. Later, Naomi seeks to cancel her contract with Primetime.

A Does Naomi and Michael's agreement to have contact only through their lawyers render the performance of Naomi's Primetime contract impossible? Yes. Performance of the Primetime contract is rendered impossible by the parties' agreement prohibiting contact except through counsel. Because of Michael's position, performance of the Primetime contract requires his direct input, which is prohibited by his agreement with Naomi. Additionally, this agreement was not foreseeable, so the Primetime contract could not have provided for its occurrence.

Exhibit 16.1 Contract Discharge**commercial impracticability**

A situation in which the duty to perform becomes too difficult or costly due to unforeseen factors.

Commercial Impracticability A party may sometimes be excused from performing a contract under the doctrine of **commercial impracticability**. Performance becomes commercially impracticable when it turns out to be significantly more difficult or expensive than anticipated. The added burden of performing must be extreme and must not have been foreseeable by the parties at the time the contract was made.

Example 16.9 Sanchez Excavation Company contracts with Energy Fuel to bury a pipeline. Several days into the work, Sanchez encounters unforeseen difficulties in the subsurface that significantly increase its original excavation costs. Both parties agree to discharge the contract on the ground of commercial impracticability. ■

Caution should be used in invoking the doctrine of commercial impracticability. The added burden of performing must be extreme and must not have been foreseeable by the parties at the time the contract was made.

Temporary Impossibility An occurrence or event (such as a war) that makes performance temporarily impossible operates to suspend performance temporarily. Once the temporary event ends, the parties must perform the contract as originally planned.

For a visual summary of all the ways in which a contract can be discharged, see Exhibit 16.1.

16-2 Contract Remedies

remedy

The relief given to an innocent party to enforce a right or compensate for the violation of a right.

A **remedy** is the relief provided for an innocent party when the other party has breached the contract. It is the means employed to enforce a right or to redress an injury. The most common remedies are damages, rescission and restitution, and specific performance.

16-2a Types of Damages

When a party breaches a contract, the nonbreaching party can sue for damages (money). **Damages** are designed to compensate the nonbreaching party for the loss of the bargain. Generally, innocent parties are to be placed in the position they would have occupied had the contract been fully performed. A nonbreaching party can sue for four types of damages: compensatory damages, consequential damages, punitive damages, and liquidated damages.

damages

Money sought as a remedy for a breach of contract or a wrongful act.

Compensatory Damages Damages compensating the nonbreaching party for the loss of the bargain are **compensatory damages**. These damages compensate the injured party only for injuries actually sustained and proved to have arisen directly from the breach of contract.

The amount of compensatory damages is the difference between the value of the breaching party's promised performance and the value of their actual performance. This amount is reduced by any loss that the injured party has avoided.

Example 16.10 Julietta wires Roy, her financial advisor, \$34,980 to purchase an allocation of FluidCoins initial cryptocurrency offering. Roy does not invest these funds as agreed, instead co-mingling them with funds used for his personal acquisition of FluidCoins. Julietta sues Roy, seeking \$34,980 in compensatory damages. Finding breach of contract, a court awards Julietta the \$34,980 plus attorney's fees and litigation cost, with interest. ■

The measurement of compensatory damages varies by type of contract. In a contract for a sale of goods, the usual measure of compensatory damages is the difference between the contract price and the market price at the time and place of delivery.

compensatory damages

A monetary award equivalent to the actual value of injuries or damages sustained by the aggrieved party.

Learning Outcome 3

Identify different types of damages.

Highlighting the Point



River Community College loses its accreditation from the National League of Nursing Accreditation Commission (NLNAC) in July. The college does not inform its nursing students of this development until after classes have started.

Can River Community College nursing students sue? If so, what should they ask for? Yes. Students paid their fees in exchange for a degree with an NLNAC-accredited institution. By losing that accreditation, River breached the contract. That breach will harm the students' career prospects. Hence, compensatory damages can be determined by measuring the difference between the students' future earnings capacity as graduates of an NLNAC-accredited nursing college and their future earnings capacity as graduates of now non-accredited River Community College.

Consequential Damages **Consequential damages** are reasonably foreseeable damages that result from a party's breach of contract. They differ from compensatory damages in that they are caused by special circumstances beyond the contract itself. For a nonbreaching party to recover consequential damages, the breaching party must know (or have reason to know) that special circumstances will cause the nonbreaching party to suffer an additional loss.

consequential damages

Special damages to compensate for a loss that goes beyond the contract itself.

Highlighting the Point



Maddox contracts to purchase six hundred cases of a specialty sports drink from Nathan. Nathan knows that Maddox has contracted with Chloe to resell and ship the beverage within hours of its receipt. The beverage will be then sold to fans attending the Super Bowl. Nathan fails to deliver the sports drink in time for Maddox to get the shipment to Chloe.

Can Maddox recover consequential damages from Nathan? Yes. Maddox can recover the consequential damages—the loss of profits from the planned resale to Chloe—caused by Nathan's nondelivery.

punitive damages

Damages that are awarded to punish the wrongdoer.

liquidated damages

A reasonable estimate of the damages that will occur in the event of a breach.

penalty

A sum named in a contract as punishment for a default.

Punitive Damages Punitive damages are designed to punish a wrongdoer and set an example to deter similar conduct in the future. Such damages are very seldom awarded in lawsuits for breach of contract. In general, punishment does not play a role in contract law.

Liquidated Damages A liquidated damages provision in a contract specifies a certain amount to be paid in the event of a future default or breach of contract. (Liquidated means determined, settled, or fixed.) Liquidated damages differ from penalties. A **penalty** specifies a certain amount to be paid in the event of a default or breach of contract and is designed to penalize the breaching party. Liquidated damages provisions normally are enforceable, but penalty provisions are not.

To determine whether a particular provision is for liquidated damages or for a penalty, a court must answer two questions:

1. When the contract was formed, was it difficult to estimate the potential damages that would be incurred if the contract was not performed on time?
2. Was the amount set as damages a reasonable estimate of those potential damages?

If both answers are yes, the provision is for liquidated damages and will be enforced. If either answer is no, the provision is for a penalty and normally will not be enforced.

16–2b Rescission and Restitution

Rescission is essentially an action to undo, or cancel, a contract and to return nonbreaching parties to the positions that they occupied before the transaction. When fraud, a mistake, duress, or failure of consideration is present, rescission is available. In addition, the failure of one party to perform entitles the other party to rescind the contract. The rescinding party must give prompt notice to the breaching party.

To rescind a contract, the parties must make **restitution** to each other by returning goods, property, or funds previously conveyed. If the property or goods have been consumed, restitution must be an equivalent amount of money. Basically, restitution is a way to avoid the unjust enrichment of one party at the expense of another. In other words, any benefit unfairly obtained must be returned.

Learning Outcome 4

Define the remedy of rescission and restitution.

restitution

The restoration of goods, property, or funds previously conveyed.



Highlighting the Point

Alima pays \$10,000 to Milos in return for Milos's promise to design a house for her. The next day, Milos calls Alima and tells her that he has taken a position with a large architectural firm in another state and cannot design the house. Alima decides to hire another architect that afternoon.

If Alima sues Milos for restitution, what can Alima recover? Alima can obtain restitution of \$10,000, because an unjust benefit of \$10,000 was conferred on Milos.

16–2c Specific Performance

The equitable remedy of **specific performance** calls for the exact performance of the act promised in the contract. Specific performance is not granted unless the party's legal remedy (monetary damages) is inadequate.

specific performance

An equitable remedy requiring exactly the performance that was specified in a contract.

Readily Available Goods Contracts for the sale of goods, such as wheat or corn, that are readily available rarely qualify for specific performance. Damages ordinarily are adequate in such situations because substantially identical goods can be bought or sold in the market.

Rare or Unique Goods If a contract involves goods that are rare or unique—such as a painting or parcel of land—a court will decree specific performance. In this situation, obtaining substantially identical goods in the market is nearly impossible. **Example 16.11** Levy contracts to sell twelve acres to Solano for \$65,000. Solano pays for a survey and other costs and gives Levy \$1,000 as a demonstration of good faith. Before the sale closes, Levy dies. His heir, Herschel, refuses to go through with the deal. Solano files a suit against Herschel. Because Solano has substantially fulfilled his duties under the contract and stands ready to perform the rest, a court normally will issue an order of specific performance in his favor. ■

Contracts for Personal Services Personal-service contracts require one party to work personally for another party. Courts normally refuse to grant specific performance of personal-service contracts. Ordering a party to perform personal services against their will amounts to involuntary servitude, which is against public policy.

Exhibit 16.2 summarizes the remedies available to a nonbreaching party.

16–2d Mitigation of Damages

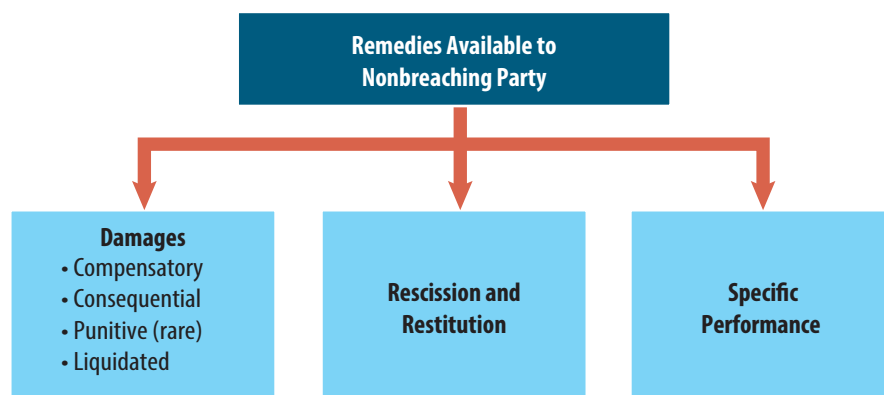
In most situations, when a breach of contract occurs, the injured party has a duty to mitigate, or reduce, the damages that they suffer. Under this doctrine of **mitigation of damages**, the required action depends on the nature of the situation.

mitigation of damages

A rule requiring a plaintiff to reasonably minimize the damages caused by the defendant.

In the majority of states, for instance, a person whose employment has been wrongfully terminated has a duty to mitigate damages by taking a similar job if one is available. If the person fails to do this, the damages received will be equivalent to the person's former salary less the income they would have received in a similar job obtained by reasonable means.

Exhibit 16.2 Remedies for Breach of Contract





Linking Business Law to Your Career

Performance and Compromise

In any career field, if you become a contractor, you may take on a job that you cannot or do not wish to perform. Simply walking away from the job and hoping for the best normally is not the most effective way to avoid litigation. Instead, you should consider various options that may reduce the likelihood of litigation.

Suppose that you are a building contractor, and you sign a contract to build a home for the Afumbas. Performance is to begin on June 15. On June 1, Central Enterprises offers you a position that will give you two and a half times the amount of income you could earn as an independent builder. To take this new job, you would have to start on June 15.

Consider Your Options When You Cannot Perform

What can you do in this situation? One option is to subcontract the work on the Afumbas' home to another builder

and oversee the work to make sure it conforms to the contract. Another option is to negotiate with the Afumbas for a release. You can offer to find another contractor who will build a house of the same quality at the same price. Or you can offer to pay any additional costs if another builder takes the job but is more expensive.

In any event, this additional cost would be one measure of damages that a court would impose on you if the Afumbas prevailed in a lawsuit for breach of contract. In addition, you could be liable for any costs the Afumbas suffered as a result of the breach, such as costs due to the delay in construction. Thus, by making the offer, you might be able to avoid the expense of litigation—if the Afumbas accept.

Chapter Summary—Termination and Remedies

Learning Outcome 1: Explain the difference between complete and substantial performance.

A contract may be discharged by complete performance or by substantial performance. Complete performance takes place when conditions expressly stated in a contract are fully met. Substantial performance does not vary greatly from the performance promised in a contract and must result in substantially the same benefits. A party who in good faith performs substantially all of the terms of a contract can enforce the contract against the other party.

Learning Outcome 2: Describe discharge by agreement.

Any contract can be discharged by an agreement of the parties. This agreement may be part of the original contract, or the parties may form a new contract that expressly discharges the original contract. Parties may also agree to discharge their contract by (1) mutual rescission, (2) novation, or (3) accord and satisfaction.

Learning Outcome 3: Identify different types of damages.

Damages are designed to compensate a nonbreaching party for the loss of a bargain on the breach of a contract. Types of damages include (1) compensatory damages, (2) consequential damages, (3) punitive damages, and (4) liquidated damages.

Learning Outcome 4: Define the remedy of rescission and restitution.

Rescission is an action to cancel a contract and return the parties to the positions that they occupied before the transaction. The rescinding party must give prompt notice to the breaching party. When a contract is rescinded, the parties must make restitution—return to each other the goods, property, or money previously conveyed.

Straight to the Point

1. What is the most common way to terminate, or discharge, a contract? (See Learning Outcome 1.)
2. What are two ways in which performance of a contract can be accomplished? (See Learning Outcome 1.)
3. How can mutual rescission take place? (See Learning Outcome 1.)
4. What is a statute of limitations? (See Learning Outcome 1.)
5. What are three ways in which performance of a contract may become impossible in an objective sense? (See Learning Outcome 1.)
6. What are the two principal types of damages recoverable on a breach of contract? (See Learning Outcome 3.)
7. In most situations, when a breach of contract occurs, the injured party has a duty to do what? (See Learning Outcome 3.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. George contracts to build a storage shed for Ron. Ron pays George in full, but George completes only half the work. Ron pays Paula \$500 to finish the shed. If Ron sues George, what will be the measure of recovery? (See Learning Outcome 3.)
2. Amy contracts to sell her ranch to Bastien, who is to take possession on June 1. Amy delays the transfer until August 1. Bastien incurs expenses in providing for cattle that he bought to stock the ranch. When they made the contract, Amy had no reason to know of the cattle. Is Amy liable for Bastien's expenses in providing for the cattle? Explain your answer. (See Learning Outcome 3.)

Real Law

16–1. Specific Performance. Harmony Development agreed to sell seven acres of a planned subdivision to Jerry Davis for \$1.5 million. The contract required Harmony to spend \$1.85 million improving the property so that Davis could construct a health club on it. After Harmony made the improvements, Davis informed the company that the subdivision no longer “fit in harmony” with his plans and refused to complete the purchase. Harmony sued for breach of contract. How should a court rule on this case and what remedy might it impose on Davis? [*Davis v. Harmony Development, LLC*, 220 W.Y. 39 (S.Ct. WY, 2020)] (See Learning Outcome 4.)

16–2. Conditions. H&J Ditching & Excavating, Inc., was hired by JRSF, LLC, to perform excavating and grading work on a residential construction project in Tennessee. Cornerstone Community Bank financed the project with a loan to JRSF. When JRSF defaulted on the loan, Cornerstone took possession of the property. H&J filed a suit in a Tennessee state court against the bank to recover the final payment for the work on its contract. The bank responded that H&J had not received its last payment because it had failed to obtain an engineer's certificate of completion—a

condition under its contract with JRSF. H&J argued that it had completed all the work it had contracted to do. Is H&J entitled to the final payment? Discuss. [*H&J Ditching & Excavating, Inc. v. Cornerstone Community Bank*, 2016 WL 675554 (Tenn.App. 2016)] (See Learning Outcome 1.)

16–3. Specific Performance. Russ Wyant owned Humble Ranch in South Dakota. Edward Humble was Wyant's uncle and held a two-year option to buy the ranch from Wyant. The option included specific conditions. Once it was exercised, for instance, the parties had thirty days to enter into a purchase agreement and the seller could become the buyer's lender by matching the terms of the proposed financing. After the option was exercised, Wyant and Humble engaged in lengthy negotiations. Humble, however, did not respond to Wyant's proposed purchase agreement nor did Humble advise him of available financing terms before the option expired. Six months later, Humble filed a suit against Wyant to enforce the option. Is Humble entitled to specific performance? Explain. [*Humble v. Wyant*, 843 N.W.2d 334 (S.Dak. 2014)] (See Learning Outcome 1.)

Ethical Questions

16–4. Impossibility of Performance. Should the courts allow the defense of impossibility of performance to be used more often? (See Learning Outcome 1.)

16–5. Commercial Impracticability. Lisa Goldstein reserved space for a wedding in a building owned by Orensanz Events, LLC, in New York City. The rental agreement provided that on cancellation of the event “for any reason beyond” Orensanz’s control, the client’s sole remedy was another date for the event or a refund. Shortly before the wedding, the New York City Department of Buildings found Orensanz’s building to be structurally unstable and

ordered it vacated. Orensanz closed the building and told Goldstein to find another venue. Goldstein filed a lawsuit in a New York state court against Orensanz for breach of contract, arguing that the city’s order had been for a cause within the defendant’s control. Was the commercial building’s structural issue a foreseeable difficulty, thus making Goldstein’s claim valid? Is the owner of a commercial building ethically obligated to keep it structurally sound? Explain your answers. [*Goldstein v. Orensanz Events, LLC*, 146 A.D.3d 492, 44 N.Y.S.3d 437 (1 Dept. 2017)] (See Learning Outcome 2.)

Chapter 16—Work Set

True-False Questions

- _____ 1. Complete performance occurs when a contract's conditions are fully satisfied.
- _____ 2. A material breach of contract does not discharge the other party's duty to perform.
- _____ 3. An executory contract cannot be rescinded.
- _____ 4. Damages compensate a nonbreaching party for the loss of the contract or give a nonbreaching party the benefit of the contract.
- _____ 5. Punitive damages are usually not awarded for a breach of contract.
- _____ 6. Liquidated damages are uncertain in amount.
- _____ 7. Consequential damages are awarded for foreseeable losses caused by special circumstances beyond the contract.
- _____ 8. Specific performance is available only when damages are also an adequate remedy.
- _____ 9. Objective impossibility discharges a contract.

Multiple-Choice Questions

- _____ 1. Sam owes Lyle \$300. Sam promises, in writing, to give Lyle a PlayStation 5 in lieu of payment of the debt. Lyle agrees, and Sam delivers the gaming console. Substituting and performing one duty for another is
 - a. a rescission.
 - b. an accord and satisfaction.
 - c. a novation.
 - d. none of the above.
- _____ 2. C&D Services contracts with Ace Concessions, Inc., to service Ace's vending machines. Later, C&D wants Dean Vending Services to assume the duties under a new contract. Ace consents. This is
 - a. a rescission.
 - b. an accord and satisfaction.
 - c. an alteration of contract.
 - d. a novation.
- _____ 3. Kate contracts with Bernardo to transport Bernardo's goods to his stores. If this contract is discharged as most contracts are, it will be discharged by
 - a. performance.
 - b. agreement.
 - c. operation of law.
 - d. none of the above.
- _____ 4. Alan contracts with Pam to build a shopping mall on Pam's land. Before construction begins, the city enacts a law that makes it illegal to build a mall in Pam's area. Performance of this contract is
 - a. not affected.
 - b. temporarily suspended.
 - c. discharged.
 - d. discharged on Pam's obligations only.

- _____ 5. Mix Corporation contracts to sell to Frosty Malts, Inc., eight steel mixers. When Mix refuses to deliver, Frosty buys mixers from MaxCo for 25 percent more than the contract price. Frosty is entitled to damages equal to
- what Mix's profits would have been.
 - the price Frosty would have had to pay Mix.
 - the difference between what Frosty would have had to pay Mix and what Frosty did pay MaxCo.
 - what Frosty paid MaxCo.
- _____ 6. Dave contracts with Paul to buy a delivery truck. Dave tells Paul that if the truck is not delivered on Monday, he will lose \$12,000 in business. Paul does not deliver the truck on Monday. Dave is forced to rent a truck on Tuesday. Dave is entitled to
- compensatory damages.
 - actual damages.
 - consequential damages.
 - all of the above.
- _____ 7. Jay agrees in writing to sell a warehouse and the land on which it is located to Nora. When Jay refuses to go through with the deal, Nora sues. Jay must transfer the land and warehouse to Nora if she is awarded
- rescission and restitution.
 - specific performance.
 - novation.
 - none of the above.
- _____ 8. Jake agrees to hire Kanna. Their contract provides that if Jake fires Kanna, she is to be paid whatever amount would have been payable if she had worked for the full term. This clause is
- a liquidated damages clause.
 - a penalty clause.
 - both a and b.
 - none of the above.

Answering More Legal Problems

1. Russo contracts with Playlist, Inc., to create a website through which users can post and share movies, music, and other forms of digital entertainment. Russo goes to work. Before the site is online, however, Congress passes the No Online Piracy in Entertainment (NOPE) Act. The NOPE Act makes it illegal to operate a website on which copyrighted works are posted without the copyright owners' consent.

Is Russo and Playlist's contract discharged? Yes. The contract was discharged by operation of law. After a contract has been made, performance may become impossible in an _____ sense. This impossibility of performance may discharge a contract. Certain situations qualify under the _____ impossibility rules to discharge contractual obligations, such as when a change in law renders performance of a contract illegal. Here, the purpose of the contract has been rendered illegal. The contract is discharged for _____ impossibility on the ground of illegality.

2. Marketshare, Inc., contracts with Ogle, a popular search engine, to use the searches conducted by Ogle's users

to compile data that will accurately pinpoint the users' interests and provide advertisers with a precisely targeted audience. Marketshare promises that the result will be worth \$5 billion, but its data produce incorrect assumptions about Ogle's users and mistargeted ads. The value of this effort to Ogle is actually \$1 billion. Ogle files a suit for breach of contract.

What is the measure of compensatory damages for this breach? The measure of compensatory damages generally is the difference between the value of the breaching party's promised _____ and the value of their actual _____. Compensatory damages compensate the nonbreaching party for the loss of a _____. They compensate the injured party only for injuries actually sustained and proved to have arisen directly from the _____. The amount of compensatory damages for this breach could be as much as \$4 billion.



Unit 3

Sales and Leases

Unit Contents

Chapter 17

Introduction to Sales and Lease Contracts

Chapter 18

Title and Risk of Loss

Chapter 19

Performance and Breach

Chapter 20

Warranties and Product Liability

Chapter 21

Consumer Protection

17

Introduction to Sales and Lease Contracts

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 State the scope of Article 2 of the UCC.
- 2 Identify how the UCC deals with open contract terms.
- 3 Explain the UCC's treatment of additional terms.
- 4 Discuss the UCC's Statute of Frauds.

Conflict Presented

AirWays Technologies promotes itself as a one-stop shop for electronics design and manufacturing. Barnett Communications hires AirWays to design and make access points—equipment that enables wireless devices to communicate. Barnett plans to sell the finished products to its customers.

AirWays designs and makes the access points and delivers them to Barnett, but they do not work. When Barnett refuses to pay, AirWays files a lawsuit for breach of contract. The parties dispute whether Barnett's claim falls under the Uniform Commercial Code (UCC), which applies to sales of goods but not to sales of services.

Q Does the UCC cover this deal? Why or why not?

When we turn to contracts for the sale and lease of goods, we move away from common law principles and into the area of statutory law. The state statutory law governing such transactions is based on the Uniform Commercial Code (UCC).

The primary goal of the UCC is to simplify and streamline commercial transactions. In short, the UCC allows parties to form sales and lease contracts without observing the same degree of formality used in forming other types of contracts.

17-1 Sales and Leases of Goods

sales contract

A contract to sell goods.

Learning Outcome 1

State the scope of Article 2 of the UCC.

Article 2 of the UCC governs **sales contracts**, or contracts for the sale of goods. Article 2 modifies some of the common law contract requirements discussed in previous chapters. To the extent that it has not been modified by the UCC, however, the common law also applies to sales contracts.

Article 2A of the UCC covers leases of goods. Article 2A is essentially a repetition of Article 2, but it varies to reflect the difference between sales and lease transactions.

17-1a What Is a Sale?

sale

The passing of title to property for a price.

Under Article 2 of the UCC, a **sale** is defined as “the passing of title from the seller to the buyer for a price.” Here, title refers to the formal right of ownership of property. The price may be payable in cash (or its equivalent) or in other goods or services.

Highlighting the Point



Oliver buys Grape Street Pub from Allison. Under the sales contract, in addition to the building and fixtures, Oliver agrees to buy the pub's movable property—such as tables and chairs, wall art, and dishware. Oliver buys the building outright, and he agrees to make monthly payments on the movable property. When a fire destroys much of the pub's interior, Oliver files an insurance claim to recover for the damage. Allison sues Oliver for part of the insurance proceeds because he has not fully paid for the movable property yet and thus does not have title.

Can Allison successfully claim that title to the movable property did not pass to Oliver? No. Under Article 2 of the UCC, title to the pub's movable property passed to Oliver at the time he contracted with Allison for the sale of the business. Oliver is the owner of the goods, even though he has not fully paid for them yet. As the owner, he is entitled to the insurance proceeds to replace them.

17-1b What Are Goods?

To be characterized as a good, an item of property must be tangible. **Tangible property** has physical existence—it can be touched or seen and carried from place to place. **Intangible property**—such as corporate stocks and bonds, patents and copyrights, and ordinary contract rights—has only conceptual existence and thus does not come under Article 2.

In addition, a good must be movable. A movable item can be carried from place to place. Because it is not movable, real estate is excluded from Article 2. Real estate includes land, interests in land, and things permanently attached to the land.

Goods Associated With Real Estate Goods associated with real estate can fall within the scope of Article 2. For instance, a contract for the sale of minerals (including oil and gas) is a contract for a sale of goods if they are to be severed, or detached, from the land by the seller. A sale of growing crops or timber to be cut is a contract for a sale of goods regardless of who severs them. Other “things attached” to real estate but capable of severance without material harm to the real estate (such as a window air conditioner) are considered goods regardless of who severs them from the land.

Goods and Services Combined The majority of courts treat contracts for services as being excluded from Article 2 of the UCC. In cases in which goods and services are combined, however, courts disagree. For instance, is the blood furnished to a patient during an operation a sale of goods or part of the performance of a medical service? Some courts say it is a good, but others say it is a service.

Because the UCC does not provide the answer, the courts generally use the **predominant-factor test** to determine whether a contract is primarily for the sale of goods or for the sale of services. If a court decides that a mixed contract is primarily a goods contract, any dispute, even a dispute over the services portion, will be decided under the UCC.

tangible property

Property that has physical existence.

intangible property

Property that exists only conceptually.

predominant-factor test

A test to determine whether a contract is primarily for the sale of goods or services.

Conflict Resolved

In the Conflict Presented feature at the beginning of the chapter, Barnett Communications hires AirWays Technologies to design and make access points. Barnett plans to sell the finished products to its customers. The access points delivered

(Continues)

to Barnett do not work, and Barnett refuses to pay. AirWays sues for breach of contract. Part of the dispute is whether the claim falls under the scope of the UCC.

A Does the UCC cover this deal? Why or why not? Yes. The UCC applies to this contract. The UCC covers sales of goods but not sales of services. When a transaction involves both goods and services, however, a court will apply the predominant-factor test. This test asks the question: Is the contract primarily for a sale of goods or a sale of services? The contract between Barnett and Airways requires the design and manufacture of a product that Barnett can sell to its customers. Thus, the predominant purpose of the deal is to produce and supply goods.

merchant

A person engaged in the purchase and sale of goods.

lease

An agreement to transfer the right to possess and use goods for a period of time in exchange for payment.

lessor

One who transfers the right to the possession and use of goods under a lease.

lessee

One who acquires the right to the possession and use of goods under a lease.

17-1c Who Is a Merchant?

Article 2 applies to sales transactions between all buyers and sellers. In certain situations, however, the UCC imposes special rules on **merchants** because of their commercial expertise. Under the UCC, a merchant is a person who deals in goods of the kind involved in the sales contract. In addition, merchants are those who hold themselves out as having knowledge and skill unique to the practices or goods involved in the transaction.

17-1d What Is a Lease?

Leases of goods—such as automobiles and industrial equipment—have become increasingly common in today’s business world. In this context, a **lease** is a transfer of the right to possess and use goods for a period of time in exchange for payment. The UCC’s Article 2A covers these lease agreements.

Article 2A defines a lease agreement as the lessor’s and lessee’s bargain, as found in their language and as implied by other circumstance. A **lessor** is one who transfers the right to the possession and use of goods under a lease. A **lessee** is one who acquires the right to the possession and use of goods under a lease.

17-2 Sales and Lease Contracts

As mentioned, sales and lease contracts are not governed exclusively by Articles 2 and 2A of the UCC. They are also governed by general contract law whenever it is relevant and has not been modified by the UCC. Exhibit 17.1 illustrates the relationship between general contract law and statutory law—UCC Articles 2 and 2A—governing contracts for the sale and lease of goods.

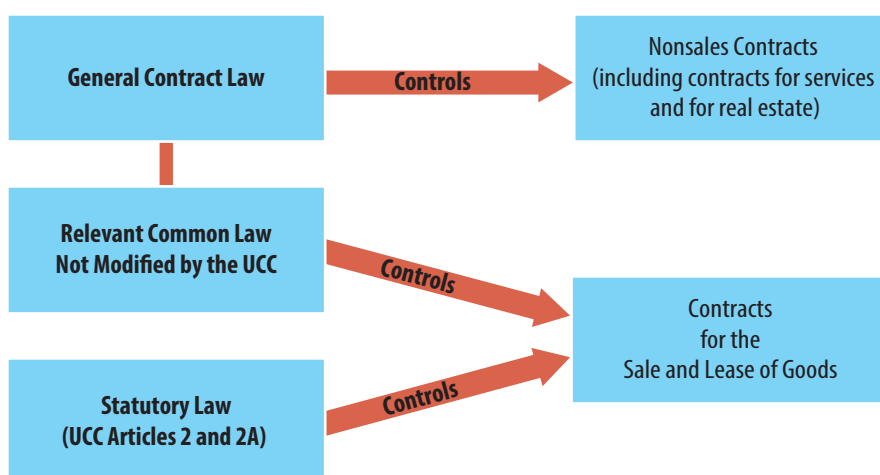
The following sections summarize how UCC provisions change the effect of the general law of contracts. It is important to remember, too, that parties to sales and lease contracts are free to establish whatever terms they wish. The UCC comes into play when the parties have left a term out of their contract and that omission later gives rise to a dispute.

17-2a Offer

In general contract law, the moment a definite offer is met by an unqualified acceptance, a binding contract is formed. In commercial sales transactions, the verbal exchanges, the correspondence, and the actions of the parties may not reveal exactly when a binding contract arises. The UCC states that an agreement sufficient to constitute a contract can exist even if the moment of its making is undetermined.

Learning Outcome 2

Identify how the UCC deals with open contract terms.

Exhibit 17.1 Law Governing Contracts

Open Terms According to general contract law, an offer must be definite enough for the parties (and the courts) to understand its essential terms when it is accepted. In contrast, the UCC states that a sales or lease contract will not fail for indefiniteness even if one or more terms are left open, as long as both of the following factors are true:

1. The parties intended to make a contract.
2. There is a reasonably certain basis for the court to grant an appropriate remedy.

The UCC provides numerous open-term provisions that can be used to fill the gaps in a contract. Thus, in the case of a dispute, all that is necessary to prove the existence of a contract is an indication (such as a purchase order) that there is a contract. Missing terms can be proved by evidence, or the courts will presume that what the parties intended was whatever is reasonable. The quantity of goods involved must be expressly stated, however. If the quantity term is left open, the courts normally will have no basis for determining a remedy.

Merchant's Firm Offer Under regular contract principles, an offer can be revoked at any time before acceptance. The UCC has an exception that applies only to **firm offers** for the sale or lease of goods made by a merchant (regardless of whether the offeree is a merchant).

A firm offer exists if a merchant gives assurances in a signed writing that the offer will remain open. A firm offer is irrevocable for the stated period or, if no definite period is stated, for a reasonable period (neither to exceed three months).

firm offer

An offer (by a merchant) that is irrevocable for a period of time.

Highlighting the Point



Chad owns and operates Famous Auto, a used car dealership. Ricardo is interested in buying a used car for his teenaged son. Ricardo meets with Chad at his business, and they discuss various options. A few days later, on January 1, Chad sends Ricardo an e-mail from his Famous Auto account. The e-mail states, "I have a 2021 GMC Sierra on the lot that I'll sell you for \$21,500 any time between now and January 31."

Is Chad's e-mail a firm offer? Yes. This writing creates a firm offer. Chad will be liable for breach if he sells that particular GMC Sierra to someone other than Ricardo before January 31.

17–2b Acceptance

Acceptance of an offer to buy, sell, or lease goods generally may be made in any reasonable manner and by any reasonable means. The UCC permits acceptance of an offer to buy goods by either a promise to ship or the prompt shipment of conforming or nonconforming goods to the buyer. Conforming goods accord with the contract's terms, whereas nonconforming goods do not.

Shipment of Nonconforming Goods If the seller promptly ships nonconforming goods, this shipment constitutes both an acceptance of an offer (a contract) and a breach. This rule does not apply, however, if the seller notifies the buyer within a reasonable amount of time that the nonconforming shipment is offered only as an accommodation. The notice of accommodation must clearly indicate that the shipment does not constitute an acceptance and that, therefore, no contract has been formed.



Highlighting the Point

McIntosh orders one thousand blue smart fitness watches from Halderson. Halderson ships one thousand black smart fitness watches to McIntosh. Halderson notifies McIntosh that it has only black watches in stock, and the black watches are being sent as an accommodation.

Is the shipment of black smart fitness watches an acceptance or an offer? The shipment is an offer. A contract will be formed only if McIntosh accepts the black watches. If Halderson ships black watches without notifying McIntosh that the goods are being sent as an accommodation, Halderson's shipment is both an acceptance of McIntosh's offer and a breach of the resulting contract. McIntosh may sue Halderson for any appropriate damages.

Notice of Acceptance Recall that a unilateral offer invites acceptance by performance. Under the common law, the offeree need not notify the offeror (a person who makes an offer) of the performance unless the offeror would not otherwise know about it. Under the UCC, however, the offeror must be notified of the offeree's performance (acceptance) within a reasonable time. Otherwise, the offeror can treat the offer as having lapsed.

Learning Outcome 3

Explain the UCC's treatment of additional terms.

Additional Terms Recall that under the common law, the mirror image rule requires that the terms of the acceptance exactly match those of the offer. **Example 17.1** Abby e-mails an offer to sell twenty Samsung Galaxy Tab S7 to Dylan. If Dylan accepts the offer but changes it to require Galaxy Tab S7+ instead, then there is no contract. ■

To avoid these types of voided contracts, the UCC dispenses with the mirror image rule. Under the UCC, a contract is formed if the offeree makes a definite expression of acceptance, such as signing the form in the appropriate location. This is true even if the terms of the acceptance either modify or add to the terms of the original offer. What happens to these new terms? The answer depends on whether the parties are nonmerchants or merchants.

1. When at least one of the parties is a nonmerchant—If one of the parties is a nonmerchant (or if both are nonmerchants), the contract is formed according to the terms of the original offer and not according to the new terms of the acceptance.

2. When both parties are merchants—When both parties to the contract are merchants, the additional terms automatically become part of the contract. There are, however, three exceptions to this rule. The terms do not become part of the contract if (a) the original offer expressly required acceptance of only its terms, (b) the new terms materially alter the contract, or (c) the offeror rejects the new terms within a reasonable time.
3. Terms subject to the offeror's consent—Regardless of merchant status, the offeree's expression is not an acceptance if the new terms are expressly conditioned on the offeror's consent. **Example 17.2** Farmland Harvest offers to sell ninety bales of hay at a certain price to Big Valley Ranch. Renata, the owner of Big Valley, says, "I accept your offer if you agree to include ten more bales." This is not an acceptance because it includes an additional term (ten more hay bales) that is expressly subject to Farmland's consent. ■

Highlighting the Point



Tanya, a public-school employee in Idaho, purchases five hundred Ready2Learn easy-grip paintbrushes from Blackwell Education Services, an online retailer based in Michigan. When the paintbrushes arrive, the accompanying invoice includes an additional term stating that any dispute between the parties will be settled in Michigan. When a dispute arises regarding payment, Blackwell files a suit in Michigan.

Is the school district bound by the additional term that was added to the invoice? No. Because the added term was included in an invoice delivered to a nonmerchant buyer (the school district), the Idaho school district is not legally bound to settle the dispute in Michigan.

17-2c Consideration

The UCC radically changes the common law rule that contract modification must be supported by new consideration. Under the UCC, an agreement modifying a contract needs no consideration to be binding.

Modifications Must Be Made in Good Faith Of course, contract modification must be sought in good faith. Good faith in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade. Modifications extorted from the other party are in bad faith and unenforceable.

Highlighting the Point



Javed agrees to manufacture and lease certain goods to Louise for a stated price. Subsequently, a sudden shift in the market makes it difficult for Javed to lease the items to Louise at the agreed-on price without suffering a loss. Javed tells Louise of the situation, and Louise agrees to pay an additional sum for leasing the goods.

Can Louise later refuse to pay more than the original lease price? No. A shift in the market is a good faith reason for contract modification. Under the UCC, Louise's promise to modify the contract needs no consideration to be binding. Thus, Louise is bound to the modified contract.

When Modification Without Consideration Requires a Writing In some situations, modification without consideration must be written to be enforceable. The contract may prohibit any changes unless they are in a signed writing. Also, any modification that brings a sales contract under the UCC's Statute of Frauds will require that the modification be written.

17-2d The UCC's Statute of Frauds

Learning Outcome 4

Discuss the UCC's Statute of Frauds.

The UCC contains a Statute of Frauds provision that applies to contracts for the sale or lease of goods. A contract for the sale of goods priced at \$500 or more or the lease of goods involving total payments of \$1,000 or more must be in writing to be enforceable. The parties can initially agree orally, so long as the agreement is evidenced by a later writing. **Example 17.3** Cosby Renovators enters into an oral contract with Anderson Plumbing Supply for the sale of four cast iron kitchen sinks for \$650. For this oral agreement to be enforceable, the parties must put the terms in writing. ■

Sufficiency of the Writing A writing, including an e-mail or other electronic record, will be sufficient as long as (1) it indicates that the parties intended to form a contract and (2) it is signed by the party against whom enforcement is sought. The contract will not be enforceable beyond the quantity of goods shown in the writing, but all other terms can be proved in court by oral testimony. For leases, the writing must reasonably identify and describe the goods leased and the lease term.



Real Case

SunOpta sold roasted sunflower kernels to food manufacturer TreeHouse. SunOpta recalled the kernels because they were contaminated. TreeHouse sued for breach of contract and breach of expressed and implied warranties. The signatures to the sales contracts were not at the end of each contract. The plaintiffs argued that the signatures therefore did not authenticate anything in the contracts that came after the signature blocks.

Do the signatures to a contract have to be placed at the end of the contract to render the contract enforceable? No. In *TreeHouse Foods, Inc. v. SunOpta Grains and Foods, Inc.*, the U.S. District Court for the Northern District of Illinois did not agree with the plaintiffs. The UCC statute of frauds permits the signature of the party to be charged to be on a "separate writing." All that is necessary is that "some writing sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought" is sufficient. The signature can be found on any documents and may consist of any symbol executed or adopted by a party with the intention to authenticate a writing.

—463 F.Supp.3d 801 (N.D.Ill.)

Written Confirmation Between Merchants Merchants can satisfy the requirements of a writing for the Statute of Frauds if, after they have agreed orally, one of the merchants sends a signed written confirmation to the other. If the merchant who receives the confirmation objects to its contents, they must give written notice of objection within ten days of receipt. Otherwise, the writing is sufficient against the receiving merchant, even though they have not signed anything.

Highlighting the Point



Alfonso is a merchant buyer in Cleveland. He contracts over the telephone to purchase \$4,000 worth of goods from Gillian, a New York City merchant seller. Two days later, Gillian sends written confirmation detailing the terms of the oral contract, and Alfonso subsequently receives it.

Is Alfonso bound to the contract? If Alfonso does not give Gillian written notice of objection to the contents of the written confirmation within ten days of receipt, Alfonso cannot raise the Statute of Frauds as a defense against the enforcement of the contract. Alfonso will be bound by the contract.

Exceptions to the UCC's Statute of Frauds There are three exceptions to the UCC's Statute of Frauds requirement. An oral contract subject to the Statute of Frauds will be enforceable despite the absence of a writing in the following circumstances:

1. **Specially manufactured goods**—An oral contract is enforceable if (a) it is for goods that are specially manufactured for a particular buyer or specially manufactured or obtained for a particular lessee, (b) these goods are not suitable for resale or lease to others in the ordinary course of the seller's or lessor's business, and (c) the seller or lessor has substantially started to manufacture the goods or has made commitments to manufacture or obtain the goods. In this situation, the buyer or lessee cannot reject the agreement claiming the Statute of Frauds as a defense.
2. **Admissions**—An oral contract is enforceable if the party against whom enforcement is sought admits under oath that a contract was made. The contract will be enforceable even though it was oral, but enforceability will be limited to the quantity of goods admitted.
3. **Partial performance**—An oral contract is enforceable if payment has been made and accepted or goods have been received and accepted. This is the "partial performance" exception. The oral contract will be enforced at least to the extent of the performance that actually took place.

17-2e The Parol Evidence Rule

Often, a contract completely sets forth all the terms and conditions agreed to by the parties that are intended as a final statement of their agreement. Such a contract cannot be contradicted by evidence of any other agreements between the parties. This is the parol evidence rule.

If, however, the writing contains some of the terms the parties agreed on but not others, a court might allow evidence to explain or supplement the terms in the contract. Such evidence may include consistent additional terms or information about course of dealing, usage of trade, or course of performance.

Consistent Additional Terms Sometimes, a court finds an ambiguity in a writing that is supposed to be a complete statement of the agreement between the parties. The court may accept evidence of consistent additional terms to clarify or remove the ambiguity. The court will not, however, accept evidence of contradictory terms.

Course of Dealing and Usage of Trade Under the UCC, the meaning of any agreement, evidenced by the language of the parties and by their actions, must be interpreted in light of commercial practices and other surrounding circumstances.

course of dealing

Previous conduct between the parties to a transaction that establishes a common basis for their understanding.

usage of trade

A practice or method of dealing observed regularly in a place, vocation, or trade.

course of performance

The conduct that occurs under the terms of a particular agreement.

In interpreting an agreement, the court will assume that the course of dealing between the parties and the usage of trade were taken into account when the agreement was phrased.

A **course of dealing** is a sequence of previous actions and communications between the parties to a transaction that establishes a common basis for their understanding.

A **usage of trade** is a more generally observed practice or method of dealing. Specifically, it is a practice or method of dealing observed so regularly in a place, vocation, or trade as to justify an expectation that it was observed in the transaction in question.

A court will interpret the express terms of an agreement and an applicable course of dealing or usage of trade to be consistent with each other whenever reasonable. When such an interpretation is unreasonable, the express terms in the agreement will prevail.

Course of Performance A **course of performance** is the conduct that occurs under the terms of a particular agreement. The parties know best what they meant by their words, and the course of performance actually undertaken is the best indication of what they meant.

Rules of Construction The UCC provides rules of construction for interpreting contracts. Express terms, course of performance, course of dealing, and usage of trade are to be construed to be consistent with each other whenever possible. When such a construction is unreasonable, the UCC establishes the following order of priority:

1. Express terms
2. Course of performance
3. Course of dealing
4. Usage of trade

Chapter Summary—Introduction to Sales and Lease Contracts

Learning Outcome 1: State the scope of Article 2 of the UCC.

Article 2 of the UCC governs contracts for sales of goods. Under the UCC, a sale is “the passing of title”—the formal right of ownership—“from the seller to the buyer for a price.” To be characterized as a good, an item of property must be tangible and movable.

Learning Outcome 2: Identify how the UCC deals with open contract terms.

Under the UCC, a sales or lease contract will not fail for indefiniteness even if one or more terms are left open as long as (1) the parties intended to make a contract and (2) there is a reasonably certain basis for the court to grant an appropriate remedy. The UCC offers numerous open-term provisions that can be used to fill the gaps in a contract. The quantity of goods must be expressly stated, however.

Learning Outcome 3: Explain the UCC’s treatment of additional terms.

A contract is formed if an offeree makes a definite expression of acceptance, even though the terms of the acceptance modify or add to the terms of the original offer. If at least one of the parties is a nonmerchant, the contract is formed according to the terms of the offer and does not include the additional terms of the acceptance.

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

- (1) The original offer expressly required acceptance of only its terms.
- (2) The new terms materially alter the contract.
- (3) The offeror rejects the new terms within a reasonable time.

Regardless of merchant status, an offeree's expression is not an acceptance if the new terms are expressly conditioned on the offeror's consent.

Learning Outcome 4: Discuss the UCC's Statute of Frauds.

Under the UCC, a contract for a sale of goods priced at \$500 or more or a lease of goods involving total payments of \$1,000 or more must be in writing to be enforceable. A writing is sufficient if it indicates that the parties intended to form a contract and is signed by the party against whom enforcement is sought. An oral contract may be enforceable despite the absence of a writing if (1) it involves specially manufactured goods, (2) the party against whom enforcement is sought admits under oath that a contract was made, or (3) partial performance has occurred.

Straight to the Point

1. What are goods? (See Learning Outcome 1.)
2. What is a sale? (See Learning Outcome 1.)
3. When does the common law govern contracts for sales and leases of goods? (See Learning Outcome 2.)
4. How may the acceptance of an offer to buy, sell, or lease goods be made? (See Learning Outcome 2.)
5. Does the modification of an agreement subject to the UCC need new consideration to be binding? (See Learning Outcome 2.)
6. Under the UCC, in the case of a merchant, what does "good faith" mean? (See Learning Outcome 3.)
7. According to the parol evidence rule, can evidence be used to explain or supplement the terms of a contract? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Brad orders 150 computer desks. Fred ships 150 printer stands. Is this an acceptance of Brad's offer or a counteroffer? If it is an acceptance, is it a breach of the contract? What if Fred told Brad that he was sending printer stands as an accommodation? (See Learning Outcome 2.)
2. Smith & Sons, Inc., sells truck supplies to J&B, which services trucks. Over the phone, J&B and Smith negotiate for the sale of eighty-four sets of tires. Smith sends a letter to J&B detailing the terms. Smith ships the tires two weeks later. J&B refuses to pay. Is there an enforceable contract between them? Explain why or why not. (See Learning Outcome 2.)

Real Law

17-1. Goods and Services Combined. Paper City, a microbrewery, entered into a contract with La Resistance, a beer distribution company, under which La Resistance would purchase beer from Paper City and distribute it to retailers. Paper City sued La Resistance for breach of contract almost five years after the alleged breach occurred. Under Article 2 of the UCC, the statute of limitations for disputes involving

contracts for the sale of goods is four years. As a result, the trial court dismissed Paper City's lawsuit. Paper City appealed, claiming that its contract with La Resistance was for services, not goods, and was therefore not covered by Article 2. Paper City further argued that, under the contract and according to "industry standards," La Resistance provided services such as managing Paper City's accounts and

representing Paper City at trade shows. The only financial transaction on record between the two companies, however, were of La Resistance paying Paper City for beer. What should an appeals court conclude with respect to the predominate factor in this case? Goods or services? [*Paper City Brewery Co., Inc. v. La Resistance, Inc.*, 124 N.E.3d 159, 95 Mass.App.Ct. 1103 (2019)] (See Learning Outcome 1.)

17–2. Acceptance. New England Precision Grinding, Inc. (NEPG), sells parts for medical equipment in Massachusetts. NEPG agreed to supply Kyphon, Inc., with probes and nozzles. NEPG contracted with Simply Surgical, LLC, to obtain the parts required. After half a dozen transactions, NEPG’s payments lagged, and Simply Surgical refused to make more deliveries. NEPG filed a suit in a Massachusetts state court against the seller, alleging breach of contract. NEPG claimed that Kyphon had rejected some of the parts supplied by Simply Surgical, which gave NEPG the right not to pay for them. Do the UCC’s rules on acceptance support

or undermine NEPG’s position? Discuss. [*New England Precision Grinding, Inc. v. Simply Surgical, LLC*, 89 Mass. App. 176, 46 N.E.2d 590 (2016)] (See Learning Outcome 2.)

17–3. The Statute of Frauds. Kendall Gardner agreed to buy from James Bowen and Richard Cagle—doing business as B&C Shavings—a specially built shaving mill to produce wood shavings for poultry processors. B&C sent an invoice to Gardner reflecting a purchase price of \$86,200, with a 30 percent down payment and the “balance due before shipment.” Gardner paid the down payment. B&C finished the mill and wrote Gardner a letter, telling him to “pay the balance due or you will lose the down payment.” By then, Gardner had lost his customers for the wood shavings and could not pay the balance due. He asked for the return of his down payment. Did these parties have an enforceable contract under the Statute of Frauds? Explain. [*Bowen v. Gardner*, 2013 Ark.App. 52, 425 S.W.3d 875 (2013)] (See Learning Outcome 4.)

Ethical Questions

17–4. Sales of Goods. Should merchants be required to act in good faith? Why or why not? (See Learning Outcome 1.)

17–5. Sales and Lease Contracts. Camal Terry signed a “Sales Contract” to buy a 1995 BMW 3 Series from Robin Drive Auto, a car dealership in Delaware. Terry agreed to pay \$4,995 and Robin Drive agreed to hold the BMW for him in contemplation of a sale within twenty-one days. Also specified were a down payment of \$1,200 and the timing of other payments. The payment schedule, however, exceeded the sale date by three weeks. In addition, the

contract provided that the payments were fees for storage and “prep” and were not deductible from the car’s price. Terry paid more than \$1,000 before asking Robin Drive to refund it. When the dealership refused, Terry filed a suit in a Delaware state court against Robin Drive. Testimony about the mismatched contract terms was conflicting. Ethically, what is wrong with this deal, and how could it have been fixed? Discuss. [*Terry v. Robin Drive Auto*, 2017 WL 65842 (2017)] (See Learning Outcome 2.)

Chapter 17—Work Set

True-False Questions

- _____ 1. If the subject of a sale is goods, Article 2 of the UCC applies.
- _____ 2. A contract for a sale of goods is subject to the same traditional principles that apply to all contracts.
- _____ 3. If the subject of a transaction is a service, Article 2 of the UCC applies.
- _____ 4. The UCC requires that an agreement modifying a contract be supported by new consideration to be binding.
- _____ 5. Under the UCC's Statute of Frauds, a writing must include all material terms except quantity.
- _____ 6. Under certain circumstances, an oral contract for a sale of goods priced at \$500 or more can be enforceable despite the absence of a writing.
- _____ 7. A lease agreement is a bargain between a lessor and a lessee, as shown by their words and conduct.
- _____ 8. Under the UCC, acceptance can be made by any means of communication reasonable under the circumstances.
- _____ 9. No oral contract is enforceable under the UCC.

Multiple-Choice Questions

- _____ 1. Adam pays Beta Corporation \$1,500 for a laptop. Under the UCC, this is
 - a. a bailment.
 - b. a consignment.
 - c. a lease.
 - d. a sale.
- _____ 2. Morro Beverage Company has a surplus of carbon dioxide (which is what puts the bubbles in Morro beverages). Morro agrees to sell the surplus to the Rock Ale Company. Morro is a merchant with respect to
 - a. carbon dioxide but not Morro beverages.
 - b. Morro beverages but not carbon dioxide.
 - c. both Morro beverages and carbon dioxide.
 - d. neither Morro beverages nor carbon dioxide.
- _____ 3. Bella Shipyard agrees to build a barge for MaxCo Shipping. The contract includes an option for up to five more barges, but states that the prices of the other barges could be higher. Bella and MaxCo have
 - a. a binding contract for at least one barge and up to six barges.
 - b. a binding contract for one barge only.
 - c. no contract because the terms of the option are too indefinite.
 - d. no contract because both parties are merchants with respect to barges.
- _____ 4. Mike and Rita orally agree to a sale of one hundred pairs of hiking boots at \$50 each. Rita gives Mike a check for \$500 as a down payment. Mike takes the check. At this point, the contract is enforceable
 - a. to the full extent because it is for specially made goods.
 - b. to the full extent because it is oral.
 - c. to the extent of \$500.
 - d. for none of these reasons.

- _____ 5. Med Labs sends Kraft Instruments a purchase order for scalpels. The order states that Med will not be bound by any additional terms. Kraft ships the scalpels with an acknowledgment that includes an additional, materially different term. Med is
- a. not bound by the term because the offer expressly states that no other terms will be accepted.
 - b. not bound by the term because the additional term constitutes a material alteration.
 - c. not bound by the term for both of the reasons above in a and b.
 - d. bound by the term.
- _____ 6. Under the parol evidence rule, a contract cannot be contradicted by evidence of any other agreements between the parties except in which of the following circumstances?
- a. Consistent terms can be used to clarify or remove an ambiguity in the writing.
 - b. Commercial practices can be used to interpret the contract.
 - c. Both a and b.
 - d. None of the above.
- _____ 7. Lena, a car dealer, writes to Sam that “I have a Honda Civic that I will sell to you for \$4,000. This offer will be kept open for one week.” Six days later, Todd tells Sam that Lena sold the car that morning for \$5,000. Who violated the terms of the offer?
- a. Lena.
 - b. Sam.
 - c. Todd.
 - d. No one.
- _____ 8. Stron Cellphones agrees to buy an unspecified quantity of microchips from SmartCorp. The quantity that a court would order Stron to buy under this contract is
- a. the amount that Stron would buy during a normal year.
 - b. the amount that SmartCorp would make in a normal year.
 - c. the amount that SmartCorp actually makes this year.
 - d. none of the amounts above.

Answering More Legal Problems

1. Western Horse, Inc., agreed to buy hay from AgriSales, Inc. They signed a “Purchase Order” for “26 tons (880 bales)” that left other details blank. AgriSales loaded and weighed a trailer and dispatched it. Before delivery, however, Western told AgriSales to cancel the order—it had arranged to buy the hay for a lower price and faster delivery from Orchard Alfalfa Fields.

Can AgriSales recover the cost of attempting to fill Western’s order? Yes. AgriSales will have to show that the parties had an enforceable contract despite the details left “blank.” The UCC states that a sales contract will not fail for indefiniteness even if one or more terms are left open as long as (1) the parties _____ to make a contract and (2) there is a _____ certain basis for the court to grant an appropriate remedy. Missing terms can be proved, or it can be presumed that the parties _____ whatever is _____, as long as the quantity is not left open.

2. Mountain Stream Trout, Inc., agreed to buy market size trout from trout grower Lake Farms, LLC. Their

five-year contract did not define market size. At the time, in the trade market size referred to fish of one-pound live weight. After three years, Mountain Stream began taking fewer, smaller deliveries of larger fish, claiming that market size varied according to whatever its customers demanded. Lake Farms filed a suit for breach of contract.

Is outside evidence admissible to explain market size? Yes. Under the UCC, in interpreting a commercial agreement, a court will assume that the usage of _____ between the parties was considered when the contract was formed. Also, the conduct that occurs under an agreement, the course of _____, is the best indication of what the parties meant. Here, the _____ usage at the time of the contract indicated that market size referred to fish of one-pound live weight. This was the standard for the course of _____ between the parties over the first three years of the contract.

18 | Title and Risk of Loss

Conflict Presented

Tatiana's Talk & Text is a retail phone and accessories store in Denver, Colorado. One day, Tatiana orders one hundred iPhone 13s from Apple Inc., F.O.B. Denver. Instead of iPhone 13s, Apple ships iPhone 12s. In addition, some of the smartphones are damaged in transit. Tatiana rejects the shipment.

Q Who suffers the loss?

Anything can happen between the time a contract is signed and the time the goods are transferred to the buyer's or lessee's possession. For instance, in a sale of oranges to be delivered after the harvest, a natural disaster, such as fire or frost, may destroy the orange groves. Or the oranges may be damaged or lost in transit. Because of these possibilities, it is important to know the rights and liabilities of the parties involved.

Under the Uniform Commercial Code (UCC), rights and liabilities are generally not determined by who has title—the right of ownership. Instead, they depend on the concepts of identification, passage of title, risk of loss, and insurable interest.

18-1 Identification

Before any interest in goods can pass from the seller or lessor to the buyer or lessee, the goods must exist and be identified as the specific goods in the contract. **Identification** takes place when specific goods are designated as the subject matter of a sales or lease contract.

Title and risk of loss cannot pass from seller to buyer unless the goods are identified to the contract. (Title to leased goods does not pass to a lessee.) Identification is significant because it gives the buyer or lessee the right to insure the goods and the right to recover from third parties who damage the goods.

The parties can agree in their contract on when identification will take place. If they do not, the UCC determines when identification takes place.

18-1a Existing Goods

If the contract calls for the sale or lease of specific goods that are already in existence, identification takes place at the time the contract is made. **Example 18.1** Dmitri's Autoplex contracts to purchase or lease a fleet of five cars designated by their vehicle identification numbers (VINs). Because the cars are identified by their VINs, identification has taken place. ■

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Explain the concept of identification.
- 2 Describe the effects of imperfect title on sales of goods.
- 3 Discuss the concept of risk of loss.
- 4 Identify insurable interest in goods.

Learning Outcome 1

Explain the concept of identification.

identification

The express designation of the goods provided for in a contract.

18–1b Future Goods

Goods that are not both existing and identified to the contract are called future goods. The UCC has several rules for future goods.

1. If a sale involves unborn animals to be born within twelve months after contracting, identification takes place when the animals are conceived.
2. If a sale involves crops that are to be harvested within twelve months (or the next harvest season occurring after contracting, whichever is longer), identification takes place when the crops are planted. Otherwise, identification takes place when they begin to grow.
3. For any other future goods, identification occurs when the goods are shipped, marked, or otherwise designated by the seller (or lessor) as the goods to which the contract refers.

18–1c Goods From a Larger Mass

Goods that are part of a larger mass are identified when the goods are marked, shipped, or somehow designated by the seller or lessor as the particular goods to pass under the contract. **Example 18.2** McKee, the buyer, orders 1,000 cases of beans from a 10,000-case lot. Identification takes place when Adhir, the seller, separates the 1,000 cases of beans from the 10,000-case lot. ■

The most common exception to this rule deals with fungible goods. **Fungible goods** are goods that are alike naturally or by agreement or trade usage. Fungible goods are essentially identical and interchangeable for the purposes of a commercial transaction. Examples are wheat and oil that are of the same grade and quality. Owners of fungible goods typically hold title as **owners in common**, which are owners with an undivided share of the whole. A seller-owner can pass title and risk of loss to the buyer without actually separating the goods. The buyer simply replaces the seller as an owner in common.

fungible goods

Goods that are alike by physical nature, by agreement, or by trade usage.

owner in common

An owner with an undivided share of the whole.

18–2 Passage of Title

Once goods exist and are identified, title can be determined. Under the UCC, any explicit understanding between the buyer and the seller determines when title passes. If there is no such agreement, title passes to the buyer at the time and the place the seller physically delivers the goods. The delivery arrangements determine when this occurs.

In lease contracts, of course, title to the goods is retained by the lessor-owner of the goods. Hence, the UCC's provisions relating to passage of title do not apply to leased goods.

shipment contract

A contract requiring the seller to deliver the goods to a carrier, at which time title passes to the buyer.

destination contract

A contract requiring the seller to tender delivery of the goods at a certain destination, at which time title passes to the buyer.

tender of delivery

The seller's act of giving the buyer reasonable notice that conforming goods are available.

18–2a Shipment Contracts

In a **shipment contract**, the seller is required or authorized to ship goods by carrier, such as a trucking company or an air freight company. Under a shipment contract, the seller is required only to deliver the goods into the hands of a carrier. Title passes to the buyer at the time and place of shipment. Generally, all contracts are assumed to be shipment contracts if nothing to the contrary is stated in the contract.

18–2b Destination Contracts

In a **destination contract**, the seller is required to deliver the goods to a particular destination, usually directly to the buyer. Title passes to the buyer when the conforming goods are tendered at that destination. A **tender of delivery** occurs when

the seller places or holds the goods at the buyer's disposition (with any reasonably necessary notice) so that the buyer can take delivery.

Example 18.3 Jackson Tools, a seller in New York, agrees to deliver goods to Spencer Hardware's warehouse in Los Angeles by truck. When the truck arrives in Los Angeles, Jackson calls to tell Spencer that the goods are in the city and to ask that the warehouse be opened so that delivery can take place. ■

18–2c Delivery Without Movement of the Goods

Some sales contracts do not call for the seller to ship or deliver the goods, such as when the buyer is to pick up the goods. The passage of title in this situation depends on whether the seller must deliver a **document of title**, such as a bill of lading or a warehouse receipt, to the buyer. A bill of lading is a receipt for goods that is signed by a carrier and that serves as a contract for the transportation of the goods. A warehouse receipt is a receipt issued by a warehouse for goods stored in a warehouse.

document of title

A document that evidences the right to possession of goods.

Required Document of Title When a document of title is required, title passes to the buyer when and where the document is delivered. Thus, if the goods are stored in a warehouse, title passes to the buyer when the appropriate documents are delivered to the buyer. The goods never move.

No Required Document of Title When no documents of title are required, title passes at the time and place the sales contract is made, if the goods have already been identified. If the goods have not been identified, title does not pass until identification occurs.

Example 18.4 Norton Timber Company sells some lumber to Byron. They agree that Byron will pick up the lumber at the company's sorting yard. If the lumber has been identified—that is, segregated or distinguished from the other lumber—title passes to Byron when the contract is signed. If the lumber is still in storage buildings, however, title does not pass to Byron until the particular pieces of lumber to be sold under this contract are identified. ■

18–2d Sales or Leases by Nonowners

Problems relating to passage of title occur when persons who acquire goods with imperfect titles attempt to sell or lease the goods. What are the rights of two parties who lay claim to the same goods when those goods are sold or leased with imperfect titles? Generally, the buyer acquires at least whatever title the seller has to the goods sold.

Learning Outcome 2

Describe the effects of imperfect title on sales of goods.

Void Title A buyer may unknowingly purchase goods from a seller who is not the owner of the goods. If the seller is a thief, the seller's title is void—legally, no title exists. Thus, the buyer acquires no title, and the real owner can reclaim the goods from the buyer. Of course, the buyer can then try to recover from the thief! The same result would occur if the goods were leased.

Highlighting the Point

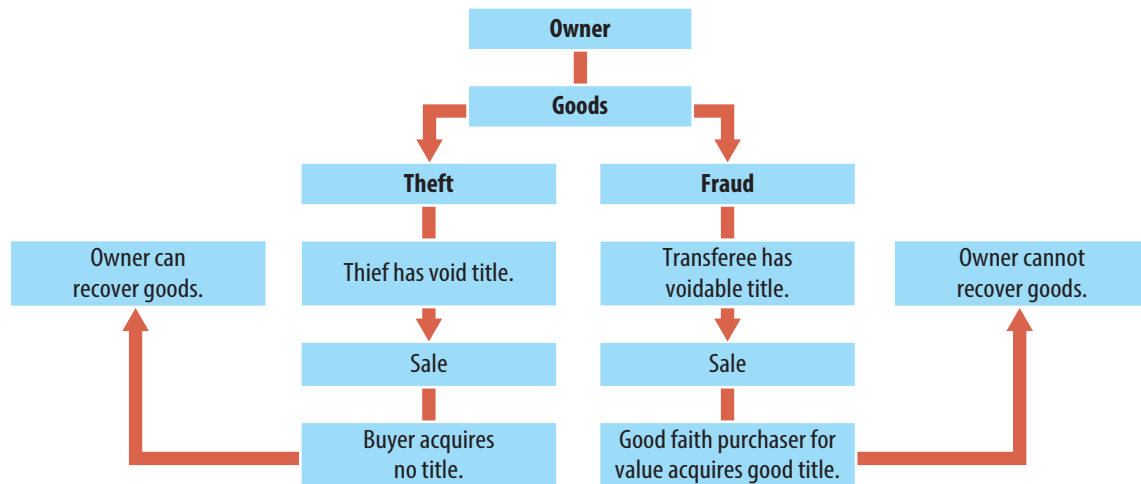


Jacy steals a Nikon digital camera owned by Margaret. He sells the camera to Sandra, who acts in good faith and honestly was not aware that the camera was stolen.

Can Margaret reclaim the camera from Sandra? Yes. Jacy had void title to the camera. Margaret can reclaim it from Sandra even though Sandra acted in good faith and honestly was not aware that the camera was stolen. Sandra can seek damages from Jacy.

Exhibit 18.1 Void and Voidable Titles

If goods are transferred from their owner to another by theft, the thief acquires no ownership rights. Because the thief's title is void, a later buyer can acquire no title, and the owner can recover the goods. If the transfer occurs by fraud, the transferee acquires a voidable title. A later good faith purchaser for value can acquire good title, and the original owner cannot recover the goods.

**insolvent**

A condition in which a person's liabilities exceed the value of their assets.

good faith purchaser

One who buys without notice of invalidity of title.

Voidable Title Sellers have voidable title if the goods they are selling were obtained by fraud, paid for with a check that is later dishonored, purchased from a minor, or purchased on credit when the sellers were **insolvent**. (Under the UCC, persons are insolvent when those persons cease to pay their debts, cannot pay the debts as they become due, or are within the meaning of federal bankruptcy law.)

In contrast to a seller with void title, a seller with voidable title has the power to transfer good title to a good faith purchaser. A **good faith purchaser** is a buyer who is unaware of circumstances that would make an average person inquire about the validity of the seller's title to the goods. The real owner cannot recover goods from a good faith purchaser. If the buyer of the goods is not a good faith purchaser, then the owner of the goods can reclaim them. Exhibit 18.1 illustrates these concepts. The same rules apply in circumstances involving leases.

entrustment rule

A rule stating the merchant's power to transfer entrusted goods to certain buyers.

The Entrustment Rule Entrusting goods to a merchant who deals in goods of that kind gives the merchant the power to transfer all rights to a buyer in the ordinary course of business. This is the **entrustment rule**.

Entrusting includes both delivering the goods to the merchant and leaving the goods with the merchant for later delivery or pickup. A buyer in the ordinary course of business is a person who, in good faith and without knowledge that the sale violates the ownership rights of a third party, buys in the normal course of business from a person (other than a pawnbroker) in the business of selling goods of that kind.

The entrustment rule basically allows innocent buyers to obtain legitimate title to goods purchased from merchants even if the merchants do not have good title. The UCC provides a similar rule for leased goods.

**Highlighting the Point**

Selena steals Aura's watch and leaves it with a jeweler for repairs. The jeweler sells the watch to Ben, who does not know that the jeweler has no right to sell it.

Against whom does Ben get good title? Ben gets good title against Selena, who entrusted the watch to the jeweler, but not against Aura. Aura neither entrusted the

watch to Selena nor authorized Selena to entrust it. Therefore, Ben is a buyer in the ordinary course of business as to Selena but not as to Aura. Aura can recover the watch from Ben.

18–3 Risk of Loss

At the various stages of sales and lease transactions, a question may arise as to who bears the risk of loss. In short, who suffers the financial loss if the goods are damaged, destroyed, or lost in transit?

Under the UCC, the risk of loss does not necessarily pass with title. When the risk of loss passes from a seller or lessor to a buyer or lessee is generally determined by the contract between the parties. When no provision in the contract indicates when risk passes, the UCC provides special rules. (See the Linking Business Law to Your Career feature at the end of this chapter for important considerations concerning the management of risk of loss.)

Learning Outcome 3

Discuss the concept of risk of loss.

18–3a Delivery With Movement of the Goods—Carrier Cases

When the contract involves movement of the goods via a common carrier but does not specify when risk of loss passes, the courts look for specific delivery terms in the contract. The terms traditionally used in contracts within the United States are defined in Exhibit 18.2. These terms determine which party will pay the costs of delivering the goods and who bears the risk of loss. If the contract does not include these terms, then the courts must decide whether the contract is a shipment contract or a destination contract.

Shipment Contracts and Risk of Loss Recall that in a shipment contract, the seller or lessor is required or authorized to ship goods by carrier. Risk of loss passes to the buyer or lessee when the goods are delivered to the carrier.

Exhibit 18.2 Contract Terms—Definitions

These contract terms help determine which party will bear the costs of delivery and when risk of loss will pass from the seller to the buyer.

Term	Definition
F.O.B. (free on board)	Indicates that the selling price of goods includes transportation costs to the specific F.O.B. place named in the contract. The seller pays the expenses and carries the risk of loss to the F.O.B. place named. If the named place is the place from which the goods are shipped (for example, the seller's city or place of business), the contract is a shipment contract. If the named place is the place to which the goods are to be shipped (for example, the buyer's city or place of business), the contract is a destination contract.
F.A.S. (free alongside ship)	Requires that the seller, at their own expense and risk, deliver the goods alongside the vessel in the manner usual in that port or on a dock designated and provided by the buyer. An F.A.S. contract is essentially an F.O.B. contract for ships.
C.I.F. or C.&F. (cost, insurance, and freight or just cost and freight)	Requires, among other things, that the seller "put the goods in the possession of a carrier" before risk passes to the buyer. (These are basically pricing terms, and the contracts remain shipment contracts, not destination contracts.)
Delivery ex-ship (delivery from the carrying vessel)	Means that risk of loss does not pass to the buyer until the goods are properly unloaded from the ship or other carrier.



Highlighting the Point

Russell Orchards, a seller in Houston, Texas, sells five hundred cases of grapefruit to Grocers Fruit Brokers, a buyer in New York. The contract states that the sale is “F.O.B. Houston” (free on board in Houston—that is, the buyer pays the transportation charges from Houston). The contract authorizes a shipment by carrier. It does not require that the seller tender the grapefruit in New York.

If the goods are damaged in transit, who suffers the loss—the seller or the buyer? The loss is the buyer’s. Risk passes to the buyer when conforming goods are placed in the possession of the carrier.

Destination Contracts and Risk of Loss In a destination contract, the risk of loss passes to the buyer or lessee when the goods are tendered to the buyer or lessee at that destination. In the preceding Highlighting the Point feature, for instance, if the contract had been F.O.B. New York, risk of loss during transit to New York would have been the seller’s.

Conflict Resolved

In the Conflict Presented feature at the beginning of the chapter, Tatiana orders smartphones for her retail phone and accessories store in Denver, Colorado. She orders one hundred iPhone 13s from Apple, Inc., F.O.B. Denver, but Apple ships iPhone 12s. In addition, some of the phones are damaged in transit. Tatiana rejects the shipment.

A Who suffers the loss? The loss falls on Apple. If Apple had shipped iPhone 13s instead of iPhone 12s (nonconforming goods), the loss would have been Tatiana’s.

The goods were sold and shipped “F.O.B. Denver.” The term “F.O.B.” (free on board) indicates that the price includes transportation costs to the named place (Denver). Denver is the buyer’s location, making the transaction a destination contract.

Under a destination contract, the risk of loss passes to the buyer (Tatiana) when the goods are tendered at that destination. If, however, the seller (Apple) ships nonconforming goods, as in this case, the risk does not pass until the defects are cured or the goods are accepted in spite of their defects. Apple did not cure the nonconforming goods, nor did Tatiana accept them.

18–3b Delivery Without Movement of the Goods

The UCC also addresses situations in which the seller or lessor is required neither to ship nor to deliver the goods. Frequently, the buyer or lessee is to pick up the goods from the seller or lessor. At other times, the goods are held by the bailee. Under the UCC, a **bailee** is a party who, by a bill of lading, warehouse receipt, or other document of title, acknowledges possession of goods and contracts to

bailee

One to whom goods are entrusted by a bailor.

deliver them. For instance, a warehousing company or a trucking company that normally issues documents of title for goods it receives is a bailee.

Goods Held by the Seller or Lessor If the goods are held by the seller or lessor, a document of title is usually not used. If the seller or lessor is a merchant, risk of loss to goods held by the seller or lessor passes to the buyer or lessee when the buyer or lessee takes physical possession of the goods. In other words, the merchant-seller bears the risk of loss between the time the contract is formed and the time the buyer picks up the goods.

Highlighting the Point



Douglas buys a manufactured home from Andy's Mobile Home and Land Sales. Douglas pays the full price and makes arrangements to have the home moved to his property the next day. The night before it is to be moved, however, fire destroys the home.

Does Douglas suffer the loss? No. The risk of loss passes to the buyer (Douglas) from the merchant-seller (Andy's) only when the buyer takes actual physical possession of the goods. Even though Douglas is the owner of the home, he has not taken physical possession of the home yet. As the merchant-seller, Andy's suffers the loss.

If the seller or lessor is not a merchant, the risk of loss passes to the buyer or lessee on tender of delivery. That is, sellers bear the risk of loss until they make the goods available to buyers and notify the buyers that the goods are ready to be picked up.

Goods Held by a Bailee When a bailee is holding goods for a seller and the goods are to be delivered without being moved, the goods are usually represented by a document of title. The title document may be written on paper or evidenced by an electronic record. This document may be negotiable or nonnegotiable. Negotiable and nonnegotiable documents transfer different rights to the goods that the documents cover.

With a negotiable document of title, a party can transfer the rights by signing and delivering the document. The rights to the goods—free of any claims against the party that issued the document—pass with the document. **Example 18.5** Home Care Appliances signs a negotiable document of title that covers certain goods and delivers it to Town & Country Furniture Stores. As the buyer, Town & Country acquires all rights to the goods (and, by signing and delivering the document, may transfer those rights to someone else). ■

With a nonnegotiable document of title, the party who receives it obtains only the rights that the party transferring it had, subject to any prior claims.

When goods are held by a bailee, risk of loss passes to the buyer when one of the following occurs:

1. The buyer receives a negotiable document of title for the goods.
2. The bailee acknowledges the buyer's right to possess the goods.
3. The buyer receives a nonnegotiable document of title and has had a reasonable time to present the document to the bailee and demand the goods.

In respect to leases, the risk of loss passes to the lessee on acknowledgment by the bailee of the lessee's right to possession of the goods.

18–3c Conditional Sales

Buyers and sellers sometimes form sales contracts that are conditioned either on the buyer's approval of the goods or on the buyer's resale of the goods. Unless otherwise agreed, if the goods are for the buyer to use, the transaction is a sale on approval. If the goods are for the buyer to resell, the transaction is a sale or return.

sale on approval

Buyer takes goods on a trial basis.

Sale on Approval When a seller permits a buyer to take goods on a trial basis, a **sale on approval** is made. Title and risk of loss (from causes beyond the buyer's control) remain with the seller until the buyer accepts the offer. Acceptance can be made expressly or by any act inconsistent with the trial purpose or the seller's ownership—for instance, reselling the goods or failing to return the goods within the trial period. If the buyer does not wish to accept, the buyer must return the goods to the seller. The return is at the seller's expense and risk. Goods held on approval are not subject to the claims of the buyer's creditors until acceptance.

Example 18.6 Brad orders a Bowflex Max Trainer online, and the manufacturer allows him to try it risk-free for thirty days. If Brad decides to keep the Max Trainer, then the sale is complete. If he returns it within thirty days, however, there is no sale, and he is not charged. If Brad files for bankruptcy within the thirty-day period and still has the Max Trainer in his possession, his creditors may not attach (seize) the Max Trainer, because he has not accepted it yet. ■

sale or return

A conditional sale that can be rescinded by the buyer during a specified time.

Sale or Return In a **sale or return**, the sale is completed, but the buyer has an option to return the goods and undo the sale. Sale-or-return contracts often arise when a merchant purchases goods primarily for resale but has the right to return part or all of the goods in lieu of payment if the goods are not resold. **Example 18.7** Curtis, Inc., a diamond wholesaler, delivers gems to Shane Company, a jewelry retailer. Their understanding is that Shane can return any unsold gems at the end of six months. This transaction is a sale or return. ■

When the buyer receives possession at the time of sale, the title and risk of loss pass to the buyer. Both remain with the buyer until the buyer returns the goods to the seller. If the buyer fails to return the goods within a specified time, the sale is finalized. The return of the goods is at the buyer's risk and expense. Goods held under a sale-or-return contract are subject to the claims of the buyer's creditors while they are in the buyer's possession.



Real Case

American Legend Cooperative (ALC), a cooperative that represents mink fur farmers in the United States and Canada, sued Top Lot Processors to recover millions of dollars for fire-damaged mink pelts. Top Lot's processing facility had caught fire. The pelts were a total loss in *American Legend Coop. v. Top Lot Farms*. In response, Top Lot argued that ALC did not have ownership over the pelts. ALC did not concur, arguing that the agreement was a contract of sell or return. ALC claimed that it did not exercise its option to return the pelts, and therefore the ownership of the pelts passed to ALC.

Was the contract for a sale or return? No. Therefore, ALC did not take ownership of the pelts at the execution of the agreement with Top Lot Processors. Thus, title did not pass to ALC immediately upon delivery of the pelts. Rather, title remained with Top Lot until the pelts were sold to a third party.

—2020 WL 6581857 (U.S. Dist. Ct., S.D.)

18–3d Risk of Loss When a Contract Is Breached

There are many ways to breach a sales or lease contract. The transfer of risk operates differently depending on which party breaches. Generally, the party in breach bears the risk of loss.

When the Seller or Lessor Breaches Sometimes, the seller breaches by supplying goods that are so nonconforming that the buyer has the right to reject them. In this situation, the risk of loss does not pass to the buyer until the defects are cured or until the buyer accepts the goods in spite of their defects. The seller can **cure** a defect by repairing or replacing the goods or discounting their price. **Example 18.8** David orders blue Sony earbuds, but Nikki, the seller, ships red ones. The risk of loss remains with Nikki unless David accepts the earbuds in spite of their color. ■

If a buyer accepts a shipment of goods and later discovers a defect, acceptance can be revoked. Revocation allows the buyer to pass the risk of loss back to the seller, at least to the extent that the buyer's insurance does not cover the loss.

There is a similar rule for leases. When a lessee has the right to reject the goods, the risk of loss remains with the lessor until cure or acceptance. When a lessee accepts and then revokes acceptance, the risk passes back to the lessor.

cure

The right of a party to correct nonconforming performance.

When the Buyer or Lessee Breaches When a buyer or lessee breaches a contract, the general rule is that the risk of loss immediately shifts to the buyer or lessee. There are three important limitations to this rule:

1. The seller or lessor must already have identified the goods under the contract.
2. The buyer or lessee bears the risk for only a commercially reasonable time after the seller or lessor learns of the breach.
3. The buyer or lessee is liable only to the extent of any deficiency in the seller's insurance coverage.

18–4 Insurable Interest

Parties to sales or lease contracts often obtain insurance coverage to protect against damage, loss, or destruction of goods. Any party purchasing insurance, however, must have a “sufficient interest” in the insured item to obtain a valid policy. Insurance laws—not the UCC—determine “sufficiency.” The UCC is helpful, however, because it contains certain rules regarding the buyer's and seller's insurable interest in goods.

Learning Outcome 4

Identify insurable interest in goods.

18–4a Insurable Interest of the Buyer or Lessee

Buyers and lessees have an **insurable interest** in identified goods. The moment goods are identified to the contract by the sellers or lessors, the buyers or lessees have an interest that allows them to obtain insurance coverage for those goods even before the risk of loss passes.

insurable interest

A property interest in goods that permits a party to obtain insurance.

Highlighting the Point



In March, Hillcrest Farms sells a cotton crop that it hopes to harvest in October. After the crop is planted, Simpson Textiles, the buyer, insures it against hail damage. In September, a hailstorm ruins the crop. Simpson files a claim under its insurance policy. The insurer—Liberty Insurance Company—refuses to pay, asserting that Simpson has no insurable interest in the crop.

Is Liberty Insurance correct? No. Simpson acquired an insurable interest when the crop was planted, because it had a contract to buy it.

18–4b Insurable Interest of the Seller or Lessor

Sellers have an insurable interest in goods as long as they retain title to the goods. Even after title passes to a buyer, a seller who has a security interest (a right to secure payment) in the goods still has an insurable interest and can insure the goods. Hence, a buyer and a seller can have an insurable interest in identical goods at the same time.

In regard to leases, the lessor retains an insurable interest in leased goods unless the lessee exercises an option to buy. In that event, the risk of loss passes to the lessee.



Linking Business Law to Your Career

Risk Management

Issues of liability can arise when an event such as fire or theft damages goods in transit. Before a loss occurs, it is important that a company assess the risk of potential liability and take steps to guard against it.

Liability Provision

Businesses almost always allocate the risk of liability for a loss in their contracts. When your company is allocated the risk, the next step is to obtain insurance to protect against it.

Delivery Terms

If a sales or lease contract does not refer to liability for damaged or lost goods and the goods are to be shipped or delivered, then the risk is borne by the party having control of the goods. The delivery terms in a contract can serve as a basis for determining control. Thus, under “F.O.B. buyer’s business”—a destination-delivery term—the risk of loss does not pass to the buyer until there is a tender of delivery at the

point of destination. The seller is liable for any damage in transit because the seller has control until tender is made.

Most sellers prefer “F.O.B. seller’s business” as a delivery term. Once the goods are delivered to the carrier, the buyer bears the risk of loss. Thus, if conforming goods are lost in transit, the buyer suffers the loss.

Breach of Contract

If a contract is silent as to risk and either party breaches the contract, the breaching party is liable for any loss. For instance, if a buyer orders fifteen cooling fans to be installed at a certain location in a manufacturing facility, and the seller ships the wrong size, the risk of loss does not pass to the buyer until this defect is cured.

Before a loss occurs, you should first determine at which point your company will have an insurable interest in the goods. Then, you must obtain insurance to cover any potential liability for the damage, loss, or destruction of the goods.

Chapter Summary—Title and Risk of Loss

Learning Outcome 1: Explain the concept of identification.

Before an interest in goods can pass from a seller or lessor to a buyer or lessee, the goods must exist and be identified as the specific goods designated in the contract. Identification occurs when specific goods are designated as the subject matter of a sales or lease contract. Title and risk of loss cannot pass from seller to buyer unless the goods are identified to the contract. Identification gives the buyer or lessee the right to insure the goods and the right to recover from third parties who damage the goods.

Learning Outcome 2: Describe the effects of imperfect title on sales of goods.

When a person who acquires goods with an imperfect title attempts to sell the goods, a buyer acquires at least whatever title the seller has. If the seller is a thief, the seller’s title is void, the buyer acquires no title, and the real

owner can reclaim the goods. A seller with voidable title can transfer good title to a good faith purchaser for value, and the real, or original, owner cannot recover the goods. Entrusting goods to a merchant who deals in goods of that kind gives the merchant the power to transfer all rights to a buyer in the ordinary course of business.

Learning Outcome 3: Discuss the concept of risk of loss.

Risk of loss determines who bears the financial loss in a sales or lease contract when goods are damaged, destroyed, or lost. Under the UCC, risk of loss is not necessarily determined by title. When the risk of loss passes from a seller or lessor to a buyer or lessee is generally determined by the contract between the parties. When no provision in the contract indicates when risk passes, the UCC provides special rules. Unless the parties agree otherwise, the risk of loss passes from the seller or lessor to the buyer or lessee at the time and place the seller or lessor physically delivers the goods. Under a shipment contract, this occurs when the seller or lessor delivers the goods into the hands of a carrier. Under a destination contract, the risk passes on the tender of delivery of the goods at the destination specified in the contract.

Learning Outcome 4: Identify insurable interest in goods.

A buyer or lessee has an insurable interest in goods that are identified to the contract. A seller or lessor has an insurable interest in goods if the seller or lessor has title to them or a security interest in them.

Straight to the Point

1. If a contract calls for the sale or lease of goods that are already in existence, when does identification take place? (See Learning Outcome 1.)
2. In a transaction for a sale of goods subject to a shipment contract, when does title pass? (See Learning Outcome 2.)
3. What determines who suffers a financial loss if goods are damaged, destroyed, or lost? (See Learning Outcome 3.)
4. Who bears the risk of loss when a sales or lease contract is breached? (See Learning Outcome 3.)
5. What can a party to a sales or lease contract obtain to protect against a financial loss if goods are damaged, destroyed, or lost? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Adams Textiles in Kansas City sells certain fabric to Silk & Satin Stores in Oklahoma City. Adams packs the fabric and ships it by rail to Silk. While the fabric is in transit across Kansas, a tornado derails the train and scatters and shreds the fabric across miles of cornfields. What are the consequences if Silk bore the risk? If Adams bore the risk? (See Learning Outcome 4.)
2. Paula boards her horse, Blaze, at Gold Spur Stables. She sells the horse to George and calls Gold Spur to say, "I sold Blaze to George." Gold Spur says, "Okay." That night, Blaze is kicked in the head by another horse and dies. Who pays for the loss? (See Learning Outcome 3.)

Real Law

18–1. Risk of Loss—Destination Contracts. C&C North America paid Total Quality Logistics (TQL) to arrange for a shipment of a truckload of granite to Sun City Granite. Balance Transportation signed a contract with TQL

to transport the load. Balance's driver delivered the granite in good condition to Sun City, whose representative signed, dated, and returned the bill of lading. As a Sun City employee unloaded the first block of granite, other blocks

fell out of the truck and were damaged. TQL paid C&C for the cost of the damage and then filed a complaint against Balance seeking recovery on a claim of breach of its contract with TQL. A court issued a summary judgment in Balance's favor. TQL appealed. Did the damage to the goods occur after the risk of loss passed from the carrier to the buyer? [*Total Quality Logistics, LLC v. Balance Transportation, LLC*, 2020-Ohio-620 (Ct. of Appeals of Ohio, 12th Dist. 2020)] (See Learning Outcome 3.)

18-2. Passage of Title. James McCoolidge, a Nebraska resident, saw a used Honda Element for sale online. He contacted the seller, Daniel Oyvetzsky, who offered to sell the vehicle for \$7,500 on behalf of Car and Truck Center, a dealership in Nashville, Tennessee. McCoolidge paid the price and received the car and a certificate of title. Before he registered the certificate with the Nebraska Department of Motor Vehicles, he learned that the state of Tennessee had issued numerous certificates of title to the Element. Based on these documents, title could ultimately be traced

to McCoolidge. But McCoolidge chose to file a suit in a Nebraska state court against Oyvetzsky, claiming that he had not received "clear" title. What does the UCC provide with respect to the passage of title under a sales contract? How does that rule affect McCoolidge's claim? Discuss. [*McCoolidge v. Oyvetzsky*, 292 Neb. 955, 874 N.W.2d 892 (2016)] (See Learning Outcome 2.)

18-3. Risk of Loss. Ethicon, Inc., entered into an agreement with UPS Supply Chain Solutions, Inc., to transport pharmaceuticals. Under a contract with UPS's subsidiary, Worldwide Dedicated Services, drivers were provided by International Management Services Co. During the transport of a shipment from Ethicon's facility in Texas to buyers "F.O.B. Tennessee," one of the trucks collided with a concrete barrier, damaging the goods. Who was liable for the loss, and why? [*Royal & Sun Alliance Insurance, PLC v. International Management Services Co.*, 703 F.3d 604 (2d Cir. 2013)] (See Learning Outcome 3.)

Ethical Questions

18-4. Risk of Loss. If the parties to a contract do not specify when the risk of loss passes, the risk generally rests with the party who has possession of the goods or the right to their possession. Why is this the rule? (See Learning Outcome 3.)

18-5. Passage of Title. Indiana enacted the Vapor Pens and E-Liquid Act to regulate the manufacture and distribution of e-cigarettes. The act was based on the state's interest in public health and safety. Requirements included childproof packaging and labels designating active ingredients, nicotine content, and expiration dates. The act covered in-state and out-of-state production and sales. Legato Vapors, LLC, an out-of-state maker of e-liquid products, filed a lawsuit in a federal district court against David Cook, head of the

Indiana Alcohol and Tobacco Commission, seeking an injunction. Legato argued that the state's act violated the U.S. Constitution, which prohibits the application of a state statute to commerce that takes places completely outside of the state. Specifically, Legato noted that direct online sales by out-of-state manufacturers to Indiana consumers could not be regulated by the state act. Under the UCC, when does title to goods pass from the seller to the buyer? Does this UCC provision support Legato's argument for an injunction of the state act? In any event, should Legato follow the act's requirements for ethical reasons? Discuss. [*Legato Vapors, LLC v. David Cook*, 847 F.3d 825 (7th Cir. 2017)] (See Learning Outcome 2.)

Chapter 18—Work Set

True-False Questions

- _____ 1. Identification occurs when goods are shipped by the seller.
- _____ 2. Unless the parties agree otherwise, title passes at the time and place that the buyer accepts the goods.
- _____ 3. Unless a contract provides otherwise, it is normally assumed to be a shipment contract.
- _____ 4. A buyer and a seller cannot both have an insurable interest in the same goods at the same time.
- _____ 5. In a sale on approval, the risk of loss passes to the buyer as soon as the buyer takes possession.
- _____ 6. A buyer can acquire valid title to stolen goods if the buyer does not know that the goods are stolen.
- _____ 7. Under a destination contract, title passes at the time and place of shipment.
- _____ 8. If a seller is a merchant, the risk of loss passes when a buyer takes physical possession of the goods.

Multiple-Choice Questions

- _____ 1. Siva contracts to sell to the Marcos University Bookstore 10,000 black USB flash drives. Siva identifies the flash drives by boxing up the order, attaching labels with Marcos's address to the cartons, and leaving the boxes on the loading dock for shipping. Between Siva and Marcos,
 - a. the risk of loss has passed with respect to all of the flash drives.
 - b. the risk of loss has passed with respect to half of the flash drives.
 - c. the risk of loss has passed with respect to the flash drives with labels on the boxes.
 - d. none of the above has occurred.
- _____ 2. Sam obtains his Aunt Claire's tablet computer through fraud. He then sells the tablet to Jill. If Jill does not know that the tablet was acquired by fraud, what title does she take?
 - a. Jill takes voidable title based on Sam's voidable title.
 - b. Jill takes good title because she was a good faith purchaser.
 - c. Jill takes valid title but may be subject to a tort claim for embezzlement.
 - d. Jill has no title because Sam's title was void.
- _____ 3. On Monday, Stan buys a mountain bike from Pierre, his neighbor, who says, "Take the bike." Stan says, "I'll leave it in your garage until Friday." On Tuesday, Rosie steals the bike from Pierre's garage. Who bears the risk?
 - a. Stan.
 - b. Pierre.
 - c. Both Stan and Pierre.
 - d. Neither Stan nor Pierre.
- _____ 4. On Monday, Craft Computers in Seattle delivers five hundred Apple iPads to Pac Transport to take to Portland under a destination contract with Connecting Point Stores. The iPads arrive in Portland on Tuesday, and Pac tells Connecting Point they are at Pac's warehouse. On Thursday, the warehouse burns down. On Friday, Connecting Point learns of the fire. The risk of loss passes to Connecting Point on
 - a. Monday.
 - b. Tuesday.
 - c. Friday.
 - d. none of the above days.

- _____ 5. Foster Wholesalers agrees to sell one hundred game players to Beta Electronics. Foster identifies the goods by marking the crates with red stripes. Title has not yet passed to Beta. Who has an insurable interest in the goods?
- Only Foster.
 - Only Beta.
 - Both Foster and Beta.
 - Neither Foster nor Beta.
- _____ 6. Under a contract with QT Corporation, Gold Medical ships an assortment of medical supplies. When QT opens the crates, it discovers that the supplies are the wrong assortment but agrees to accept them anyway. The risk of loss passes to QT when
- Gold ships the supplies.
 - QT opens the crates.
 - QT discovers that the goods are the wrong assortment.
 - QT accepts the supplies.
- _____ 7. Chelsey Bike Makers agrees to sell forty mountain bikes to Orange Mountain Recreation under a shipment contract. Chelsey delivers the goods to Sugar Trucking to take to Orange Mountain. Sugar delivers the goods. Title to the goods passed
- when Chelsey agrees to sell the goods.
 - when Chelsey delivers the goods to Sugar.
 - when Sugar delivers the goods to Orange Mountain.
 - at none of the above times.
- _____ 8. Helena leaves her car with OK Auto Sales & Service for repairs. OK sells the car to Pete, who does not know that OK has no right to sell the car. Helena can recover from
- OK only.
 - Pete only.
 - OK and Pete.
 - neither OK nor Pete.

Answering More Legal Problems

1. Hank bought a twelve-foot four-by-four beam at Econo Lumber. An Econo employee loaded the beam onto Hank's truck but did not secure it. A sign at the lumberyard stated that the store did not secure loads. Hank did not secure the beam, either. As he drove on the highway, the beam fell from the truck. While trying to retrieve it, Hank was struck by a car and injured.

Who held title to the beam at the time of the accident? Hank held the title. Unless the parties agree otherwise, when delivery is made without moving the goods—when the buyer picks them up—title passes at the time and place the _____ was made, if the goods have been _____. Here, title to the beam passed when Hank selected it and paid for it at Econo. **Who bore the risk of loss when the beam fell from Hank's truck?** Hank bore the risk of loss at the time of the accident. If a buyer is to pick up goods, and the seller is a merchant, the risk of loss to the goods passes to the buyer when the buyer takes _____ of the goods.

The risk of loss passed from Econo to Hank when the beam was loaded onto his truck.

2. Price-Cut Markets ordered strawberries, blueberries, and raspberries from Driscoll County Harvest Distribution Cooperative. Driscoll employees designated the berries for Price-Cut, loaded them onto a truck, and dispatched it. En route, the truck overturned, and the berries were damaged.

When could Price-Cut obtain insurance on the berries? Once _____ of the berries as the subject matter of the contract between Price-Cut and Driscoll occurred, Price-Cut could insure against their loss or damage. **When did identification of the berries as the subject matter of the contract take place?** Identification occurred when Driscoll employees _____ the berries for Price-Cut. Unless a buyer and seller agree otherwise, identification takes place when goods are marked, shipped, or somehow _____ by the seller as the goods to pass under a contract.



19 | Performance and Breach

Conflict Presented

In San Francisco, Reg contracts to sell Arturo five used trucks, which both parties know are located in a warehouse in Chicago. The parties expect that Arturo will pick up the trucks, but nothing about a place of delivery is specified in the contract.

Q What is the place for delivery of the trucks? How can Reg “deliver” the trucks without moving them?

The performance that is required of the parties under a sales or lease contract consists of the obligations and duties each party has under the terms of the contract. The basic obligations of good faith and commercial reasonableness underlie every contract under the Uniform Commercial Code (UCC). These standards are read into every contract. They also provide a framework in which the parties can specify particulars of performance.

In this chapter, we examine the basic performance obligations of the parties under a sales or lease contract. Sometimes, circumstances make it difficult for a person to carry out the promised performance. In this situation, the contract may be breached. When a breach occurs, the aggrieved party looks for remedies.

19–1 Obligations of the Seller or Lessor

The seller’s or lessor’s major obligation under a sales contract is to tender **conforming goods** to the buyer or lessee.

19–1a Tender of Delivery

Tender of delivery requires that the seller or lessor hold conforming goods at the buyer’s or lessee’s disposal and give the buyer or lessee whatever notification is reasonably necessary to enable the buyer or lessee to take delivery.

Tender must occur at a reasonable hour and in a reasonable manner. Unless the parties have agreed otherwise, the goods must be tendered for delivery at a reasonable hour and kept available for a reasonable period of time to enable the buyer to take possession of them.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Explain the seller’s or lessor’s contractual obligations.
- 2 Identify the buyer’s or lessee’s contractual duties.
- 3 List the seller’s or lessor’s remedies when the buyer is in breach.
- 4 State the buyer’s or lessee’s remedies when the seller is in breach.

Learning Outcome 1

Explain the seller’s or lessor’s contractual obligations.

conforming goods

Goods that conform to contract specifications.



Highlighting the Point

Miguel purchases a toolshed kit from Homestead Company. The sales contract requires full payment on tender of delivery of the kit at Miguel's property. The kit is to be delivered on June 30. On the morning of June 30, Homestead tells Miguel it no longer provides home delivery. Instead, Miguel must come to Homestead's headquarters that evening, make his final payment, and provide his own transportation for the kit. Otherwise, the firm will sell the kit to another customer the following day.

Is Homestead's tender of delivery being done in a reasonable manner? No. Waiting until the agreed-on delivery date to inform Miguel that he must pick up the kit himself or lose it to another customer is unreasonable. Miguel can sue Homestead for breach of contract.

All goods called for by a contract must be tendered in a single delivery unless the parties agree otherwise or one of the parties can rightfully request delivery in lots. **Example 19.1** Trend Fashion Stores (the buyer) orders one thousand shirts from Off-the-Rack Clothing (the seller). Both parties understand that the shirts are to be delivered as they are produced in four lots of 250 each, with the price apportioned accordingly. It is commercially reasonable to deliver this order in four lots. In contrast, delivering the order ten shirts at a time would be commercially unreasonable. ■

19-1b Place of Delivery

The UCC provides for the place of delivery under a contract if the contract does not state or otherwise indicate a place.

Noncarrier Cases If the contract does not designate the place of delivery for the goods, and the buyer is expected to pick them up, the place of delivery is the seller's place of business. If the seller has no place of business, the place of delivery is the seller's residence. If the goods are located somewhere other than at the seller's place of business (such as at a warehouse), then the location of the goods is the place for delivery. In this situation, the goods must have been identified, and the parties must have known their location when they formed the contract.

Carrier Cases In many instances, circumstances or delivery terms in the contract make it apparent that the parties intend that a carrier, such as a trucking company, be used to move the goods. In carrier cases, the seller can fulfill the obligation to deliver the goods through either a shipment contract or a destination contract.

1. **Shipment contracts**—A shipment contract requires or authorizes the seller to ship goods by a carrier. The contract does not require that the seller deliver the goods at a particular destination. Unless otherwise agreed, the seller must do the following:
 - Put the goods into the hands of the carrier.
 - Make a contract for their transportation that is reasonable according to the nature of the goods and their value. Certain types of goods, such as frozen vegetables, need refrigeration in transit.
 - Obtain and promptly deliver or tender to the buyer any documents necessary to enable the buyer to obtain the goods from the carrier.
 - Promptly notify the buyer that shipment has been made.

If the seller fails to perform any of these duties and a material loss of the goods or a delay results, the buyer can reject the shipment.

2. **Destination contracts**—Under a destination contract, the seller agrees to see that conforming goods are tendered to the buyer at a particular destination. The goods must be tendered at a reasonable hour and held at the buyer's disposal for a reasonable length of time. The seller must also give the buyer appropriate notice. In addition, the seller must provide the buyer with any documents of title necessary to enable the buyer to obtain delivery from the carrier.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Reg contracts in San Francisco to sell Arturo trucks located in a warehouse in Chicago. Nothing is said about delivery, although the parties expect Arturo to pick up the trucks.

A **What is the place for delivery of the trucks?** Chicago. **How can Reg “deliver” the trucks without moving them?** Arturo will need some type of document to show the bailee (the warehouse) that Arturo is entitled to the trucks. Reg can tender delivery without moving the trucks by either giving Arturo a negotiable document of title or obtaining the bailee's (warehouse's) acknowledgment that Arturo is entitled to possession.

19–1c The Perfect Tender Rule and Its Exceptions

If the goods or the tender of delivery fail in any respect to conform to the contract, the buyer or lessee can accept the goods, reject the entire shipment, or accept part and reject part. This is known as the **perfect tender rule**. Because of the rigidity of the perfect tender rule, several exceptions have been created. These exceptions are discussed next.

perfect tender rule

A rule requiring that goods conform exactly to a contract's terms or the seller is in breach.

Agreement of the Parties An exception to the perfect tender rule may be established by agreement of the parties involved in a sales or lease contract. **Example 19.2** Bell Lane Nursery contracts with Hanley Growers, Inc., to purchase two hundred tomato plants for the spring growing season. Both parties agree that Bell Lane will not reject defective (dead or diseased) plants if Hanley replaces them within a reasonable time—specifically, no more than five business days. This agreement creates an exception to the perfect tender rule. ■

Cure Another exception to the perfect tender rule involves a seller's or lessor's right to cure. The term “cure” refers to the seller's or lessor's right to repair, adjust, or replace defective or nonconforming goods. The seller or lessor has a right to attempt to cure when the following are true:

1. A delivery is rejected because the goods were nonconforming.
2. The time for performance has not yet expired.
3. The seller or lessor provides timely notice to the buyer or lessee of the intention to cure.
4. The cure can be made within the contract time for performance.

Once the time for performance has expired, the seller or lessor can still exercise the right to cure. In this situation, however, the seller or lessor must have had reasonable grounds to believe that the nonconforming goods would be acceptable to the buyer or lessee.



Highlighting the Point

In the past, Reddy Electronics frequently allowed the Topps Company to substitute certain electronic supplies when the goods Reddy ordered were not available. Under a new contract for the same type of goods, Reddy rejects the substitute supplies on the last day Topps can perform the contract.

Does Topps have the right to cure? Yes. Topps had reasonable grounds to believe Reddy would accept a substitute. Therefore, Topps can cure within a reasonable time, even though conforming delivery will occur after the actual time limit for performance allowed under the contract.

The right to cure substantially restricts the right of the buyer or lessee to reject. To reject, the buyer or lessee must inform the seller or lessor of the defect. Otherwise, the seller or lessor does not have the opportunity to cure it. Generally, buyers and lessees must act in good faith and state specific reasons for refusing to accept the goods.

Substitution of Carriers Another exception to the perfect tender rule involves the substitution of carriers. An agreed-on manner of delivery may become impracticable or unavailable through no fault of either party. For instance, the agreed-on carrier may become unavailable. If a commercially reasonable substitute is available, this substitute performance is sufficient.

installment contract

A contract in which payments due are made periodically.

Installment Contracts An **installment contract** is a single contract that requires or authorizes delivery in two or more separate lots to be accepted and paid for separately. In an installment contract, a buyer or lessee can reject an installment only if the nonconformity substantially impairs the value of the installment and cannot be cured.

Example 19.3 A seller, Refrigerated Appliances, Inc., is to deliver fifteen freezers in lots of five each. In the first lot, four of the freezers have defective cooling units that cannot be repaired. The buyer in these circumstances, Home Furnishings stores, can reject the entire lot. ■ An entire installment contract is breached only when one or more nonconforming installments substantially impair the value of the whole contract.

Commercial Impracticability Sometimes, unforeseen occurrences can render performance commercially impracticable. When this happens, the perfect tender rule no longer holds. The seller or lessor must, of course, notify the buyer or lessee as soon as possible that there will be a delay.

Commercial impracticability arises only when the parties—at the time the contract was made—had no reason to anticipate that the unforeseen event would occur. This exception to the perfect tender rule, however, does not extend to events that could have been foreseen, such as an increase in cost due to inflation.

Highlighting the Point



Ellis Dairy enters into a contract to supply a local school district with milk for one year. The contract price is the market price of milk in June. By December, however, the price of raw milk has increased by 25 percent due to inflation. Ellis stands to lose \$20,000 on the contract. To avoid this loss, Ellis claims that the cost increase makes performance of the contract commercially impracticable.

Can Ellis use the commercial impracticability exception to cancel its contract with the school district? No. Commercial impracticability arises when an event occurs that is unforeseeable. Inflation and fluctuating prices can be foreseen. They do not render performance commercially impracticable.

Destruction of Identified Goods When identified goods under a contract are completely destroyed through no fault of either party and before risk passes to the buyer or lessee, the parties are excused from performance. If the goods are only partially destroyed, however, the buyer or lessee can inspect them and either treat the contract as void or accept the damaged goods with a reduction of the contract price.

Assurance and Cooperation If one party to a contract has “reasonable grounds” to believe that the other party will not perform as contracted, they may demand in writing assurance of performance from the other party. Until the assurance is received, they may suspend further performance. What constitutes “reasonable grounds” is determined by commercial standards.

Sometimes, the performance of one party depends on the cooperation of the other. When the cooperation does not happen, the first party can proceed to perform the contract in any reasonable manner or suspend their own performance and hold the uncooperative party in breach.

19–2 Obligations of the Buyer or Lessee

Once the seller or lessor has tendered delivery, the buyer or lessee is obligated to accept the goods and pay for them according to the terms of the contract. In the absence of any specific agreements, the buyer or lessee must do the following:

1. Furnish facilities reasonably suited for receipt of the goods.
2. Make payment at the time and place the buyer receives the goods.

19–2a Payment

Payment can be made by any means agreed on between the parties—cash or any other method of payment generally acceptable in the commercial world. If a seller demands cash, the seller must give the buyer reasonable time to obtain it. When a sale is made on credit, the buyer must pay according to the specified terms (for example, ninety days). The credit period usually begins on the date of shipment.

19–2b Right of Inspection

Unless otherwise agreed, the buyer or lessee has an absolute right to inspect the goods before making payment. This right allows the buyer or lessee to verify, before making payment, that the goods conform to the contract. If the goods are not what

Learning Outcome 2

Identify the buyer's or lessee's contractual duties.

the buyer or lessee ordered, they have no duty to pay. Unless otherwise agreed, inspection can take place at any reasonable place and time and in any reasonable manner. Generally, what is reasonable is determined by custom of the trade, past practices of the parties, and the like.

19–2c Revocation of Acceptance

After a buyer or lessee accepts a lot or a commercial unit, any return of the goods must be by revocation of acceptance. (Revocation means withdrawal.) Acceptance can be revoked if a nonconformity substantially impairs the value of the unit or lot and if one of the following factors is present:

1. Acceptance was based on the reasonable assumption that the nonconformity would be cured, and it has not been cured within a reasonable time period.
2. The buyer or lessee did not discover the nonconformity until after acceptance. The failure to discover must have resulted from difficulty in detecting the nonconformity before acceptance or from the seller's or lessor's assurance that the goods were conforming.

To effectively revoke acceptance, a buyer must return the goods or at least stop using them, unless the use is necessary to avoid substantial hardship.



Real Case

Kimberly Accettura purchased a recreational vehicle (RV) from Vacationland, Inc. Accettura later returned the RV to get a leak fixed. Vacationland notified her that the RV would have to be sent back to the manufacturer for repairs. Accettura called Vacationland and verbally revoked her purchase. After the RV was repaired, she confirmed her earlier revocation and sued the seller for a return of the purchase price. Vacationland countered that it had not been given a reasonable opportunity to cure the RV's defect before Accettura revoked.

Must Vacationland return the purchase price to Accettura? Yes. In *Accettura v. Vacationland, Inc.*, the Illinois Supreme Court rejected Vacationland's argument. Because Accettura did not know about the leak when she purchased the RV, she had properly revoked acceptance despite not giving Vacationland time to fix the problem.

—155 N.E.3d 406 (S.Ct. Ill.)

19–2d Anticipatory Repudiation

What if, before the time for performance, one party clearly communicates to the other the intention not to perform? Such an action is a breach of the contract by anticipatory repudiation. Anticipatory repudiation is the refusal to acknowledge the party's obligations under the contract. When anticipatory repudiation occurs, the aggrieved party can suspend performance and do the following:

1. Await performance by the repudiating party, hoping that they will decide to honor the contract.
2. Resort to any remedy for breach.

A Repudiation May Be Retracted. The breaching party is allowed to retract repudiation. This can be done by any method that clearly indicates the party's intent to perform. Once retraction is made, the rights of the repudiating party under

the contract are reinstated. Note, though, that there can be no retraction if, since the time of the repudiation, the other party has cancelled or materially changed position or otherwise indicated that the repudiation is final.

19–3 Remedies of the Seller or Lessor

A buyer or lessee may breach a contract by wrongfully rejecting or revoking acceptance of the contract goods, failing to make proper and timely payment, or repudiating all or part of the contract. Numerous remedies are available to a seller or lessor under the UCC when the buyer or lessee is in breach. Several such remedies are discussed next.

Learning Outcome 3

List the seller's or lessor's remedies when the buyer is in breach.

19–3a The Right to Withhold Delivery

In general, sellers and lessors need not continue to perform when buyers or lessees are in breach. If the breach occurs when the seller or lessor is still in possession of the goods, or when the goods are in transit, the seller or lessor can withhold or stop delivery. If a breach results from the buyer's or lessee's inability to pay debts, the seller or lessor can refuse to deliver the goods unless the buyer or lessee pays in cash.

19–3b The Right to Reclaim the Goods

If, after delivery, a seller discovers that the buyer has received goods on credit and is insolvent (meaning the buyer's debts outweigh assets), the seller can demand return of the goods. The demand generally must be made within ten days of the buyer's receipt of the goods.

In regard to lease contracts, if the lessee fails to make payments that are due, the lessor may reclaim the leased goods that are in the possession of the lessee.

19–3c The Right to Resell the Goods

A seller or lessor still in possession of the goods when the buyer or lessee breaches can resell or dispose of the goods. When the goods contracted for are unfinished at the time of the breach of contract, the seller or lessor can do one of two things:

1. Cease manufacturing the goods and resell them for scrap or salvage value or
2. Complete the manufacture of the goods and resell or dispose of them.

In any case, the seller or lessor can recover any deficiency between the resale price and the contract price, along with **incidental damages** (costs to the seller or lessor resulting from the breach).

Incidental Damages

Damages for reasonable expenses incurred because of a contract's breach.

19–3d The Right to Recover the Purchase Price

An unpaid seller or lessor can bring an action to recover the purchase price or payments due under the contract (and incidental damages) under the following circumstances:

1. When the buyer or lessee has accepted the goods and has not revoked acceptance.
2. When conforming goods have been lost or damaged after the risk of loss has passed to the buyer or lessee.
3. When the buyer or lessee has breached the contract after the contract goods have been identified and the seller or lessor is unable to resell the goods.

If a seller or lessor sues for the contract price of goods that they have been unable to resell, the goods must be held for the buyer or lessee. The seller or lessor can resell at any time prior to collection of the judgment from the buyer or lessee, but the net proceeds from the sale must be credited to the buyer or lessee.



Highlighting the Point

Dixon Management Consultants contracts with Gem Point to purchase one thousand laser pointers with the company name inscribed on them. Gem Point delivers the laser pointers, but Dixon refuses to accept them.

Can Gem Point bring an action for the full purchase price? Yes. Gem Point can bring an action for the purchase price because it delivered conforming goods, and Dixon refused to accept or pay for the goods. Gem Point obviously cannot resell the laser pointers to another buyer because Dixon's business name is inscribed on them.

19–3e The Right to Recover Damages

If a buyer or lessee repudiates a contract or wrongfully refuses to accept the goods, a seller or lessor can bring an action to recover the damages that were sustained. Ordinarily, the amount of damages equals the difference between the contract price and the market price at the time and place of tender of the goods, plus incidental damages.

Sometimes, the difference between the contract price or lease payments and the market price is too small to place the seller or lessor in the position that they would have been in if the buyer or lessee had fully performed. In these situations, the proper measure of damages is the seller's or lessor's lost profits, including a reasonable allowance for overhead and other incidental expenses.

19–4 Remedies of the Buyer or Lessee

Learning Outcome 4

State the buyer's or lessee's remedies when the seller is in breach.

The UCC makes numerous remedies available to the buyer or lessee in the event of a breach of a contract. Of course, the buyer or lessee can recover as much of the price as has been paid. Next, we discuss four additional remedies.

19–4a The Right of Rejection

If either the goods or the tender of the goods by the seller or lessor fails to conform to the contract in any respect, the buyer or lessee normally can reject the goods. If some of the goods conform to the contract, the buyer or lessee can keep the conforming goods and reject the rest.

Timeliness and Reason for Rejection Required The buyer or lessee must reject the goods within a reasonable amount of time and must notify the seller or lessor **seasonably** (in a timely fashion). Failure to do so bars the buyer or lessee from using those defects to justify rejection or to establish breach when the seller or lessor could have cured the defects if they had been stated seasonably.

seasonably

Within a specified time period or within a reasonable time.

Duties of Merchant Buyers and Lessees When Goods Are Rejected If a merchant buyer or lessee rightfully rejects goods, they must follow any reasonable instructions received from the seller or lessor with respect to the goods controlled by the buyer or lessee. **Example 19.4** Clearwater Pool Supplies enters into a sales contract with North Glen Construction to deliver eight outdoor pool slides to a work site. Clearwater delivers the slides to the site, but North Glen rejects the goods because half of the slides are cracked. Clearwater then asks North Glen to store the defective slides on-site until it can retrieve them the following day. According to the UCC, in this situation North Glen is required to store the damaged slides because the request is reasonable. ■

If there are no instructions, the buyer or lessee may store the goods or reship them to the seller or lessor. In any of these situations, the buyer or lessee is entitled to reimbursement for the costs involved.

19-4b The Right to Obtain Specific Performance

A buyer or lessee can obtain specific performance—that is, exactly what was contracted for—when the goods are unique or when the buyer’s or lessee’s remedy at law (monetary damages) is inadequate. Specific performance may be appropriate, for instance, when the contract is for the purchase of a particular work of art, a copyright, or a similarly unique item.

Highlighting the Point



Sutherlin Vintage Motors contracts to sell a customized classic 1969 Chevrolet Camaro to Fenwick for \$40,000. The sales contract states that delivery and payment are due on June 14. Fenwick tenders payment on June 14, but Sutherlin refuses to deliver the Camaro.

If Fenwick sues Sutherlin, can Fenwick obtain the car? Yes. Because the 1969 Camaro is unique, Fenwick can probably obtain specific performance of the contract from Sutherlin.

19-4c The Right to Obtain Cover

In certain situations, buyers and lessees can protect themselves by obtaining **cover**—that is, by substituting goods for those that were due under the contract. This option is available to a buyer or lessee who has rightfully rejected goods or revoked acceptance. The option is also available when the seller or lessor repudiates the contract or fails to deliver the goods. After purchasing substitute goods, the buyer or lessee can recover from the seller or lessor the difference between the cost of cover and the contract price, plus incidental and consequential damages, less the expenses (such as delivery costs) that were saved as a result of the breach.

Consequential damages include any loss suffered by the buyer or lessee that the seller or lessor could have foreseen (had reason to know about) at the time of the contract’s formation. **Example 19.5** Ridgeline Construction, Inc., tells Quarry Sales Corporation, a heavy equipment manufacturer, that it needs a certain piece of equipment by July 1 to close a \$50,000 deal. Quarry can foresee that if the equipment is not delivered by that date, Ridgeline will suffer consequential damages. ■

cover

A buyer’s purchase of substitute goods on a seller’s breach.

19-4d The Right to Recover Damages

If a seller or lessor repudiates the contract or fails to deliver the goods, the buyer or lessee can sue for damages. The measure of recovery is the difference between the contract amount and the current market value at the time the buyer or lessee learned of the breach. The market value is determined at the place where the seller or lessor was supposed to deliver the goods. The buyer or lessee can also recover incidental and consequential damages less expenses that were saved as a result of the seller’s or lessor’s breach.

When the seller or lessor breaches a warranty, the measure of damages equals the difference between the value of the goods as accepted and their value if they had been delivered as warranted. For this and other types of breaches in which the buyer or lessee has accepted the goods, the buyer or lessee is entitled to recover for any loss resulting in the ordinary course of events.

Chapter Summary—Performance and Breach

Learning Outcome 1: Explain the seller's or lessor's contractual obligations.

The seller's or lessor's major obligation is to tender conforming goods to the buyer or lessee. Tender must occur at a reasonable hour and in a reasonable manner. If the seller or lessor tenders nonconforming goods and the buyer or lessee rejects them, the seller or lessor may cure—repair or replace the goods—within the contract time for performance. If the agreed-on means of delivery becomes impracticable or unavailable, a commercially reasonable substitute is sufficient.

Learning Outcome 2: Identify the buyer's or lessee's contractual duties.

On a seller's or lessor's tender of conforming goods, a buyer or lessee is obligated to accept them and pay for them according to the contract terms. Unless the parties agree otherwise, a buyer or lessee has a right to inspect the goods before accepting them. The buyer or lessee can revoke acceptance if, among other things, a nonconformity substantially impairs the value of the goods.

Learning Outcome 3: List the seller's or lessor's remedies when the buyer is in breach.

When the buyer or lessee is in breach, the seller or lessor may withhold delivery, reclaim the goods, resell the goods, recover the purchase price, or sue for damages.

Learning Outcome 4: State the buyer's or lessee's remedies when the seller is in breach.

When the seller or lessor is in breach, the buyer or lessee may recover as much of the price as has been paid, reject the goods, sue for specific performance, obtain cover, or sue to recover damages.

Straight to the Point

1. What does tender of delivery require? (See Learning Outcome 1.)
2. What is the perfect tender rule? (See Learning Outcome 1.)
3. When and how does a buyer or lessee pay for goods? (See Learning Outcome 2.)
4. In what situations can a buyer or lessee revoke their acceptance of goods? (See Learning Outcome 2.)
5. When can a seller or lessor bring an action to recover damages from a buyer or lessee? (See Learning Outcome 3.)
6. When can a buyer or lessee sue to recover damages from a seller or lessor? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Mike agrees to sell one thousand espresso makers to Jenny, to be delivered on May 1. Due to a strike, Mike can only deliver the espresso makers two hundred at a time over a period of ten days, with the first delivery on May 1. Does Mike have the right to deliver the goods in five lots? Explain. (See Learning Outcome 1.)
2. Pic Post-Stars agrees to sell Ace Novelty five thousand posters of celebrities, to be delivered on April 1. On March 1, Pic tells Ace, "The deal's off." Ace says, "I expect you to deliver. I'll be waiting." Can Ace sue Pic without waiting until April 1? Why or why not? (See Learning Outcome 1.)

Real Law

19-1. Anticipatory Repudiation. BRC Rubber and Plastics, Inc., had a contract with Continental Carbon Co., in which Continental would sell carbon black to the buyer. Carbon black is used principally in the manufacture of rubber products. At one point in the parties' five-year contract, supplies of carbon black became tight. Continental tried to use such market shortages to impose an increase in the baseline price to BRC. BRC became worried that Continental would no longer be able to supply the necessary quantities of carbon black. Continental stopped shipping carbon black to BRC because the latter had not agreed to a price increase. BRC began looking for alternate suppliers. BRC asked Continental for "adequate assurance" that Continental would continue to supply carbon black under the existing five-year contract. Continental finally stated that it could ship the necessary quantities of carbon black under the five-year contract, but the dates would not be the same and BRC would have to accept the higher price demanded. If BRC did not believe that Continental was providing adequate assurance for future deliveries of carbon black, could it use the doctrine of anticipatory repudiation? [*BRC Rubber and Plastics, Inc. v. Continental Carbon Co.*, 981 F.3d 618 (Ct. App., 7th Cir. 2020)] (See Learning Outcome 2.)

19-2. Remedies of the Buyer or Lessee. M.C. and Linda Morris own a home in Gulfport, Mississippi, that was extensively damaged in Hurricane Katrina. The Morris

es contracted with Inside Outside, Inc. (IO), to rebuild their kitchen. When the new kitchen cabinets were delivered, some defects were apparent. As installation progressed, others were also revealed. IO ordered replacement parts to cure the defects. Before the parts arrived, however, the parties' relationship deteriorated. IO offered to remove the cabinets and refund the price, and the Morrises asked to be repaid for the installation fee as well. IO refused but emphasized that it was willing to fulfill its contractual obligations. At this point, are the Morrises entitled to revoke their acceptance of the cabinets? Why or why not? [*Morris v. Inside Outside, Inc.*, 185 So.3d 413 (Miss.App. 2016)] (See Learning Outcome 4.)

19-3. The Right of Rejection. Erb Poultry, Inc., is a distributor of fresh poultry products in Lima, Ohio. CEME, LLC, does business as Bank Shots, a restaurant, in Trotwood, Ohio. CEME ordered chicken wings and "dippers" from Erb, which were delivered, and for which CEME issued a check in payment. A few days later, CEME stopped payment on the check. When contacted by Erb, CEME alleged that the products were beyond their freshness date, mangled, spoiled, and the wrong sizes. CEME did not provide any evidence to support the claims or arrange to return the products. Is CEME entitled to a full refund of the amount paid for the chicken? Explain. [*Erb Poultry, Inc. v. CEME, LLC*, 20 N.E.3d 1228 (Ohio App. 2 Dist. 2014)] (See Learning Outcome 4.)

Ethical Questions

19-4. Commercial Impracticability. How does the doctrine of commercial impracticability attempt to balance the rights of both parties to a contract? (See Learning Outcome 1.)

19-5. Buyer's Remedies. Samsung Telecommunications America, LLC, makes Galaxy phones. Daniel Norcia bought a Galaxy S4 phone at a Verizon store in San Francisco, California. A Verizon employee opened the box, unpacked the phone, and helped Norcia transfer his contacts to the new phone. Norcia took the phone and its accessories and left the store. Less than a year later, he

filed an action on behalf of himself and other Galaxy S4 buyers in a federal district court against Samsung. He alleged that Samsung had misrepresented the phone's storage capacity and had rigged it to operate at a higher speed when it was being tested. If these allegations are true, what are some remedies Norcia, as the buyer, can claim? Why would Samsung's decision makers choose to misrepresent their product? [*Norcia v. Samsung Telecommunications America, LLC*, 845 F.3d 1279 (9th Cir. 2017)] (See Learning Outcome 4.)

Chapter 19—Work Set

True-False Questions

- _____ 1. Performance of a sales contract is controlled by the agreement between the seller and the buyer.
- _____ 2. If identified goods are destroyed through no fault of either party and risk has not passed to the buyer, the parties are excused from performance.
- _____ 3. Payment is always due at the time of delivery.
- _____ 4. A buyer or lessee can always reject delivered goods on discovery of a defect, regardless of previous opportunities to inspect.
- _____ 5. If a buyer or lessee is in breach, the seller or lessor can cancel the contract and sue for damages.
- _____ 6. If a seller or lessor cancels a contract without justification, the seller or lessor is in breach, and the buyer or lessee can sue for damages.
- _____ 7. A buyer's principal obligation is to tender delivery.
- _____ 8. In an installment contract, a buyer can reject any installment for any reason.
- _____ 9. A seller or lessor cannot consider a buyer or lessee in breach until the time for performance has passed.

Multiple-Choice Questions

- _____ 1. Standard Office Products orders one hundred tablets from National Suppliers. National promises to deliver on Tuesday. The delivery
 - a. must be at a reasonable hour, but it can be in any manner.
 - b. must be in a reasonable manner, but it can be at any time.
 - c. must be at a reasonable hour and in a reasonable manner.
 - d. is described by none of the above.
- _____ 2. Bill delivers six satellite dishes to Ramiz, according to their contract. The contract says nothing about payment. Ramiz must pay for the goods
 - a. within thirty days of the seller's request for payment.
 - b. within ten days.
 - c. within ten business days.
 - d. on delivery.
- _____ 3. Neal contracts to sell five laser printers to Willow. Under either a shipment or a destination contract, Neal must give Willow
 - a. the documents necessary to obtain the goods.
 - b. appropriate notice regarding delivery.
 - c. both a and b.
 - d. none of the above.
- _____ 4. World Toy Company agrees to sell fifty model rockets to Tom's Hobby Shop. World tenders delivery, but Tom refuses to accept or to pay for the model rockets. If World sues Tom for damages, World could recover the difference between the contract price and the market price at the time and place of
 - a. contracting.
 - b. tender.
 - c. rejection.
 - d. none of the above.

- _____ 5. Alto Corporation agrees to buy ten saxophones from Musical Equipment Warehouse (MEW). When MEW fails to deliver, Alto is forced to cover. Alto sues MEW. Alto can recover from MEW
- the cover price less the contract price.
 - incidental and consequential damages.
 - both a and b.
 - none of the above.
- _____ 6. Pep Paints agrees to sell Grade A-1 latex outdoor paint to Monar Painters to be delivered September 8. On September 7, Pep tenders Grade B-2 paint. Monar rejects the Grade B-2 paint. If, two days later, Pep tenders Grade C-3 paint with an offer of a price allowance, Pep will have
- one day to cure.
 - a reasonable time to cure.
 - additional, unlimited time to cure.
 - none of the above.
- _____ 7. Radner's Game Town orders virtual reality headsets from Hawking, Inc. Hawking delivers, but Radner rejects the shipment without telling Hawking the reason. If Hawking had known the reason, it could have corrected the problem within hours. Radner sues Hawking for damages. Radner will
- win because Hawking's tender did not conform to the contract.
 - win because Hawking made no attempt to cure.
 - lose because Radner's rejection was unjustified—Hawking could have cured.
 - lose because a buyer cannot reject goods and sue for damages.
- _____ 8. AdamCo agrees to sell the latest version of its Go! video game to Cutter Game stores. AdamCo delivers an outdated version of Go! (nonconforming goods). Cutter's possible remedies may include
- recovering damages.
 - revoking acceptance.
 - rejecting part or all of the goods.
 - all of the above.

Answering More Legal Problems

1. Sara contracted to buy a new Steinway Model O grand piano for \$52,400 from InTune Pianos. InTune delivered a piano that had been in storage for a year and had been moved at least six times. The piano showed unacceptable damage, according to Sara.

Could Sara reject the piano? Yes. If goods fail to _____ to a contract in any respect, the buyer can reject them. Here, the piano showed unacceptable damage. **What was Sara's measure of recovery for InTune's delivery of a damaged piano?** Sara was entitled to at least \$52,400. If a seller fails to deliver _____ goods, the buyer is entitled to damages. The measure is the difference between the _____ price and the market price of the goods at the place the seller was supposed to deliver and at the time the buyer learned of the breach. The buyer can also recover incidental and consequential _____. In this case, these might include sales tax, delivery charges, attorneys' fees, and court costs.

2. Cal bought a 1952 Mickey Mantle Topps baseball card for \$17,750 from Theodore, who represented that the card was in near-mint condition. Cal put the card in a safe-deposit box. Two years later, Cal sent the card to a sports-card grading service to be evaluated. The service determined that the card could not be graded because it had been doctored and discolored.

Could Cal reject the baseball card? Yes. If goods fail to _____ to a contract in any respect, the buyer can reject them. In this case, the card was defective—doctored and discolored. **What was Cal's measure of recovery for Theodore's delivery of a defective card?** Cal could recover at least \$17,750. When the seller breaches a _____, the measure of damages equals the difference between the value of the goods as accepted and their _____. If they had been delivered as _____. The buyer can also recover any loss resulting in the ordinary course of events. Here, Theodore represented that the card was in near-mint condition, but it was not. In addition to the value of the card, Cal might recover court costs.

20 | Warranties and Product Liability

Conflict Presented

Loren is a salesperson for Main Street Auto Dealership. One afternoon, he shows a used vehicle to Raven, a potential buyer. Loren claims, "This is the best used car to come along in years. It has four new tires and a 250-horsepower engine just rebuilt this year. It's worth a fortune! Anywhere else, you'd pay \$30,000 for it."

Q Which of Loren's statements are express warranties?

In sales and lease law, a warranty is an assurance by one party of the existence of a fact on which the other party can rely. The Uniform Commercial Code (UCC) has many rules governing product warranties as they relate to sales and lease contracts. Under the UCC, warranties that can arise in a sales and lease contract include (1) warranties of title, (2) express warranties, and (3) implied warranties.

Warranties are meant to protect buyers. Other protections arise from the concept of product liability, which concerns who has legal responsibility for physical harm and property damage caused by a product.

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Name the three types of warranties of title.
- 2 State when express warranties arise in a sales or lease contract.
- 3 Identify the implied warranties that arise in a sales or lease contract.
- 4 Define a warranty disclaimer.
- 5 List the requirements of strict product liability.

20-1 Warranties of Title

Title warranty arises automatically in most sales contracts. There are three types of warranties of title: good title, no liens, and no infringements.

Learning Outcome 1

Name the three types of warranties of title.

20-1a Good Title

In most cases, sellers warrant that they have valid title to the goods sold and the right to transfer that title. If, after purchasing goods, a buyer learns that the seller did not have good title to the goods, the buyer can sue the seller for breach of this warranty.

Example 20.1 Alexis steals a diamond ring from Calvin and sells it to Emma, who does not know that the ring is stolen. If Calvin discovers that Emma has the ring, then he has the right to reclaim it from Emma. When Alexis sold Emma the ring, Alexis automatically warranted to Emma that the title conveyed was valid and that she had the right to transfer it. Because a thief has no title to stolen goods, Alexis breached the warranty of title imposed by the UCC and became liable to Emma for appropriate damages. ■

20-1b No Liens

A second warranty of title provided by the UCC protects buyers who are unaware of any liens against goods at the time the contract is made. A lien is a claim on a person's property to secure the payment of a debt. This protects buyers who, for instance,

unknowingly buy goods that are subject to a creditor's security interest. (Here, a security interest means an interest in goods that secures payment or performance of an obligation.) If a creditor repossesses the goods from a buyer who had no knowledge of the security interest, the buyer can recover from the seller for breach of warranty.



Highlighting the Point

Gavin buys a used boat from Shing for \$15,000 cash. A month later, Carol, a creditor who lent Shing money, proves that she has a valid security interest in the boat. In fact, Shing is five payments behind and in default on the boat loan. Carol repossesses the boat from Gavin. Gavin demands his cash back from Shing.

Can Gavin get his \$15,000 back from Shing under the UCC? Yes. Gavin has legal grounds to recover from Shing. As a seller of goods, Shing warrants that the goods are delivered free from any security interest or other lien of which the buyer (Gavin) has no knowledge.

A buyer who has actual knowledge of a security interest has no recourse against a seller. If the seller is a merchant and the buyer is a “buyer in the ordinary course of business,” however, the buyer is generally free of the security interest even if the buyer knows of it.

20–1c No Infringements

A third type of title warranty is a warranty against infringement of any patent, trademark, or copyright. In other words, a merchant is deemed to warrant that the goods delivered are free from any patent, trademark, or copyright claims of a third person. If this warranty is breached and the buyer is sued by the claim holder, the buyer must notify the seller within a reasonable time. This notification enables the seller to decide whether to participate in the defense against the lawsuit.

20–2 Express Warranties

Learning Outcome 2

State when express warranties arise in a sales or lease contract.

express warranty

A warranty that assures the quality, description, or performance of the goods.

A seller or lessor can create an **express warranty** by making representations about the quality, condition, or performance potential of the goods. Express warranties arise when a seller or lessor indicates any of the following:

1. That the goods conform to any affirmation or promise of fact that the seller or lessor makes to the buyer or lessee about the goods. Statements such as “These drill bits will easily penetrate stainless steel” are express warranties.
2. That the goods conform to any description. A label that reads “crate contains one diesel engine” creates an express warranty.
3. That the goods conform to any sample or model. **Example 20.2** Howard, a sports equipment salesperson, shows Belva sample baseballs. Belva orders one hundred of them. The baseballs that are delivered to Belva must conform to the samples he was shown by Howard. ■

20–2a Basis of the Bargain

To create an express warranty, the seller or lessor does not need to use formal words such as warrant or guarantee. Nor must the seller or lessor state that they have a specific intention to make a warranty. The UCC requires only that the affirmation,

promise, description, sample, or model must become part of the “basis of the bargain.” The UCC does not define this concept. Thus, a court must determine in each case whether a representation was made at such a time and in such a way that it induced the buyer or lessee to enter into the contract.

20–2b Statements of Opinion

Only statements of fact create express warranties. A seller or lessor who states an opinion about or recommends the goods does not create an express warranty. Neither does a seller or lessor who makes a statement about the value or worth of the goods. **Example 20.3** Douglas, an electronics salesperson, says that the quality of his Motorola cable modems is “excellent and unsurpassed.” This is known as puffery (or seller’s talk) and creates no warranty. ■

If the seller or lessor is an expert and gives an opinion as an expert, however, then a warranty may be created. **Example 20.4** Vincenzo, an art dealer and expert in seventeenth-century Dutch paintings, tells Lacey that a particular painting is a Rembrandt. Lacey buys the painting. Vincenzo has warranted the accuracy of his opinion. ■

The reasonableness of the buyer’s or lessee’s reliance is the controlling criterion in many cases. **Example 20.5** Ruby is a salesperson for Miller Hardware. Ruby’s statements that a ladder “will never break” and will “last a lifetime” are so clearly improbable that no reasonable buyer should rely on them. ■

Real Case



Harry’s Dairy entered a contract to purchase 3,000 tons of hay from Jeff Good. Harry’s Dairy stopped accepting Good’s hay because of mold. After Good sued Harry’s Dairy for breach of contract, Harry’s Dairy countersued, professing that Good had violated an expressed warranty. This claim was based on a statement that Good made to one of Harry’s Dairy representatives when asked about the recent bad weather on the product. Good said that “the hay had not been exposed to weather that would result in damage or mold to the hay.”

Was there an expressed warranty because of Good’s statement? No. In *Good v. Harry’s Dairy, LLC*, the Idaho Supreme Court dismissed Harry’s Dairy’s claim, holding that “no expressed warranty existed” because Good’s statement was neither an “affirmation of fact” about the possibility of mold nor a “promise” that the hay would not be moldy.

—166 ID 483 (S.Ct. ID)

Conflict Resolved

In the Conflict Presented feature at the beginning of the chapter, Loren, a salesperson for Main Street Auto Dealership, shows a vehicle to Raven, a potential buyer. Loren states, “This is the best used car to come along in years. It has four new tires and a 250-horsepower engine just rebuilt this year. It’s worth a fortune—anywhere else, you’d pay \$30,000 for it.”

A Which of Loren’s statements are express warranties? Loren’s affirmations of fact create express warranties. The facts include that the car has a rebuilt, 250-horsepower engine and four new tires. In contrast, his claims that the vehicle is “the best used car to come along in years” and that it is “worth a fortune” are opinions. Opinions do not create express warranties.

20–3 Implied Warranties

Learning Outcome 3

Identify the implied warranties that arise in a sales or lease contract.

implied warranty

A warranty implied by law.

implied warranty of merchantability

An implied warranty that goods are reasonably fit for the general purpose for which they are sold or leased.

An **implied warranty** is one that the law implies based on the nature of the transaction or the situation or circumstances of the parties. The UCC recognizes several types of implied warranties, including those discussed next.

20–3a Implied Warranty of Merchantability

An **implied warranty of merchantability** automatically arises in every sale or lease of goods made by a merchant who deals in goods of the kind sold. **Example 20.6** Mountaintop Sports, a retailer of sports gear, makes an implied warranty of merchantability when it sells a pair of skis to Rosanna, a consumer. But Damien, Rosanna's neighbor, does not make such a warranty when he sells his skis at a garage sale. ■

Merchantable Goods Goods that are merchantable are “reasonably fit for the ordinary purposes for which such goods are used.” They must be of at least average, fair, or medium-grade quality. The quality must be comparable to quality that will pass without objection in the trade or market for goods of the same description. The goods must be adequately packaged and labeled. They also must conform to the promises or affirmations of fact made on the container or label, if any.

Nonmerchantable Goods Some examples of goods that do not meet these standards include cell phones that burst into flames during extended use and high heels that break off under normal use. Such goods are nonmerchantable even if the merchant had no way to know about or discover their defects.



Highlighting the Point

Dwight buys an ax at Gershwin's Hardware Store. No express warranties are made. The first time he chops wood with the ax, the handle breaks, and he is injured. Dwight immediately notifies Gershwin's. Examination shows that the wood in the handle was rotten but that the rottenness could not have been noticed by either Gershwin's or Dwight. Nonetheless, Dwight notifies Gershwin's that he will hold the store responsible for his medical bills.

Can Gershwin's be held liable? Yes. Gershwin's is responsible because a merchant-seller of goods warrants that the goods it sells are fit for normal use. This ax was obviously not fit for normal use.

20–3b Implied Warranty of Fitness for a Particular Purpose

implied warranty of fitness for a particular purpose

An implied warranty by a merchant that goods are fit for a particular purpose specified by a buyer.

The **implied warranty of fitness for a particular purpose** arises in the sale or lease of goods when a seller or lessor (merchant or nonmerchant) knows both of the following:

1. That a buyer or lessee will use the goods for a particular purpose.
2. That the buyer or lessee is relying on the skill and judgment of the seller or lessor to select suitable goods.

A “particular purpose” of the buyer or lessee differs from the “ordinary purpose for which goods are used” (merchantability). Goods can be merchantable but unfit for a buyer's or lessee's particular purpose. **Example 20.7** Denzel needs a gallon of

paint to match the color of his office walls—a light shade of peach. He takes a sample to the local hardware store and requests a gallon of paint of that color. Instead, he is given a gallon of fuchsia pink paint. The salesperson has not breached any warranty of implied merchantability because the fuchsia pink paint is suitable for interior walls. The salesperson, however, has breached an implied warranty of fitness for a particular purpose, which is the correct color of paint to match Denzel's office walls. ■

A seller or lessor does not need to have actual knowledge of the buyer's or lessee's particular purpose. It is sufficient if a seller or lessor "has reason to know" the purpose. The buyer or lessee, however, must have relied on the seller's or lessor's skill or judgment in selecting or furnishing suitable goods.

20–3c Other Implied Warranties

The UCC recognizes that implied warranties can also arise from the following:

- The course of dealing is a sequence of conduct between the parties to a transaction that establishes a common basis for their understanding.
- Course of performance is the conduct that occurs under an agreement, indicating what the parties to the agreement intended for it to mean.
- Usage of trade is a practice or method of dealing so regularly observed as to justify an expectation that it will be observed in a particular transaction.

Thus, in the absence of evidence to the contrary, when both parties to a contract have knowledge of a well-recognized trade custom, the courts will infer that they both intended for that custom to apply to their contract.

20–4 Warranty Disclaimers and Limitations on Liability

A **warranty disclaimer** is an oral or written statement indicating that the seller is not bound by any warranty guarantees regarding the product sold. The UCC allows for warranty disclaimers. Because each type of warranty is created in a different way, the manner in which each one can be disclaimed or limited by the seller varies.

20–4a Disclaimer of Title Warranty

In an ordinary sales transaction, the title warranty can be disclaimed or modified only by specific language in a contract. **Example 20.8** Craft Tool Corporation sells metalworking tools to Dunlap Milling Company. Among the warranties and disclaimers that accompany the goods, Craft Tool asserts that it is transferring only the rights, title, and interest that it has in the goods. ■

20–4b Disclaimer of Express Warranties

A seller or lessor can disclaim all oral express warranties by including a written disclaimer in the contract. The disclaimer must be in language that is clear and conspicuous (obvious), grabbing a buyer's or lessee's attention. For instance, the disclaimer might be printed in a different color, font, or size from the rest of the contract. The buyer or lessee must be made aware of any warranty disclaimers or modifications at the time the contract is formed.

20–4c Disclaimer of Implied Warranties

Generally, the implied warranties of merchantability and fitness are disclaimed by an expression such as "as is" and "with all faults." Both parties must understand that the expression is intended to call the buyer's attention to the fact that there are no implied warranties.

Learning Outcome 4

Define a warranty disclaimer.

warranty disclaimer

A statement limiting the seller's liability for any product defects.

To disclaim the implied warranty of fitness, the disclaimer must be in writing and be conspicuous. The word fitness does not have to be mentioned. It is sufficient if the disclaimer states, “There are no warranties that extend beyond the description on the face hereof.” A merchantability disclaimer must mention the word merchantability. A merchantability disclaimer does not have to be in writing. If it is, however, the writing must be conspicuous.



Highlighting the Point

Mandy buys a new smart TV from Marshall Superstore. The sales contract includes a provision disclaiming all express or implied warranties, including the implied warranty of merchantability. This disclaimer appears in the same type size and color as the rest of the contract. When the TV does not work properly, Mandy demands a full refund. She claims that Marshall has breached the implied warranty of merchantability.

Can Mandy receive a refund for the TV, despite the contract’s disclaimer of the implied warranty of merchantability? Yes. An implied warranty of merchantability can be disclaimed orally, but if the disclaimer is in writing, the writing must be conspicuous. Because the disclaimer in Mandy’s contract is printed in the same type size and color as the rest of the contract, it is not conspicuous. Thus, the warranty disclaimer is not effective, and Mandy can ask for a refund.

20–4d Buyer’s or Lessee’s Examination or Refusal to Inspect

If a buyer or lessee fully examines the goods or refuses to examine them, there is no implied warranty with respect to defects that could be found during a reasonable examination. Failing to examine the goods and refusing to examine them are not the same. A refusal occurs only when the seller or lessor demands that the buyer or lessee examine the goods and the buyer or lessee declines to do so.

The seller or lessor remains liable for any latent (hidden) defects that ordinary inspection would not reveal. What the examination ought to reveal depends in part on a buyer’s or lessee’s skill and method of examination. **Example 20.9** Robin, an auto mechanic, is purchasing a car. He should be able to discover defects that a non-expert buyer would not be expected to find. ■

20–4e Magnuson-Moss Warranty Act

The Magnuson-Moss Warranty Act of 1975 was designed to prevent deception in warranties by making them easier to understand. Under the act, no seller or lessor is required to give an express written warranty for consumer goods. If a seller or lessor chooses to do so, however, and the cost of the consumer goods is more than \$25, the warranty must be labeled as “full” or “limited.” A full warranty requires free repair or replacement of any defective part.

In addition, the warrantor must make certain disclosures completely and obviously in a single document in “readily understood language.” These disclosures include the name and address of the warrantor, what specifically is warranted, procedures for enforcement of the warranty, any limitations on relief, and the fact that the buyer has legal rights.

20–5 Product Liability

Manufacturers and sellers of goods can be held liable to consumers, users, and bystanders for physical harm or property damage that is caused by the goods. This is called **product liability**. Product liability may be based on the warranty theories just discussed, as well as on the theories of negligence, misrepresentation, and strict liability.

product liability

Liability for injuries or damages suffered because of defects in goods.

20–5a Negligence

Negligence is the failure to use the degree of care that a reasonable, prudent person would have used under the circumstances. If a seller fails to exercise such reasonable care and an injury results, the seller may be sued for negligence.

Due Care Must Be Exercised A manufacturer must exercise “due care” to make a product safe. Due care must be exercised in all of the following areas:

- Designing the product.
- Selecting the materials.
- Using the appropriate production process.
- Assembling and testing the product.
- Placing adequate warnings on the label to inform the user of dangers of which an ordinary person might not be aware.
- Inspecting and testing any purchased components used in the product.

Highlighting the Point



Cabner bought a Cessna U206F plane. While he was flying, it crashed shortly after take-off, killing one son and injuring his wife, babysitter, and himself. He sued the maker of the engine, based on a manufacturing defect. At trial, experts testified that there were sharp metal edges in the engine cylinders in violation of design specifications. These edges broke off, lodged in the engine's valve, and led to loss of power and the crash.

Could a jury conclude that this manufacturing defect made the plane unreasonably dangerous? Yes, liability is imposed on a manufacturer regardless of whether the manufacturer's quality control efforts were reasonable. Most cases of manufacturing defects are often decided on the opinions and testimony of experts, as was this one.

Privity of Contract Not Required An action based on negligence does not require privity of contract between the plaintiff and the defendant. A manufacturer is liable for failure to exercise due care to any person who is injured by a negligently made (defective) product.

20–5b Misrepresentation

When a fraudulent misrepresentation has been made to a user or consumer and that misrepresentation results in an injury, the basis of liability may be the tort of fraud. **Example 20.10** Bright Eyes Company makes and sells cosmetics. If Bright Eyes intentionally mislabels packaged cosmetics or intentionally conceals a product's defects, it is guilty of fraudulent misrepresentation. ■

The misrepresentation must be of a material fact, and the seller must have intended to induce the buyer to rely on the misrepresentation. In addition, the buyer must have relied on the misrepresentation.

20–5c Strict Liability

Under the doctrine of strict liability, people are liable for the results of their acts regardless of their intentions or their exercise of reasonable care. **Example 20.11** Roadwork Construction uses dynamite to blast for a road. Roadwork is strictly liable for any damages that it causes, even if the company takes reasonable and prudent precautions to prevent the damages. ■ In the area of product liability, the doctrine applies to the sellers of goods, including manufacturers, processors, wholesalers, distributors, and retailers. As with negligence, liability does not depend on privity of contract.

Learning Outcome 5

List the requirements of strict product liability.

unreasonably dangerous

Defective to the point of threatening a consumer's health or safety.

Requirements of Strict Product Liability A person who is injured by a product does not necessarily have a cause of action against the manufacturer. The following requirements must be met:

1. The product must be in a defective condition when the defendant sells it.
2. The defendant normally must be engaged in the business of selling that product.
3. The product must be unreasonably dangerous to the user or consumer because of its defective condition (in most states). A product is **unreasonably dangerous** if it is defective to the point of threatening a consumer's health or safety.
4. The plaintiff must incur physical harm to self or property by use or consumption of the product.
5. The defective condition must be the proximate cause of the harm.
6. The goods must not have been substantially changed from the time the product was sold to the time the injury was sustained.

20-5d Product Defects

Three types of defects are recognized in product liability law—manufacturing defects, design defects, and inadequate warnings. (Avoiding product defects is the goal of quality control management, which is discussed in the Linking Business Law to Your Career feature at the end of this chapter.)

1. Manufacturing defects—A product contains a manufacturing defect when the product departs from its intended design. This is true even when all possible care was exercised in the preparation and marketing of the product.
2. Design defects—A product with a design defect is made in conformity with the manufacturer's design specifications, but the design itself is flawed.

A product is defective in design when:

- The foreseeable risks of harm posed by the product could have been reduced or avoided by the adoption of a reasonable alternative design.
- The failure to use the alternative design renders the product not reasonably safe.

To successfully assert a design defect, a plaintiff must show that a reasonable alternative design was available and that the defendant's failure to adopt the alternative design made the product unreasonably dangerous.

Highlighting the Point



Ralph is driving his Ford F-150 truck when it collides with another vehicle. During the collision, the truck's driver-side door opens, and Ralph is ejected and killed. Ralph's widow, Lana, files a product liability suit against Ford Motor Company. She alleges that the design of the Ford truck's door-latch system allows the doors to open in high-impact accidents, which makes the truck unreasonably dangerous. At trial, she offers evidence that Ford is aware of a reasonable (although more expensive) alternative door-latch design and that Ford engineers agree it is safer than the one in Ralph's truck.

Does Lana have a valid design defect claim against Ford? Yes. Because Ford did not adopt the alternative door-latch design, the Ford truck is unreasonably dangerous. Ford should have foreseen the risk that vehicle doors would open during a collision. It should have chosen the more reasonable alternative, despite the extra costs.

3. Inadequate warnings—A product is defective because of inadequate instructions or warnings when:
 - The foreseeable risks of harm posed by the product could have been reduced or avoided by the provision of reasonable instructions or warnings.
 - The omission of the instructions or warnings renders the product not reasonably safe.

To successfully assert an inadequate warning claim, courts would consider such factors as obvious product risks or the warning's thoroughness and accuracy.

Suppliers of Component Parts Under the rule of strict liability in tort, the basis of liability includes suppliers of component parts. **Example 20.12** General Motors buys brake pads from a subcontractor and puts them in Chevrolets without changing their composition. If those pads are defective, both the supplier of the brake pads and General Motors will be held strictly liable for the damages caused by the defects. ■

20–5e Defenses to Product Liability

Defendants in product liability cases can raise a number of defenses. These defenses include assumption of risk, product misuse, comparative negligence, and commonly known dangers.

Assumption of Risk To establish a defense of assumption of risk, the defendant must show the following:

1. The plaintiff voluntarily engaged in the risk while realizing the potential danger.
2. The plaintiff knew and appreciated the risk created by the defect in the product.
3. The plaintiff's decision to undertake the known risk was unreasonable.

Product Misuse Similar to the defense of voluntary assumption of risk is that of product misuse, which occurs when a product is used for a purpose for which it was not intended. The courts have severely limited this defense, however, and it is now recognized as a defense only when the particular use was not foreseeable. If the misuse is reasonably foreseeable, the seller must take measures to guard against it.



Highlighting the Point

Dave loves popcorn so much that he consumes several bags of microwave popcorn daily for several years. He develops bronchiolitis obliterans ("popcorn lung"). He files suit against all popcorn manufacturers.

Was Dave's behavior a foreseeable misuse of the product? Yes. It is foreseeable that a person might consume several bags of microwave popcorn a day. Therefore, manufacturers have a duty to warn users about the potential health risk associated with doing so.

Comparative Negligence Most states consider the negligent or intentional actions of the plaintiff when determining liability and damages. This is the doctrine of comparative negligence. Under this doctrine, the amount of the defendant's liability is reduced in proportion to the amount by which the plaintiff's injury or damage was caused by the plaintiff's own negligence.

Commonly Known Dangers The dangers associated with certain products (such as sharp knives and guns) are so commonly known that manufacturers need not warn users of those dangers. If a defendant succeeds in convincing a court that a plaintiff's injury resulted from a commonly known danger, the defendant normally will not be liable.



Linking Business Law to Your Career

Quality Control Management

Companies that have cost-effective quality control systems make products with fewer defects. As a result, these companies incur fewer warranty and product liability lawsuits.

Three Types of Quality Control

Most management systems involve three types of quality control—preventive, concurrent, and feedback. Preventive quality control occurs before the manufacturing process

begins, concurrent control takes place during the process, and feedback control occurs afterward.

For instance, preventive quality control might involve inspecting raw materials. During production, measuring and monitoring devices can assess whether a product is meeting certain standards as part of a concurrent quality control system. Once the manufacturing is complete, the product can undergo a final inspection as part of a feedback quality control system.

Chapter Summary—Warranties and Product Liability

Learning Outcome 1: Name the three types of warranties of title.

There are three types of warranties of title: good title, no liens, and no infringements.

Learning Outcome 2: State when express warranties arise in a sales or lease contract.

As part of a sale or lease, an express warranty arises when the seller or lessor indicates that the goods conform to (1) an affirmation or promise of fact, (2) a description of goods, or (3) a sample or model.

Learning Outcome 3: Identify the implied warranties that arise in a sales or lease contract.

An implied warranty of merchantability arises as part of a sale or lease when a merchant who deals in goods of the kind sold or leased warrants that the goods are reasonably fit for the ordinary purposes for which such goods are used.

An implied warranty of fitness for a particular purpose arises when a seller or lessor knows the particular purpose for which the goods will be used and knows that the buyer or lessee is relying on the seller's or lessor's selection.

Other implied warranties can arise as a result of course of dealing, course of performance, or usage of trade.

Learning Outcome 4: Define a warranty disclaimer.

A warranty disclaimer is a written or oral statement that limits the seller's liability for any defects or problems with the goods sold.

Learning Outcome 5: List the requirements of strict product liability.

The requirements to establish a cause of action based on strict product liability are as follows:

- (1) The product must be in a defective condition when the defendant sells it.
- (2) The defendant normally must be engaged in the business of selling that product.
- (3) The product must be unreasonably dangerous to the user or consumer because of its defective condition (in most states).
- (4) The plaintiff must incur physical harm to self or property by use or consumption of 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.

Straight to the Point

1. What is a title warranty and when does it arise? (See Learning Outcome 1.)
2. What is an express warranty? (See Learning Outcome 2.)
3. When does an implied warranty of merchantability arise? (See Learning Outcome 3.)
4. What is product liability? (See Learning Outcome 5.)
5. How does negligence-based product liability differ from strict product liability? (See Learning Outcome 5.)
6. What types of defects are recognized in product liability law? (See Learning Outcome 5.)
7. What are four defenses to product liability? (See Learning Outcome 5.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. General Construction Company (GCC) tells Industrial Supplies, Inc., that it needs an adhesive to do a particular job. Industrial provides a five-gallon bucket of a certain brand. When it does not perform to GCC's specifications, GCC sues Industrial, which claims, "We didn't expressly promise anything." What should GCC argue? (See Learning Outcome 3.)
2. Anchor, Inc., makes prewrapped mattress springs. Through an employee's carelessness, an improperly wrapped spring is sold to Bloom Company, which uses it in the manufacture of a mattress. Bloom sells the mattress to Beds Unlimited, which sells it to Kay. While sleeping on the mattress, Kay is stabbed in the back by the spring. The wound becomes infected, and Kay becomes seriously ill. Can Anchor be held liable? Why or why not? (See Learning Outcome 5.)

Real Law

20–1. Implied Warranties. My Custom Shop, Inc., (MCS) bought an 18-year-old Ford Ranger truck with 178,000 miles at auction for about \$1,300. MCS made several improvements to the vehicle and then sold it to Seth Kiewiz for \$3,800, verbally promising to replace any malfunctioning parts that it had installed. Both the purchase contract and the “sticker” attached to the truck’s window stated that the vehicle was being sold “AS IS,” without any warranties. Kiewiz immediately noticed problems with the truck’s engine and brakes. After MCS made several failed attempts to resolve these issues, Kiewiz demanded a full refund. MCS refused. Kiewiz sued, claiming breach of the implied warranty of merchantability. Should Kiewiz be able to return the truck for a full refund? [*Kiewiz v. My Custom Shop, Inc.*, 939 N.W.2d 882 (WI App. 10 2020)] (See Learning Outcome 4.)

20–2. Express Warranties. Charity Bell bought a used Toyota Avalon from Awny Gobran of Gobran Auto Sales, Inc. The odometer showed that the car had been driven 147,000 miles. Bell asked whether it had been in any accidents. Gobran replied that it was in good condition. The parties signed a warranty disclaimer that the vehicle was sold “as is.” Problems with the car arose the same day as

the purchase. Bell obtained a vehicle history report from Carfax, which showed that the Avalon had been damaged in an accident and that its last reported odometer reading was 237,271. Was the “as is” disclaimer sufficient to put Bell on notice of potential misrepresentations? Can Gobran avoid liability because Bell did not obtain the Carfax report until after she bought the car? Discuss. [*Gobran Auto Sales, Inc. v. Bell*, 335 Ga.App. 873, 783 S.E.2d 389 (2016)] (See Learning Outcome 2.)

20–3. Implied Warranties of Merchantability or Fitness. Bariven, S.A., agreed to buy 26,000 metric tons of powdered milk for \$123.5 million from Absolute Trading Corp. The milk was to be delivered in shipments from China to Venezuela. After the first three shipments, China halted dairy exports due to the presence of melamine (a harmful chemical) in some products. Absolute assured Bariven that its milk was safe, and when China resumed its dairy exports, Absolute delivered sixteen more shipments. Sample testing of the milk revealed that it contained dangerous levels of melamine. Did Absolute breach any implied warranties? Discuss. [*Absolute Trading Corp. v. Bariven S.A.*, 2013 WL 49735 (11th Cir. 2013)] (See Learning Outcome 3.)

Ethical Questions

20–4. Inadequate Warnings. Do pharmacists have a duty to warn customers about the side effects of drugs? (See Learning Outcome 5.)

20–5. Warranties. George Gregory is a competitive shotgun shooter. When the top and bottom ribs of his Winchester Model 21 became loose, he sent it to Connecticut Shotgun Manufacturing Company (CSM) for repairs. While CSM was working on the Model 21, Gregory contacted Lou Frutuoso, one of CSM’s salespersons. Gregory wanted to purchase two Grand American shotguns—a 12-gauge and a 28-gauge—that matched the specifications of his Model 21. Gregory received an “order conformation” and “terms and conditions” for the sale of the two shotguns. The conformations from

CSM included specifications for each shotgun but did not state in writing that they would match the specifications of Gregory’s Model 21. When the shotguns were delivered, they were not the correct weight or dimensions, according to Gregory, and did not match his Model 21 specifications. Gregory filed a suit in a Texas state court against CSM, alleging breach of warranty. Because Gregory’s claims about matching specifications contradicted the express terms of the order conformation, however, the court ruled in CSM’s favor. Despite the favorable outcome, what might CSM tell its sales staff, with respect to the ethics of making deals? Why? [*Gregory v. Connecticut Shotgun Manufacturing Co.*, 2017 WL 511222 (Tex.App.—Tyler 2017)] (See Learning Outcome 2.)

Chapter 20—Work Set

True-False Questions

- _____ 1. A contract cannot involve both an implied warranty of merchantability and an implied warranty of fitness for a particular purpose.
- _____ 2. A seller's best protection from being held accountable for express statements is not to make them in the first place.
- _____ 3. A clear, conspicuous, written statement brought to a buyer's attention when a contract is formed can disclaim all warranties not contained in the written contract.
- _____ 4. To disclaim the implied warranty of merchantability, a merchant must mention "merchantability."
- _____ 5. Whether or not a buyer examines goods before entering into a contract, there is an implied warranty with respect to defects that an examination would reveal.
- _____ 6. Privity of contract is required to hold a manufacturer liable in a product liability action based on negligence.
- _____ 7. In a defense of comparative negligence, an injured party's failure to exercise reasonable care against a known defect will be considered in determining liability.
- _____ 8. Under the doctrine of strict liability, defendants are liable for the results of their acts only if they intended those results.
- _____ 9. Promises of fact made during the bargaining process are express warranties.

Multiple-Choice Questions

- _____ 1. Noel's Ski Shop sells a pair of skis to Verlyn. When he first uses the skis, they snap in two. The cause is something that Noel did not know about and could not have discovered. If Verlyn sues Noel, he will likely
 - a. win because Noel breached the merchant's implied duty of inspection.
 - b. win because Noel breached the implied warranty of merchantability.
 - c. lose because Noel knew nothing about the defect that made the skis unsafe.
 - d. lose because consumers should reasonably expect to find on occasion that a product will not work as warranted.
- _____ 2. Tyler Desk Corporation writes in its contracts, in large red letters, "There are no warranties that extend beyond the description on the face hereof." The disclaimer negates
 - a. the implied warranty of merchantability.
 - b. the implied warranty of fitness for a particular purpose.
 - c. the warranty of title.
 - d. all of the above warranties.
- _____ 3. Eagle Equipment sells motor vehicle parts to dealers. In response to a dealer's order, Eagle ships a crate with a label that reads, "Crate contains one 150-horsepower diesel engine." This statement is
 - a. an express warranty.
 - b. an implied warranty of merchantability.
 - c. an implied warranty of fitness for a particular purpose.
 - d. described by none of the above.
- _____ 4. B&B Sales, Inc., sells drones. A B&B salesperson claims, "This is the finest drone ever made." This statement is
 - a. an express warranty.
 - b. an implied warranty of merchantability.
 - c. an implied warranty of fitness for a particular purpose.
 - d. described by none of the above.

- _____ 5. Damba is injured in an accident involving a defective tractor. Damba sues the maker of the tractor. To successfully claim assumption of risk as a defense, the defendant must show
- a. that Damba voluntarily engaged in the risk while realizing the potential danger.
 - b. that Damba knew and appreciated the risk created by the defect.
 - c. that Damba's decision to undertake the known risk was unreasonable.
 - d. all of the above.
- _____ 6. T&T, Inc., designs a product that is safe when used properly. Bob uses the product in an unforeseeable, improper way. If Bob sues T&T, the manufacturer will likely be held
- a. liable for negligence or misrepresentation.
 - b. strictly liable.
 - c. to be either a or b.
 - d. to be none of the above.
- _____ 7. Jane buys a defective product from Valu-Mart and is injured as a result of using the product. If Jane sues Valu-Mart based on strict liability, to recover damages she must prove that Valu-Mart
- a. was in privity of contract with her.
 - b. was engaged in the business of selling the product.
 - c. failed to exercise due care.
 - d. defectively designed the product.
- _____ 8. Fine Textiles, Inc., sells cloth to Gail by showing her a sample that Fine's salesperson says is the same as the goods. This statement is
- a. an express warranty.
 - b. an implied warranty.
 - c. a warranty of title.
 - d. puffery.

Answering More Legal Problems

1. Stella bought a cup of coffee at the Roasted Bean Drive-Thru. The coffee had been heated to 190 degrees and consequently had dissolved the inside of the cup. When Stella lifted the lid, the cup collapsed, spilling the contents onto her lap. To recover for third-degree burns on her thighs, Stella filed a suit against the Roasted Bean.

Can Stella recover for breach of the implied warranty of merchantability? Yes. An implied warranty of merchantability arises in every _____ of goods made by a merchant who deals in goods of the kind. Goods that are merchantable are _____ for the ordinary purposes for which such goods are _____. Merchantable goods can include merchantable food, such as clam chowder or coffee. Merchantable food is food that is _____ to eat or drink on the basis of consumer expectations. A consumer should reasonably expect hot coffee to be hot, but not so hot that it causes third-degree burns.

2. Jared bought a cell phone made by WiFi Communications, Inc. Three months later, after recharging the battery through a power jack, Jared picked up the phone

only to have it ignite in his hand. As a result, he suffered a severe burn. Jared filed a strict product liability lawsuit against WiFi, alleging that a design defect in the phone weakened the connection between the power jack and the motherboard, causing the wiring to overheat and creating an unreasonable safety hazard.

Could Jared succeed on his strict product liability claim? Yes. Jared can succeed with his claim if he can meet the requirements. A product is defective in design when the foreseeable _____ of harm posed by the product could have been reduced or avoided by the adoption of a reasonable alternative design, and the failure to use the alternative design renders the product not reasonably _____. Jared must show that the phone was defective when WiFi sold it, WiFi was normally engaged in selling that product, the phone was unreasonably _____ to a user because of its defect, Jared incurred physical harm by use of the phone, the defect was the proximate _____ of the harm, and the phone was not substantially changed from the time that it was sold to the time of the injury.

21 | Consumer Protection

Conflict Presented

The makers of Campbell's soups advertised that "most" Campbell's soups were low in fat and cholesterol and thus were helpful in fighting heart disease. What the ad did not say was that some Campbell's soups were high in sodium (salt) and high-sodium diets may increase the risk of heart disease.

Q Does this omission make the advertising deceptive?

Consumer law includes all statutes, agency rules, and common law judicial decisions that attempt to protect the interests of consumers. Countless federal and state laws are aimed at protecting consumers from such problems as unfair trade practices, unsafe products, and discriminatory or unreasonable credit requirements. Nearly every federal agency has an office of consumer affairs, and most states have one or more such offices as well.

In this chapter, we focus on consumer protections at the federal level. Note, though, that state laws often provide more sweeping and significant protections for consumers than do federal laws.

21-1 Deceptive Advertising

The Federal Trade Commission Act created the Federal Trade Commission (FTC) to carry out the broadly stated goal of preventing unfair and deceptive trade practices, including deceptive advertising. Generally, **deceptive advertising** occurs if a reasonable consumer would be misled by the advertising claim. Vague generalities and obvious exaggerations—known as puffery—are permissible.

21-1a Forms of Deceptive Advertising

False or deceptive advertising comes in many forms. Deception may arise from a false statement or claim about a company's own products or a competitor's products. The deception may concern a product's quality, effects, price, origin, availability, or other attributes.

Example 21.1 Teak Tables posts an online ad on several furniture retailers' websites. The ad refers to the firm's wide selection of custom tables. Because the ad does not mention that most of Teak's tables are made from oak, it is deceptive. Online consumers could reasonably be led to assume that the tables are made of teak wood because of the company name. ■

Some advertisements contain "half-truths," meaning that the presented information is true but incomplete and therefore may lead consumers to a false conclusion.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Define deceptive advertising.
- 2 Recognize what information must be included on labels.
- 3 State the Truth-in-Lending Act requirements.
- 4 Describe health and safety protection.

Learning Outcome 1

Define deceptive advertising.

deceptive advertising
Advertising that misleads consumers.



Highlighting the Point

FotoFree, Inc., makes and distributes an app that allows users to send and receive photos and other digital information. The app includes a “Find” function to help senders locate their intended recipients. FotoFree’s advertising states that the “Find” feature uses a recipient’s mobile phone number to perform a search. But the ad does not state—and the app does not notify users—that the function also collects the names and numbers of all of the contacts in the senders’ and recipients’ mobile devices’ address books.

Is this deceptive advertising? Yes. FotoFree advertises that its app uses a mobile number to perform a search without stating that the function also collects all of the names and numbers in the users’ address books. Users are thereby misled into concluding that their privacy and personally identifiable information are protected.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, the makers of Campbell’s soups stated in their advertising that most of the soups were low in fat and cholesterol and thus helped to fight heart disease. The ad did not say that some of the soups were also high in sodium (salt), which can increase the risk of heart disease.

A Does this omission make the advertising deceptive? Yes. The FTC ruled that the claims were deceptive. Half-truths can lead consumers to false conclusions.

Advertising that contains an endorsement by a celebrity may be deemed deceptive if the celebrity does not actually use the product. In addition, advertising that appears to be based on factual evidence but, in fact, is not reasonably supported by some evidence will be deemed deceptive.

Example 21.2 Health Plus advertises its herbal supplements, claiming that its products ward off harmful bacteria and germs that cause the common cold. No scientific studies or research can support this claim, however. Thus, the FTC can seek an injunction to stop Health Plus from running the deceptive ads. ■

21–1b Bait-and-Switch Advertising

One of the FTC’s most important rules is contained in its “Guides against Bait Advertising.” The rule is designed to prohibit **bait-and-switch advertising**. This kind of advertising occurs when a retailer advertises low-priced merchandise (the “bait”) just to get consumers into the store. Once there, consumers are urged to buy more expensive items instead (the “switch”). They may be told, for instance, that the advertised item is no longer available.

According to the FTC guidelines, bait-and-switch advertising occurs if the seller does any of the following:

- Refuses to show the advertised item.
- Fails to have reasonably adequate quantities of the advertised item available.
- Fails to promise to deliver the advertised item within a reasonable time.
- Discourages employees from selling the advertised item.

bait-and-switch advertising

Advertising low-priced products to entice customers into a store to buy higher-priced products.

21–1c Online Deceptive Advertising

The FTC actively monitors online advertising. It has identified hundreds of websites that have made false or deceptive claims for products ranging from medical treatments for various diseases to exercise equipment.

Generally, online ads—like all other ads—must be truthful and not misleading, and any claims must be substantiated. FTC guidelines on internet marketing also call for “clear and conspicuous” disclosure of any qualifying information.

Advertisers should assume that consumers will not read an entire webpage. Therefore, to satisfy the “clear and conspicuous” requirement, advertisers should place a disclosure as close as possible to the claim being qualified or include the disclosure within the claim. If that is not possible, the disclosure should appear on a section of the page to which a consumer can easily scroll. Generally, hyperlinks to a disclosure are recommended only for long disclosures or for disclosures that must be repeated in a variety of locations on a webpage.

21–1d FTC Actions Against Deceptive Advertising

The FTC receives complaints about deceptive advertising from many sources. These include competitors of alleged violators, consumers, consumer organizations, trade associations, Better Business Bureaus, government organizations, and state and local officials. If complaints are widespread, the FTC will investigate. If, after investigating, the FTC believes that a given advertisement is unfair or deceptive, it drafts a formal complaint, which is sent to the alleged offender.

The company may agree to settle the complaint without further proceedings. If not, the FTC can conduct a hearing. If the FTC succeeds in proving that an advertisement is unfair or deceptive, it usually issues a **cease-and-desist order** requiring that the challenged advertising be stopped. It might also require a sanction known as **counteradvertising**. Here, the company must advertise anew to inform the public about the earlier misinformation.

Example 21.3 Match.com allows users to maintain free profiles on its website. Such users cannot, though, respond to other members without paying a subscription fee. The FTC sued the corporate parent of Match.com for engaging in deceptive advertising practices that were designed to “trick” nonpaying members into purchasing access to the site. Match.com sent millions of fake “You caught his eye” e-mails to users who had only free accounts, suggesting that another member was romantically interested in them. Well over 5,000 users, the agency estimated, were convinced to buy paid subscriptions after being flattered by these fraudulent e-mails. ■

cease-and-desist order

An order prohibiting specified activities.

counteradvertising

New advertising that corrects earlier false claims.

21–1e False Advertising Claims Under the Lanham Act

The Lanham Act, which protects trademarks, also covers false advertising claims. To state a successful claim under the act, a business must establish the following:

1. The company suffered a competitive or commercial injury in reputation or sales.
2. The injury was directly caused by false or deceptive advertising.
3. The company lost business from consumers or other buyers who were deceived by the advertising.

Highlighting the Point



Doyle International sells the only style of toner cartridge that works with its laser printers. Other businesses—called remanufacturers—refurbish used Doyle cartridges and then sell them in competition with the Doyle's cartridges. Central Control, Inc., makes and sells components for the remanufactured cartridges, including microchips that

(Continues)

mimic the chips in Doyle's cartridges. Doyle releases advertisements claiming that Central's microchips infringe Doyle's patents. Central files a claim against Doyle, alleging lost sales and damage to its reputation by Doyle's false advertising about Central's microchips.

Does Central have a cause of action for false advertising under the Latham Act? Yes. Businesses do not need to be direct competitors to bring an action for false advertising. To establish a claim, a plaintiff must allege a competitive or commercial injury in reputation or sales that directly flows from the false advertising. Central meets this test.

21-2 Labeling Laws and Consumer Sales

Two important areas of consumer protection law focus on giving consumers information. Labeling and packaging laws apply to the information on product labels and packages, while consumer sales law deals with information about sales transactions.

21-2a Labeling and Packaging Laws

Learning Outcome 2

Recognize what information must be included on labels.

A number of federal and state laws deal specifically with the information given on labels and packages. In general, labels must be accurate, and they must use words that are understood by ordinary consumers. In other words, all labels must be accurate and not misleading.

In some instances, labels must specify the raw materials used in the product, such as the percentage of cotton used in a garment. In other instances, the products must carry a health warning, such as those required on cigarette packages. A few important laws that affect labeling and packaging are discussed next.

The Fair Packaging and Labeling Act The Fair Packaging and Labeling Act requires that food product labels identify (1) the product; (2) the net quantity of the contents and, if the number of servings is stated, the size of a serving; (3) the manufacturer; and (4) the packager or distributor. Additional requirements concern descriptions on packages, savings claims, and components of nonfood products.

Example 21.4 Fay is highly allergic to hazelnuts. By reading the labels required by the Fair Packaging and Labeling Act on all food products, Fay can avoid eating foods that could trigger an allergy attack. ■

The Nutrition Labeling and Education Act The Nutrition Labeling and Education Act requires food labels to provide standard nutrition facts (including the amount and type of fat that the food contains) and regulates the use of such terms as “fresh” and “low fat.” These rules are updated annually.

21-2b Consumer Sales

A number of statutes that protect consumers in sales transactions concern the disclosure of certain terms in sales. Others provide rules governing telephone and mail-order transactions, unsolicited merchandise, and online sales.

Telephone and Mail-Order Sales The FTC's Mail or Telephone Order Merchandise Rule provides specific protections for consumers who purchase goods over the phone, through the mail, or online. For instance, merchants are required to ship orders within the time promised in their advertisements and to notify consumers when orders cannot be shipped on time. The rule also requires merchants to issue a refund within a specified period of time when a consumer cancels an order.

The TCPA and the TRACED Acts Congress passed the Telephone Consumer Protection Act (TCPA) that prohibits telephone solicitations using an automatic telephone dialing system. The TCPA, however, has long been considered lacking when it comes to protecting consumers against unsolicited robocalls—calls or texts generated by computerized autodialing technology and placed by a telemarketer. Americans receive billions of robocalls each month. In response, Congress passed the TRACED Act, an amendment to the TCPA that broadens the definition of prohibited robocalls and requires telephone providers to offer consumers more effective robocall-blocking options. The amendment also gives the FTC the ability to impose substantial fines on individuals or business entities.

Online Sales Many business-to-consumer sales take place on the internet, and it is not surprising that some involve fraudulent and deceptive sales practices. The FTC and other federal agencies have brought numerous enforcement actions against those who commit online fraud. Nonetheless, protecting consumers from such practices has proved to be a challenging task. The number of consumers who have fallen prey to internet fraud has actually grown in recent years.

Exhibit 21.1 indicates many of the areas of consumer law, including consumer sales, which are regulated by federal statutes.

21–3 Credit Protection

Credit protection is an especially important aspect of consumer protection legislation. The Consumer Financial Protection Bureau oversees the practices of banks, mortgage lenders, and credit card companies. We discuss significant consumer credit protection legislation next.

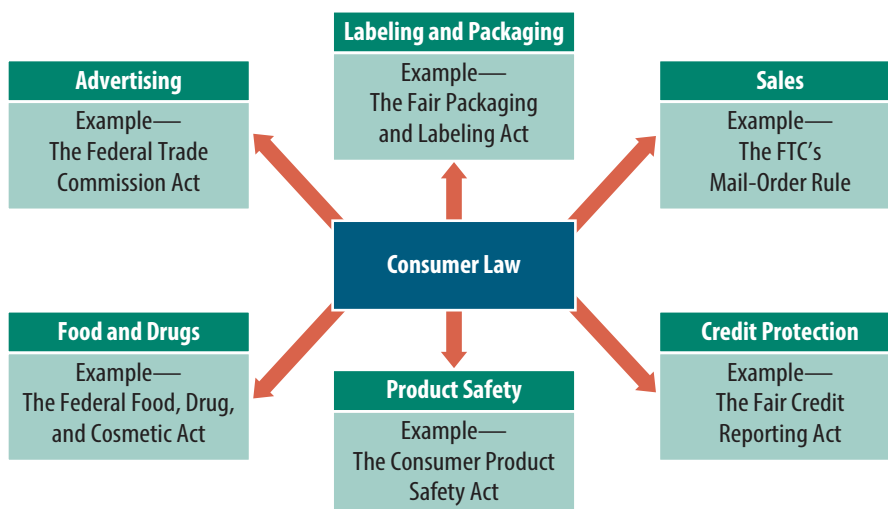
21–3a The Truth-in-Lending Act

One of the most important statutes regulating the credit and credit card industry is Title 1 of the Consumer Credit Protection Act. This statute is commonly known as the Truth-in-Lending Act (TILA) and is administered by the Federal Reserve Board. The TILA is basically a disclosure law. It requires sellers and lenders to disclose credit terms or loan terms so that individuals can shop around for the best financing arrangements.

Learning Outcome 3

State the Truth-in-Lending Act requirements.

Exhibit 21.1 Selected Areas of Consumer Law Regulated by Statutes



Regulation Z

A set of rules that implements the Truth-in-Lending Act.

Application TILA requirements apply only to those who, in the ordinary course of their business, lend funds, sell on credit, or arrange for the extension of credit. Thus, sales or loans made between two consumers do not come under the protection of the act. Also, only debtors who are natural persons—as opposed to the artificial “person” of a corporation—are protected by this law.

Disclosure Requirements The disclosure requirements under the TILA are found in **Regulation Z**, which was issued by the Federal Reserve Board. If the contracting parties are subject to the TILA, the requirements of Regulation Z apply to any transaction involving an installment sales contract in which payment is to be made in more than four installments. These transactions include installment loans, retail and installment sales, car loans, home-improvement loans, and certain real estate loans if the amount of financing is less than \$25,000.

The TILA also applies to those who lease consumer goods in the ordinary course of their business, if the goods are priced at \$25,000 or less and if the lease term exceeds four months. For consumers who lease automobiles and other goods, lessors are required to disclose in writing all of the material terms of the lease.

Under the TILA, all of the terms of a credit instrument must be fully disclosed. The TILA also provides for contract rescission if a creditor fails to follow exactly the procedures required.

Equal Credit Opportunity Act The Equal Credit Opportunity Act (ECOA), an amendment to the TILA, prohibits the denial of credit solely on the basis of race, religion, national origin, color, gender, marital status, or age. The act also prohibits credit discrimination based on whether an individual receives certain forms of income, such as public-assistance benefits. In addition, a creditor cannot require the signature of a cosigner on a credit application if the applicant qualifies under its standards of creditworthiness for the amount and terms of the applicant’s credit request.



Real Case

Chase Bank USA rejected Jeffery Chen’s application for a credit card, simply citing his previous “unsatisfactory relationship with the bank.” Chen filed suit against Chase for violating the ECOA. Chase moved for the action to be dismissed because Chen could not show that he had been a victim of discrimination based on any of the factors identified in the ECOA.

Could Chen’s suit proceed? Yes. In *Chen v. Chase Bank USA, N.A.*, a federal court discovered that Congress intended for the ECOA to also provide educational informational benefits to consumers. Thus, “instead of being told only that they do not meet a particular creditors’ standards,” rejected credit applicants must be given specific reasons for the denial. Because Chase clearly failed to provide Chen with this information, the court ruled that Chen’s action under the ECOA could proceed.

—393 F.Supp.3d 850 (N.D. Cal.)

Credit Cardholder Protection Under the TILA, the liability of a credit cardholder is limited to \$50 per card for unauthorized charges made before the time the creditor is notified that the card is lost. A credit card company cannot bill a consumer for unauthorized charges if the credit card was improperly issued. If a consumer receives an unsolicited credit card in the mail that is later stolen, the company that issued the card cannot charge the consumer for any of the unauthorized charges.

If a debtor thinks that an error has occurred in billing or wishes to withhold payment for a faulty product purchased by credit card, the TILA outlines specific procedures for settling the dispute.

Other Credit Card Rules Additional credit card protections of TILA include the following provisions:

1. Cardholders are protected from retroactive interest rate increases on existing card balances unless the account is sixty days delinquent.
2. Cardholders must be notified at least forty-five days before changes are made to their credit card terms.
3. A monthly bill must be sent to a cardholder at least twenty-one days before the due date.
4. The interest rate charged on a cardholder's balance can be increased only in specific situations, such as when a promotional rate ends.
5. Over-limit fees can be charged only in specific situations.
6. Cardholders' payments in excess of the minimum amount due must be applied to the higher-interest balances first (such as cash advances, which are commonly charged higher interest rates).
7. Finance charges cannot be based on a previous billing cycle. (This provision relates to a practice known as double-cycle billing under which a cardholder is charged interest on the balance from a previous cycle even when that balance was paid in full.)

21–3b The Fair Credit Reporting Act

To protect consumers against inaccurate credit reporting, Congress enacted the Fair Credit Reporting Act (FCRA). This act provides that consumer credit reporting agencies may issue credit reports to users only for specified purposes, including the extension of credit. Any time a consumer is denied credit or insurance on the basis of their credit report, the consumer must be notified of that fact and of the name and address of the credit reporting agency that issued the report.

Consumer Requests Under the FCRA, consumers can request the source of any information used by the credit agency, as well as the identity of anyone who has received an agency's report. If consumers discover that the agency's files contain inaccurate information about their credit standing, they can send a written request for an investigation. The agency must then investigate the disputed information. Any unverifiable or erroneous information must be deleted within a reasonable time.

Liability An agency that fails to comply with the FCRA is liable for monetary damages. Creditors and others—such as lenders and insurance companies—that use information from credit reporting agencies may also be liable for violations.

21–3c The Fair and Accurate Credit Transactions Act

In an effort to combat rampant identity theft, Congress passed the Fair and Accurate Credit Transactions (FACT) Act. The act established a national fraud alert system so that consumers who suspect that they have been, or may be, victimized by identity theft can place an alert in their credit files.

The FACT Act requires the major credit reporting agencies to provide consumers with a free copy of their credit reports every twelve months. Account numbers on credit card receipts must be shortened so that merchants, employees, and others who have access to the receipts cannot obtain a consumer's name

and full credit card numbers. Financial institutions must work with the FTC to identify “red flag” indicators of identity theft and to develop rules on how to dispose of sensitive credit information. The FACT Act also gives consumers who have been victimized by identity theft some assistance in rebuilding their credit reputations.

21–3d The Fair Debt Collection Practices Act

The Fair Debt Collection Practices Act (FDCPA) attempts to curb abuses by collection agencies. The act applies only to specialized debt-collection agencies that regularly attempt to collect debts on behalf of someone else. Creditors who attempt to collect debts are not covered unless they cause the debtor to believe that they are part of a collection agency.

Requirements of the Act The act prohibits the following debt-collection practices:

1. Contacting consumers at their place of employment if the employer objects, contacting consumers at inconvenient or unusual times, or contacting consumers if they have an attorney.
2. Contacting third parties other than parents, spouses, or financial advisers about the payment of a debt unless authorized by a court.
3. Using harassment and intimidation (such as using abusive language) or using false or misleading information (such as posing as a police officer).
4. Communicating with the consumer after receipt of a notice that the consumer is refusing to pay the debt, except to advise the consumer of further action to be taken by the collection agency.

validation notice

Notice from a collection agency informing debtors they have thirty days to challenge a debt and request verification.

Validation Notice Under the Act The FDCPA also requires collection agencies to include a **validation notice** whenever they initially contact a debtor for payment of a debt or within five days of that initial contact. The notice must state that the debtor has thirty days within which to dispute the debt and to request a written verification of the debt from the collection agency. The debtor need not dispute the debt in writing, but a request for debt validation must be in writing.



Highlighting the Point

Roma borrows \$200,000 from Suburban Mortgages to buy a house. Roma defaults on the payments. On Suburban's behalf, Cash-Out Collection Agency initiates a foreclosure. Roma receives a validation notice stating that the debt to Suburban is assumed valid unless she disputes it in writing. Roma objects.

Does Suburban's notice violate the FDCPA? Yes. Suburban violated the FDCPA by telling Roma that she could dispute the debt only in writing. There is no such requirement in the FDCPA.

Enforcement of the Act The enforcement of the FDCPA is primarily the responsibility of the FTC. The act allows debtors to recover civil damages, as well as attorneys' fees, in an action against a collection agency that violates provisions of the act.

21–4 Protection of Health and Safety

There is a significant distinction between regulating the information dispensed about a product and regulating the product's actual content. Tobacco products are the classic example. Producers of tobacco products are required to warn consumers about the hazards associated with the use of their products. The sale of tobacco products, however, has not been subjected to significant restrictions or banned outright despite the obvious dangers to public health.

Learning Outcome 4

Describe health and safety protection.

21–4a The Federal Food, Drug, and Cosmetic Act

The Federal Food, Drug, and Cosmetic Act (FDCA) protects consumers against tainted and misbranded foods and drugs. The act establishes food standards, specifies safe levels of potentially hazardous food additives, and provides classifications of food and food advertising. Most of these statutory requirements are monitored and enforced by the U.S. Food and Drug Administration (FDA). The FDCA also charges the FDA with the responsibility of ensuring that drugs are safe and effective before they are marketed to the public.

21–4b The Consumer Product Safety Act

The Consumer Product Safety Act protects consumers from unreasonable risk of injury from hazardous products. The act also created the Consumer Product Safety Commission (CPSC). Generally, the CPSC is authorized to set standards for consumer products and to ban the manufacture and sale of any product that poses an unreasonable risk to consumers. The commission can remove products from the market if it considers them imminently hazardous. The CPSC can also require manufacturers to report information about any products already sold or intended for sale that have proved to be hazardous.

Chapter Summary—Consumer Protection

Learning Outcome 1: Define deceptive advertising.

Advertising is deceptive if a reasonable consumer would be misled by the advertising claim. For example, the Federal Trade Commission (FTC) prohibits bait-and-switch advertising. This occurs when a seller advertises a lower-priced product (the bait) intending not to sell the product but to lure consumers into the store and convince them to buy a higher-priced product (the switch). The FTC may issue a cease-and-desist order requiring the advertiser to stop the challenged advertising, or the FTC may order counteradvertising, in which the advertiser corrects the earlier misinformation.

Learning Outcome 2: Recognize what information must be included on labels.

Manufacturers must comply with the labeling or packaging requirements for their specific products. In general, all labels must be accurate and not misleading.

Learning Outcome 3: State the Truth-in-Lending Act requirements.

The Truth-in-Lending Act (TILA) requires sellers and lenders to disclose credit or loan terms so consumers can shop around for the best available financing terms. Creditors who, in the ordinary course of business, lend funds, sell on credit, or arrange for the extension of credit are subject to the TILA. Regulation Z is a set of rules issued by the Federal Reserve Board to implement the TILA.

Learning Outcome 4: Describe health and safety protection.

The Federal Food, Drug, and Cosmetic Act protects consumers against tainted and misbranded foods and drugs. The act establishes food standards, specifies safe levels of potentially hazardous food additives, and provides classifications of food and food advertising.

Under the Consumer Product Safety Act, the Consumer Product Safety Commission can remove dangerous products from the market and ban the manufacture and sale of such products.

Straight to the Point

1. Which federal agency is empowered to prevent unfair and deceptive trade practices? (See Learning Outcome 1.)
2. What are three forms of deceptive advertising? (See Learning Outcome 1.)
3. Which federal rule protects consumers who buy goods over the phone, through the mail, or online? (See Learning Outcome 2.)
4. Which federal agency oversees the credit practices of banks, mortgage lenders, and credit card companies? (See Learning Outcome 3.)
5. What is the extent of the liability of a credit cardholder for unauthorized charges? (See Learning Outcome 3.)
6. What federal act was passed to combat identity theft? (See Learning Outcome 3.)
7. Whom can a debt-collection agency legitimately contact in an attempt to collect a debt? (See Learning Outcome 3.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Top Electronics, Inc., advertises GEM computers at a low price. Top keeps only a few in stock and tells its sales staff to switch consumers attracted by the price to more expensive brands. Top tells its staff, “If all else fails, refuse to show the GEMs, and if a consumer insists on buying one, do not promise delivery.” Has Top violated a law? Explain your answer. (See Learning Outcome 1.)
2. Sweet Candy Company wants to sell its candy in a normal-sized package labeled “Gigantic Size.” Fine Fabrics, Inc., wants to advertise its sweaters as having “That Wool Feel,” but does not want to specify on labels that the sweaters are 100 percent polyester. What stops these firms from marketing their products as they would like? (See Learning Outcome 2.)

Real Law

21–1. Fair Debt Collection Practices Act (FDCPA). Silvia Manual owed Texas Orthopedics \$250. The debt was transferred to Merchants and Professional Bureau, Inc., for collection. Six years later, Merchants finally sent Manual four collection letters. By that time, a four-year Texas statute of limitation barred any suit to collect the debt. Otherwise stated, the debt was not legally enforceable. The collection letters did not disclose this fact. Were the collection letters false and misleading under the Fair Debt Collection Practices Act? [*Manual v. Merchants and Professional Bureau, Inc.*, 956 F.3d 822 (U.S. Ct. App. 5th Cir. 2020)] (See Learning Outcome 3.)

21–2. Debt Collection. Zakia Mashiri owns a home in San Diego, California. She is a member of the Westwood Club Homeowners’ Association (HOA), which charges each member an annual fee. When Mashiri failed to pay the fee, the law firm of Epstein Grinnell & Howell sent her a letter demanding payment. The letter read, “Failure to pay your . . . account in full within thirty-five days from the date of this letter will result in a lien . . . against your property.” Mashiri asked for validation of the debt. Within two weeks of receiving it, she sent HOA a check for the fee. Meanwhile, the law firm filed a lien against her property. Mashiri filed a lawsuit in a federal district court against the law firm,

alleging a violation of the Fair Debt Collection Practices Act. On what provision of the act did Mashiri likely base her allegation? Will she succeed in her lawsuit against the law firm? Explain your answer. [*Mashiri v. Epstein Grinnell & Howell*, 845 F.3d 984 (9th Cir. 2017)] (See Learning Outcome 3.)

21-3. Deceptive Advertising. Innovative Marketing, Inc. (IMI) sold “scareware”—computer security software. IMI’s internet ads redirected consumers to sites where they were told that a scan of their computers had detected dangerous

files—viruses, spyware, and “illegal” pornography. Kristy Ross, an IMI cofounder and vice president, reviewed and edited the ads, and was aware of the many complaints consumers had made about them. An individual can be held personally liable under the Federal Trade Commission Act for deceptive acts if the person (1) participated directly in the practices or had the authority to control them and (2) had or should have had knowledge of them. Is Ross liable under this standard? Explain. [*Federal Trade Commission v. Ross, Inc.*, 743 F.3d 886 (4th Cir. 2014)] (See Learning Outcome 1.)

Ethical Questions

21-4. Consumer Protection. Suppose a borrower attempts to avoid paying a debt by asserting that a creditor’s unintended failure to comply with a strict legal requirement excuses the obligation. Should consumer protection laws be strictly enforced when a consumer appears to abuse that law? Explain your answer. (See Learning Outcome 3.)

21-5. Consumer Protection. In Richland, Washington, Robert Ingersoll planned his wedding to include one hundred guests, a photographer, a caterer, a wedding cake, and flowers. Ingersoll had been a customer of Arlene’s Flowers and Gifts for more than nine years and had spent several thousand dollars at the shop. When he approached Arlene’s

owner, Baronelle Stutzman, to buy flowers for his wedding, she refused because Ingersoll’s betrothed, Curt Freed, was also a man. Deeply offended, Ingersoll and Freed dropped their wedding plans and married in a modest ceremony. The couple filed a suit in a Washington state court against Stutzman, alleging a violation of the state’s Consumer Protection Act (CPA). Washington’s CPA prohibits “unfair practices,” which include discriminating against customers on the basis of their sexual orientation. Would it be ethical to hold Stutzman liable for a violation of the CPA? Discuss. [*State of Washington v. Arlene’s Flowers, Inc.*, 187 Wash.2d 804, 389 P.3d 543 (2017)] (See Learning Outcome 1.)

Chapter 21—Work Set

True-False Questions

- _____ 1. Advertising will be deemed deceptive if a consumer would be misled by the advertising claim.
- _____ 2. In general, labels must be accurate—they must use words as those words are understood by the ordinary consumer.
- _____ 3. There is no federal legislation regulating food and drugs.
- _____ 4. The Truth-in-Lending Act applies to creditors who, in the ordinary course of business, lend money or sell goods on credit to consumers.
- _____ 5. Consumers may have more protection under state laws than under federal laws.
- _____ 6. The Fair Debt Collection Practices Act applies to anyone who attempts to collect a debt.
- _____ 7. There are no federal agencies that regulate sales.
- _____ 8. One who leases consumer goods in the ordinary course of business does not, under any circumstances, have to disclose all material terms in writing.

Multiple-Choice Questions

- _____ 1. Ann receives an unsolicited credit card in the mail and tosses it on her desk. Without Ann's permission, her roommate uses the card to spend \$1,000 on new clothes. Ann is liable for
 - a. \$1,000.
 - b. \$500.
 - c. \$50.
 - d. \$0.
- _____ 2. The ordinary business of Ace Credit Company is to lend funds to consumers. Ace must disclose all credit terms clearly and conspicuously in
 - a. no credit transaction.
 - b. any credit transaction in which payments are to be made in more than four installments.
 - c. any credit transaction in which payments are to be made in more than one installment.
 - d. all credit transactions.
- _____ 3. ABC Corporation sells a variety of consumer products. Generally, the labels on its products
 - a. must only be accurate.
 - b. must only use words as they are ordinarily understood by consumers.
 - c. must be accurate and use words as they are ordinarily understood by consumers.
 - d. need not conform to any of the above requirements.
- _____ 4. Rich Foods Company advertises that its cereal, "Fiber Rich," reduces cholesterol. After an investigation and a hearing, the FTC finds no evidence to support the claim. To correct the public's impression of Fiber Rich, which of the following would be most appropriate?
 - a. Counteradvertising.
 - b. Cease-and-desist order.
 - c. Civil fine.
 - d. Criminal fine.
- _____ 5. Hector's General Store advertises cans of Fancy brand whole tomatoes for fifty cents per can, although he does not have any in stock. When customers arrive to buy the tomatoes, Hector tells them that his stock of Fancy brand tomatoes has been sold and that he cannot obtain more at the lower price. Hector then informs

the customers that he has West Gold brand tomatoes in stock, for sixty cents per can. He claims that West Gold tomatoes are far superior to Fancy tomatoes. Hector's behavior is considered

- a. counter advertising.
- b. a cease-and-desist order.
- c. bait-and-switch advertising.
- d. a violation of Regulation Z.

- _____ 6. Francisco takes out a student loan from the First National Bank. After graduation, Francisco goes to work, but he does not make payments on the loan. The bank agrees with Ace Collection Agency that if Ace collects the debt, it can keep a percentage of the amount. To collect the debt, Ace can contact
- a. Francisco at his place of employment even if his employer objects.
 - b. Francisco at unusual or inconvenient times, or at any time if he retains an attorney.
 - c. third parties, including Francisco's parents, unless ordered otherwise by a court.
 - d. Francisco only to advise him of further action that Ace will take.
- _____ 7. National Foods, Inc., sells many kinds of breakfast cereals. Under the Fair Packaging and Labeling Act, National must include on the packages
- a. the identity of the product only.
 - b. the net quantity of the contents and number of servings only.
 - c. the identity of the product, the net quantity of the contents, and the number of servings.
 - d. none of the above.
- _____ 8. American Doll Company begins marketing a new doll with clothes and hair that are highly flammable, and accessories small enough to choke a little child. The Consumer Product Safety Commission can
- a. order that the doll be removed from store shelves.
 - b. warn consumers but cannot order that the doll be removed from stores.
 - c. ban the doll's manufacture but cannot order it removed from stores.
 - d. do nothing.

Answering More Legal Problems

1. LabTest Products, Inc., advertised that its weight-loss supplement, Drop-It, would cause users to lose weight quickly. The ad claimed that users could lose as much as fifteen pounds per week without dieting or exercising. In fact, to lose that much weight so fast, an individual would have to run fifty to seventy miles every day.

Was LabTest's ad for Drop-It deceptive? Yes. Deceptive advertising occurs if a reasonable consumer would be _____ by the advertising claim. _____—vague generalities and obvious exaggerations that a reasonable person would not believe to be literally true—are permissible. When a claim appears to be based on _____ evidence, but the claim cannot be scientifically supported, the claim is deceptive. Here, LabTest's ad cannot be supported by fact. It is false and _____.

2. Greta obtained an auto loan from Ridgeline Bank, but the bank did not give her a payment schedule and refused her attempts to make payments. In fact, Ridgeline told Greta that it had not given her a loan. When the bank discovered its mistake, it demanded full payment. When payment was not forthcoming, Ridgeline declared Greta in default, repossessed her car, and forwarded adverse credit information about her to credit reporting agencies without noting that she disputed the information.

Did Ridgeline violate the Fair Credit Reporting Act? Yes. The Fair Credit Reporting Act protects consumers against _____ credit reporting. Here, Ridgeline forwarded adverse credit information about Greta to credit reporting agencies without noting that she disputed the information.



Unit 4

Negotiable Instruments

Unit Contents

Chapter 22

The Essentials of Negotiability

Chapter 23

Negotiable Instruments: Transfer and Liability

Chapter 24

Banking

22

The Essentials of Negotiability

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Identify the basic types of negotiable instruments.
- 2 List the requirements of a negotiable instrument.
- 3 Distinguish between an order and a bearer instrument.
- 4 Describe a transfer by negotiation.

negotiable instrument

A signed writing that contains an unconditional promise or order to pay an exact amount.

Learning Outcome 1

Identify the basic types of negotiable instruments.

issue

The first transfer, or delivery, of a negotiable instrument to a holder.

draft

Any instrument that orders the drawee to pay a certain sum of money.

drawer

A person who initiates a draft.

drawee

A person who is ordered to pay a draft.

payee

A person to whom an instrument is made payable.

check

A signed written draft ordering the drawee to pay a fixed sum of money on demand.

Conflict Presented

Each fall, Bandon Brewing Equipment sells Dark Day Ale the supplies, including hops and malt, to brew five hundred barrels of beer. The price is \$50,000. The terms require payment in ninety days. One year, Bandon wants cash, but Dark Day wants the usual term of payment in ninety days.

Q What can Bandon and Dark Day do that will satisfy both of their wants?

Most commercial transactions would be inconceivable without negotiable instruments. A **negotiable instrument** is a signed writing that contains an unconditional promise or order to pay a specific person or entity an exact amount—either on demand or at a specific future time. Writings include electronic records.

A negotiable instrument can function as a substitute for cash or as an extension of credit. For instance, the checks that you receive are negotiable instruments that act as substitutes for cash. The promissory note that you may have signed to obtain an educational loan is a negotiable instrument that functions as an extension of credit.

The law governing negotiable instruments grew out of commercial necessity. Today, the Uniform Commercial Code (UCC) applies to transactions involving negotiable instruments, as well as to bank deposits and collections.

22-1 Types of Instruments

The UCC specifies four types of negotiable instruments: drafts, checks, promissory notes, and certificates of deposit (CDs). These are frequently divided into the two classifications: orders to pay (drafts and checks) and promises to pay (promissory notes and CDs).

Negotiable instruments may also be classified as demand instruments or time instruments. A demand instrument is payable when payment is requested. The instrument itself either states that it is payable on demand (or “at sight”) or does not state any time for payment. Thus, because a check specifies no time for payment, a check is payable on demand. A demand instrument is payable immediately after it is issued. **Issue** is the first delivery of an instrument by the party who creates it for the purpose of giving rights in the instrument to any person. A time instrument is payable at a future date.

22-1a Orders to Pay—Drafts and Checks

A **draft** is an unconditional written order that involves three parties. The party creating the draft (the **drawer**) orders another party (the **drawee**) to pay money, usually to a third party (the **payee**). The most commonly used type of draft is a **check**.

Time Drafts and Sight Drafts A time draft is payable at a definite future time. A sight (or demand) draft is payable on sight—that is, when it is presented for payment to the drawee (which is usually a bank or financial institution). A sight draft may be payable on acceptance. **Acceptance** is the drawee’s written promise to pay the draft when it comes due. One manner of accepting is by writing the word “accepted” across the face of the instrument, followed by the date of acceptance and the signature of the drawee.

acceptance

A drawee’s signed agreement to pay a draft when it comes due.

A draft can be both a time and a sight draft. Such a draft is payable at a stated time after it is presented for payment. **Example 22.1** A draft made out to Zenda states that it is payable sixty days after sight. ■

Exhibit 22.1 shows a typical time draft. For the drawee to be obligated to honor (pay) the order, the drawee must be obligated to the drawer either by agreement or through a debtor-creditor relationship. **Example 22.2** On January 16, OurTown Real Estate orders \$1,000 worth of office supplies from Eastman Supply Company, with payment due April 16. Also on January 16, OurTown sends Eastman a draft drawn on its account with the First National Bank of Whiteacre as payment. Here, the drawer is OurTown, the drawee is OurTown’s bank (First National Bank of Whiteacre), and the payee is Eastman Supply Company. First National Bank is obligated to honor the draft because of its account agreement with OurTown Real Estate. ■

Trade Acceptance A **trade acceptance** is a draft frequently used in the sale of goods. The seller is both the drawer and the payee on this draft. Essentially, this kind of draft orders the buyer to pay a specified sum of money to the seller, usually at a stated time in the future. Trade acceptances are the standard credit instruments in sales transactions.

trade acceptance

A draft drawn by a seller of goods ordering the buyer to pay a specified sum.

Example 22.3 Jackson Street Bistro buys its restaurant supplies from Osaka Industries. When Jackson requests supplies, Osaka creates a draft ordering Jackson to pay Osaka for the supplies within thirty days. Jackson accepts the draft by signing its face and is then obligated to make the payment. This is a trade acceptance and can be sold to a third party if Osaka needs cash before the payment is due. ■

Checks As with other drafts, the writer of the check is the drawer, the bank on which the check is drawn is the drawee, and the person to whom the check is payable is the payee. With certain types of checks, such as cashier’s checks, the bank is both the drawer and the drawee. The bank customer purchases a cashier’s check

Exhibit 22.1 A Typical Time Draft

The image shows a typical time draft form with the following fields and labels:

- Payee:** Whiteacre, Minnesota
- Date:** January 16, 2024
- Amount:** \$ 1,000.00
- Terms:** Ninety days after above date
- Pay to the order of:** Eastman Supply Company
- Value:** One thousand and no/100 DOLLARS
- Value received and charge the same to account of:** OurTown Real Estate
- To:** First National Bank of Whiteacre, Whiteacre, Minnesota
- By:** Jane Adams, Pres. (Signature of Jane Adams)

Labels with arrows pointing to the form:

- Payee:** Points to the payee field.
- Drawee:** Points to the bank field.
- Drawer:** Points to the signature field.

from the bank—that is, pays the bank the amount of the check—and indicates to whom the check should be made payable. The bank, not the customer, is the drawer of the check (as well as the drawee).

Conflict Resolved

In the Conflict Presented feature at the beginning of the chapter, Bandon Brewing Equipment sells \$50,000 of supplies to Dark Day Ale to brew five hundred barrels of beer. The companies do business regularly, and their contract terms normally require payment in ninety days. One year, Bandon wants to be paid in cash, but Dark Day wants the usual term of payment.

A What can Bandon and Dark Day do that will satisfy both of their wants? Bandon can draw a trade acceptance that orders Dark Day to pay \$50,000 to the order of Bandon ninety days from the date of the sale. Dark Day can accept by signing the draft and returning it to Bandon. The advantage of a trade acceptance to Bandon is that Dark Day's acceptance creates an enforceable promise to pay in ninety days. Bandon can sell a trade acceptance to another party more easily than it can assign a debt.

promissory note

A written promise signed by a maker to pay another party a certain amount on a specified date.

maker

One who issues a promissory note or certificate of deposit.

bearer

A person in possession of an instrument that does not specify a payee.

22-1b Promises to Pay—Promissory Notes

A **promissory note** is a written promise by one party to pay another party a specified sum. The party who promises to pay is the **maker** of the note. The party to whom the promise is made is the payee.

A promissory note, which is often referred to simply as a note, can be made payable at a definite time or on demand. It can name a specific payee or simply be payable to **bearer**. A bearer is a person in possession of an instrument that is payable to bearer, is not payable to an identified person, does not state a payee, or is indorsed (signed) in blank—that is, signed without additional words.

Example 22.4 On April 30, Laurence and Margaret Roberts, who are called co-makers, sign a writing unconditionally promising to pay “to the order of” the First National Bank of Whiteacre \$3,000 (with 6 percent interest) on or before June 29. This writing is a promissory note. ■ A typical promissory note is shown in Exhibit 22.2.

Exhibit 22.2 A Typical Promissory Note

Payee

\$ 3,000.00 Whiteacre, Minnesota April 30 20 24 Due 6/29/24
On or before sixty days after date.

for value received, the undersigned jointly and severally promise to pay to the order of THE FIRST NATIONAL BANK OF WHITEACRE at its office in Whiteacre, Minnesota, \$ Three thousand dollars with interest thereon from date hereof at the rate of 6 percent per annum (computed on the basis of actual days and a year of 360 days) indicated in No. 7 below.

☐ INTEREST IS PAYABLE AT MATURITY
☒ INTEREST IS PAID TO MATURITY
☒ INTEREST IS PAYABLE BEGINNING ON _____ 20 ____

SIGNATURE Laurence E. Roberts SIGNATURE Margaret P. Roberts

SIGNATURE _____ SIGNATURE _____

Co-makers

☐ SECURITIES ☐ INSURANCE ☐ SAVINGS
☐ OTHER ☐ SEC. AGREEMENT
1. INV. & ACCTS. 2. CONSUMER GOODS
3. EQUIP.

NO. _____
OFFICER **Clark**
BY _____
ACCRUAL
☐ NEW ☐ REN'L
☐ SECURED _____
☐ UNSECURED _____

Notes are used in a variety of credit transactions and often carry the name of the transaction involved. In real estate transactions, a promissory note for the unpaid balance on a house, secured by a mortgage on the property, is called a mortgage note. A note payable in installments, such as for payment for a stainless steel refrigerator over a twelve-month period, is called an installment note.

It is important to understand that a promissory note is not a debt—it is only the evidence of a debt.

Real Case



The Bricourts entered into an agreement with Wells Fargo Bank to finance the purchase of their home. In doing so, they signed a promissory note to repay Wells Fargo the amount borrowed. The couple failed to make their monthly payments, and Wells Fargo filed a foreclosure action against them. This action did not, however, include the original promissory note, which had been inadvertently lost or destroyed. Instead, Wells Fargo offered a copy of the original note. At trial, the Bricourts prevailed.

Should Wells Fargo be able to foreclose on the Bricourts' house? Yes. In *Wells Fargo Bank, N.A. v. Bricourt*, the district court of appeal of Florida ruled that, given Wells Fargo's good faith efforts to find the original, a copy was sufficient for foreclosure purposes. Even when a promissory note is unavailable, the owner/lender still retains rights and may prove the existence of a note through other evidence.

—290 S.3d 501 (Ct. App. Fla. 4th Dist.)

22–1c Promises to Pay—Certificates of Deposit

A **certificate of deposit (CD)** is a type of bank note. A CD is issued when a party deposits funds with a bank and the bank promises to repay, with interest, on a certain date. The bank is the maker of the note, and the depositor is the payee. **Example 22.5** On February 15, Sara Levin deposits \$5,000 with the First National Bank of Whiteacre. The bank issues a CD, in which it promises to repay the \$5,000, plus 2.25 percent annual interest, on August 15. ■

CDs are sold by savings and loan associations, credit unions, and commercial banks. Small CDs are for amounts up to \$100,000, and large (or jumbo) CDs for amounts more than \$100,000.

Exhibit 22.3 summarizes the types of negotiable instruments.

certificate of deposit (CD)

A bank note in which a bank acknowledges a receipt of money from a party and promises to repay it.

Exhibit 22.3 Basic Types of Negotiable Instruments

Instruments	Characteristics	Parties
Orders to pay:		
Draft	An order by one person to another person or to bearer.	Drawer—The person who signs or makes the order to pay.
Check	A draft drawn on a bank and payable on demand. (With certain types of checks, such as cashier's checks, the bank is both the drawer and the drawee.)	Drawee—The person to whom the order to pay is made.
		Payee—The person to whom payment is ordered.
Promises to pay:		
Promissory note	A promise by one party to pay funds to another party or to bearer.	Maker—The person who promises to pay.
Certificate of deposit	A note issued by a bank acknowledging a deposit of funds made payable to the holder of the note.	Payee—The person to whom the promise is made.

Learning Outcome 2

List the requirements of a negotiable instrument.

22–2 What Is a Negotiable Instrument?

For an instrument to be negotiable, it must (1) be in writing, (2) be signed by the maker or the drawer, (3) be an unconditional promise or order to pay, (4) state a fixed amount of money, (5) be payable on demand or at a definite time, and (6) be payable to order or to bearer, unless it is a check.

22–2a Written Form

Negotiable instruments must be in written form. The writing must be permanent, and it must be portable (movable).

Permanence The writing must be on material that lends itself to permanence. Instruments carved in blocks of ice or recorded on other impermanent surfaces would not qualify as negotiable instruments. **Example 22.6** Suzanne writes in the sand, “I promise to pay \$500 to the order of Julio.” This cannot be a negotiable instrument because, although it is in writing, it lacks permanence. ■

Portability The writing must have portability. If an instrument is not movable, it cannot meet the requirement that it be freely transferable. **Example 22.7** Charles writes on the side of a barn, “I promise to pay \$500 to the order of Dang.” Technically, this would meet the requirements of a negotiable instrument—except for portability. A barn cannot easily be transferred in the ordinary course of business. Thus, the “instrument” is nonnegotiable. ■

22–2b Signatures

For an instrument to be negotiable, it must be signed by (1) the maker, if it is a note or a certificate of deposit, or (2) the drawer, if it is a draft or a check. If a person signs an instrument as an authorized agent for the maker or drawer, the maker or drawer has effectively signed the instrument.

Extreme latitude is granted in determining what constitutes a **signature**.

Example 22.8 A signature may consist of a symbol (such as initials or a thumbprint) adopted by a party as their signature. A signature may be made manually or by means of a device (a rubber stamp) or a machine (such as those often used to write payroll checks). ■

The location of the signature on the document is unimportant. A handwritten statement in the body of the instrument, such as “I, Kamila Orlik, promise to pay Janelle Tan,” is sufficient to act as a signature.

22–2c Unconditional Promise or Order to Pay

The terms of the promise or order must be included in writing in a negotiable instrument. These terms must be unconditional—that is, not conditioned on the occurrence or nonoccurrence of some other event or agreement.

Promise or Order To be negotiable, an instrument must contain an express order or promise to pay. **Example 22.9** Francisco signs a promissory note that states, “I promise to pay \$500 to the order of Conrad [the seller] for the purchase of a new iMac.” Here, the requirement for a negotiable instrument is satisfied. ■

A mere acknowledgment of the debt, which might logically imply a promise, is not sufficient. **Example 22.10** The traditional I.O.U. (“I.O.U. \$10 [Signed] Bobby”) might logically imply a promise. It is not a negotiable instrument, however, because it does not contain an express promise to repay the debt. ■

Unconditionality of a Promise or Order Only unconditional promises or orders can be negotiable. Otherwise, no one could safely purchase a negotiable instrument without first investigating whether the condition was satisfied. This would restrict the instrument’s transferability.

signature

Any name, word, or mark used to authenticate a writing.

Certain conditions commonly used in business transactions do not make an otherwise negotiable instrument nonnegotiable, however. Many instruments state the terms of the underlying agreement as a matter of standard business practice. Such statements are not considered conditions and do not affect negotiability. Similarly, mere reference to another agreement does not affect negotiability. Also, terms in an instrument that provide for payment only out of a particular fund or source do not render the instrument conditional—it remains negotiable.

22–2d A Fixed Amount of Money

Negotiable instruments must state with certainty a fixed amount of money to be paid at the time the instrument is payable. In addition, to be negotiable, an instrument must be payable entirely in money.

Fixed Amount The term “fixed amount” means an amount that is ascertainable from the instrument. **Example 22.11** Mary signs a demand note payable to Rolfe with 5 percent interest. This meets the requirement of a fixed amount because its amount can be determined at the time it is payable. ■

The rate of interest may be determined with reference to information that is not contained in the instrument itself but is described by it, such as a formula or a source. For instance, an instrument that is payable at the legal rate of interest (a rate of interest fixed by statute) is negotiable. Mortgage notes tied to a variable rate of interest (a rate that fluctuates as a result of market conditions) are also negotiable.

Payable in Money Only instruments payable entirely in money are negotiable. The UCC defines money as “a medium of exchange authorized or adopted by a domestic or foreign government as a part of its currency.” For instance, a promissory note that provides for payment in diamonds or forty hours of services is not payable in money and thus is nonnegotiable. Similarly, an instrument payable in government bonds or in shares of Facebook stock is not negotiable, because neither is a government-recognized medium of exchange.

22–2e Payable on Demand or at a Definite Time

A negotiable instrument must be payable on demand or at a definite time. Otherwise, we could not determine the value of the instrument. Specifically, it is necessary to know the following:

- When the maker, drawee, or acceptor is required to pay.
- When the obligations of secondary parties will arise.
- When the instrument is due (in order to calculate when the statute of limitations may apply).

Payable on Demand Instruments that are payable on demand include those that contain the words “payable at sight” or “payable on presentment” and those that say nothing about when payment is due. **Presentment** occurs when a person brings the instrument to the appropriate party for payment or acceptance (most often, a bank or financial institution).

The nature of the instrument may indicate that it is payable on demand. A check, by definition, is payable on demand. If no time for payment is specified, and if the person responsible for payment must pay when the instrument is presented, then the instrument is payable on demand.

presentment
Presenting an instrument for acceptance or payment.

Payable at a Definite Time If an instrument is not payable on demand, to be negotiable it must be payable at a definite time. An instrument is payable at a definite time if it states that it is payable (1) on a specified date, (2) within a definite

period of time (such as thirty days) after being presented for payment, or (3) on a date or time readily ascertainable at the time of issue. The drawee in a time draft, for example, is under no obligation to pay until the specified time.

When an instrument is payable by the maker or drawer on or before a stated date, it is clearly payable at a definite time. The maker or drawer has the option of paying before the stated maturity date, but the holder can still rely on payment being made by the maturity date. The option to pay early does not violate the definite-time requirement. In contrast, an instrument that is undated and made payable “one month after date” is clearly nonnegotiable. There is no way to determine the maturity date from the face of the instrument.



Highlighting the Point

An instrument dated February 1, 2022, states, “One year after the death of my grandfather, James Ezersky, I promise to pay to the order of Henry Ling \$500. [Signed] Mary Ezersky.”

Is this instrument negotiable? No. Because the date of the grandfather’s death is uncertain, the maturity date is uncertain, even though his death is bound to occur eventually. Similarly, the instrument is not negotiable should the grandfather already have died, because it does not specify the time for payment.

acceleration clause

A clause that allows a payee or other holder of a time instrument to demand payment of the entire amount due, with interest, if a certain event occurs, such as a default in the payment of an installment when due.

Acceleration Clause An **acceleration clause** allows a payee or other holder of a time instrument to demand payment of the entire amount due, with interest, if a certain event occurs. Instruments that include acceleration clauses are negotiable because the exact value of the instrument can be ascertained. In addition, the instrument will be payable on a specified date if the event allowing acceleration does not occur. Thus, the specified date is the outside limit used to determine the value and negotiability of the instrument.

22–2f Payable to Order or to Bearer

Learning Outcome 3

Distinguish between an order and a bearer instrument.

To ensure a proper transfer, the instrument must be “payable to order or to bearer” at the time it is issued or first comes into the possession of the holder. Note, however, that a check that meets all other requirements for negotiability is a negotiable instrument even if the words “the order of” or “bearer” are missing.

order instrument

A negotiable instrument payable to the order of an identified person.

Order Instruments An instrument is an **order instrument** if it is payable to the order of an identified person (“Pay to the order of Sam Buke”) or to an identified person or order (“Pay to Ivan Hollins or order”). This allows that person to transfer the instrument to whomever they wish. Thus, the drawer is agreeing to pay either the person specified or whomever that person might designate. In this way, the instrument retains its transferability.

For the instrument to qualify as an order instrument the person specified must be identified with certainty, because that person must indorse the instrument to transfer it. **Example 22.12** Teresa signs an instrument that states, “Pay to the order of my favorite cousin.” The instrument is nonnegotiable, because a holder cannot be sure which cousin is intended to indorse and properly transfer the instrument. ■

Bearer Instruments A **bearer instrument** does not designate a specific payee. The maker or drawer of a bearer instrument agrees to pay anyone who presents the instrument for payment. An instrument containing any of the following terms is a bearer instrument:

- “Payable to the order of bearer.”
- “Payable to James Jarrot or bearer.”
- “Payable to bearer.”
- “Payable to X.”
- “Pay cash.”
- “Pay to the order of cash.”

bearer instrument

A negotiable instrument payable to the bearer.

22–3 Transfer of Instruments

Once issued, a negotiable instrument can be transferred by assignment or by negotiation.

22–3a Transfer by Assignment

An assignment is a transfer of rights under a contract. Under general contract principles, a transfer by assignment to an assignee gives the assignee only those rights that the assignor had. Any defenses that can be raised against an assignor normally can be raised against the assignee. When a transfer fails to qualify as a negotiation, it becomes an assignment. The transferee—the person to whom the instrument is transferred—is then an assignee.

22–3b Transfer by Negotiation

Negotiation is the transfer of an instrument in such form that the transferee becomes a holder. A **holder** is a person who, by the terms of a negotiable instrument, is legally entitled to payment on it. According to the UCC, a holder is a person in possession of a negotiable instrument that is either payable to that person, as identified by name, or payable to bearer.

A holder, at the very least, receives the rights of the previous possessor. Furthermore, unlike an assignment, a transfer by negotiation can make it possible for a holder to receive more rights in the instrument than the prior possessor had. (A holder who receives greater rights is known as a holder in due course.)

There are two methods of negotiating an instrument so that the receiver becomes a holder. The method used depends on whether the instrument is an order instrument or a bearer instrument.

negotiation

The transfer of a negotiable instrument to a holder.

holder

The person who is legally entitled to payment on an instrument.

Negotiating Order Instruments An order instrument contains the name of a payee capable of indorsing it, as in “Pay to the order of Elliot Goodseal.” An order instrument is negotiated by delivery with any necessary indorsements. An **indorsement** is a signature placed on an instrument for the purpose of transferring ownership in the instrument.

Learning Outcome 4

Describe a transfer by negotiation.

indorsement

A signature on an instrument transferring ownership rights in the instrument.

Highlighting the Point



Carrington Corporation issues a payroll check “to the order of Elliot Goodseal.” Goodseal takes the check to the supermarket, signs his name on the back (an indorsement), gives it to the cashier (a delivery), and receives cash.

(Continues)

Is the transfer of the check from Goodseal to the supermarket an assignment or a negotiation? A negotiation. Goodseal “delivered” the check to the supermarket with the necessary indorsement (his signature). If Goodseal had taken the check to the bank and delivered it to the teller without signing it, the transfer would not qualify as a negotiation. Instead, the transfer would be treated as an assignment, and the bank would become an assignee rather than a holder.

Negotiating Bearer Instruments If an instrument is payable to bearer, it is negotiated by delivery—that is, by transfer into another person’s possession. Indorsement is not necessary. The use of bearer instruments involves more risk from loss than does the use of order instruments.

22–3c Types of Indorsements

Indorsements are required whenever the instrument being negotiated is classified as an order instrument. An indorsement is most often written on the back of the instrument itself. A person who transfers an instrument by signing (indorsing) it and delivering it to another person is an indorser. The person to whom the instrument is indorsed and delivered is the indorsee. The following are four main categories of indorsements.



Highlighting the Point

Afam writes a check “Payable to cash” and hands it to Blaine (a delivery). Afam has issued the check to Blaine. Because no specific payee is named, the check is a bearer instrument. Blaine places the check in his wallet, which is subsequently stolen. The thief has possession of the check. At this point, negotiation has not occurred, because delivery must be voluntary on the part of the transferor.

If the thief “delivers” the check to an innocent third person, however, will negotiation be complete? Yes. Only delivery is necessary to negotiate a bearer instrument. If the thief delivers the check to an innocent third person, all rights to it pass to that third person. Blaine loses all rights to recover the proceeds of the check from that person. Of course, Blaine can recover his money from the thief if the thief is found.

Blank Indorsements A blank indorsement does not specify a particular indorsee and can consist of a mere signature. **Example 22.13** A check payable “to the order of Alan Luberta” is indorsed in blank if Luberta simply writes his signature on the back of the check. See Exhibit 22.4. ■ So, a blank indorsement converts an order instrument to a bearer instrument, which anybody can cash.

Other Indorsements Other types of indorsements include special, qualified, and restrictive indorsements.

- A special indorsement identifies the specific person to whom the indorser intends to make the instrument payable. Words such as “Pay to the order of Rick Clay,” followed by the signature of the indorser, create a special indorsement.

Exhibit 22.4 A Blank Indorsement

- A qualified endorsement disclaims any contractual liability on the indorsement. Thus, an indorser who does not want to be liable on an instrument can write “Pay to Evelyn Ling without recourse.”
- A restrictive indorsement requires the indorsee to comply with restrictions, such as “for collection only” or “for deposit” only.

As the use of paper checks has become less and less common, these types of indorsements have become less important for daily consumer and business transactions in the United States.

Chapter Summary—The Essentials of Negotiability

Learning Outcome 1: Identify the basic types of negotiable instruments.

The four types of negotiable instruments are drafts, checks, promissory notes, and certificates of deposit (CDs). These instruments can be classified as orders to pay (drafts and checks) or promises to pay (promissory notes and CDs). They can also be classified as demand instruments or time instruments.

Learning Outcome 2: List the requirements of a negotiable instrument.

For an instrument to be negotiable, it must (1) be in writing, (2) be signed by the maker or the drawer, (3) be an unconditional promise or order to pay, (4) state a fixed amount of money, (5) be payable on demand or at a definite time, and (6) be payable to order or to bearer, unless it is a check.

Learning Outcome 3: Distinguish between an order and a bearer instrument.

An order instrument is payable to the order of an identified person. A bearer instrument does not designate a specific payee.

Learning Outcome 4: Describe a transfer by negotiation.

In a transfer by negotiation, the transferee becomes a holder and can acquire more rights in the instrument than the previous possessor had. An order instrument is negotiated by indorsement and delivery. A bearer instrument is negotiated by delivery only.

Straight to the Point

1. Are only unconditional promises or orders negotiable? If yes, why? If no, why not? (See Learning Outcome 2.)
2. What indicates that an instrument is payable on demand? (See Learning Outcome 2.)
3. What is the difference between assignment and negotiation? (See Learning Outcome 4.)
4. When is an indorsement required? (See Learning Outcome 4.)
5. What is the effect of a blank indorsement? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Jim owes Sherry \$700. Sherry asks Jim to sign a negotiable instrument regarding the debt. Which of the following, if included on that instrument, would make it negotiable: “I.O.U. \$700,” “I promise to pay \$700,” or an instruction to Jim’s bank stating, “I wish you would pay \$700 to Sherry”? Explain why. (See Learning Outcome 2.)
2. Hector Caldwell gets his paycheck from his employer, indorses the back of the check by signing his name, and goes to cash it at his credit union. On the way, he loses the check. Paige finds the check. Has the check been negotiated to Paige? How might Hector have avoided any loss? (See Learning Outcome 4.)

Real Law

22-1. Acceleration Clause. Alkhemer Alialy executed a promissory note and mortgage to be paid in monthly installments over twenty-five years. The note contained an acceleration clause giving the holder the option to accelerate the debt after a default and to require immediate payment of the full amount owed. After Alialy stopped making payments, the note was transferred to Collins Asset Group, LLC (CAG). Eight years later, CAG accelerated the debt, demanding payment in full. Alialy did not pay. CAG filed suit in an Indiana state court to recover the note. The trial court dismissed the complaint on the grounds that the claim was barred by a six-year statute of limitations. When did the statute of limitations actually start to run? When the debtor stopped making payments or when the lender exercises its option to accelerate the debt? Should an appellate court reverse the trial court's ruling? [*Collins Asset Group, LLC v. Alialy*, 139 N.E.3d 712 (S.Ct. Indiana 2020)] (See Learning Outcome 2.)

22-2. Bearer Instruments. Eligio Gaitan borrowed the funds to buy real property at 4520 W. Washington St. in Downers Grove, Illinois, and signed a note payable to Encore Credit

Corp. Encore indorsed the note in blank. When Gaitan defaulted on the payments, an action to foreclose on the property was filed in an Illinois state court by U.S. Bank, N.A. The note was in the possession of the bank, but there was no evidence that the note had been transferred or negotiated to the bank. Can U.S. Bank enforce payment of the note? Why or why not? [*U.S. Bank National Association v. Gaitan*, 2013 WL 160378 (2013)] (See Learning Outcome 3.)

22-3. Indorsements. Angela Brock borrowed \$544,000 and signed a note payable to Amerifund Mortgage Services, LLC, to buy a house in Silver Spring, Maryland. The note was indorsed in blank and transferred several times “without recourse” before Brock fell behind on the payments. On behalf of Deutsche Bank National Trust Co., BAC Home Loans Servicing LP initiated foreclosure. Brock filed an action in a Maryland state court to block it, arguing that BAC could not foreclose because Deutsche Bank, not BAC, owned the note. Can BAC enforce the note? Explain. [*Deutsche Bank National Trust Co. v. Brock*, 430 Md. 714, 63 A.3d 40 (2013)] (See Learning Outcome 3.)

Ethical Questions

22-4. Requirements for Negotiability. Should the requirements for negotiability be strictly enforced? Explain your answer. (See Learning Outcome 1.)

22-5. Unconditional Promise or Order to Pay. Carlos Pardo signed a note to obtain \$627,500 to buy a house in Stamford, Connecticut. The note was secured by a mortgage. Later, Pardo signed a loan modification agreement that increased the balance due. The modification was not referenced in the note. Deutsche Bank National Trust Company

came to possess the note. When Pardo defaulted on the payments, Deutsche Bank filed a suit in a Connecticut state court against him to recover the unpaid balance. Pardo maintained that the bank could not enforce the note. He argued that the bank was not a holder because the note was not a negotiable instrument—the loan modification agreement rendered it conditional. Is Pardo correct? Was it ethical for him to make this argument? Discuss. [*Deutsche Bank National Trust Co. v. Pardo*, 170 Conn.App. 642 (2017)] (See Learning Outcome 1.)

Chapter 22—Work Set

True-False Questions

- _____ 1. A negotiable instrument can be transferred only by negotiation.
- _____ 2. A bearer instrument is payable to whoever possesses it.
- _____ 3. To be negotiable, an instrument must be in writing.
- _____ 4. To be negotiable, an instrument must expressly state when payment is due.
- _____ 5. An instrument that does not designate a specific payee is an order instrument.
- _____ 6. Indorsements are required to negotiate order instruments.
- _____ 7. An order instrument is payable to whoever properly possesses it.
- _____ 8. Indorsements are required to negotiate bearer instruments.
- _____ 9. To be negotiable, an instrument must include an unconditional promise to pay.
- _____ 10. The person who signs or makes an order to pay is the drawer.

Multiple-Choice Questions

- _____ 1. Jasmine writes out a check payable to the order of Sakura. Sakura receives the check but wants to negotiate it further to her friend Max. Sakura can negotiate the check further by
 - a. indorsing it.
 - b. delivering it to the transferee.
 - c. doing both a and b.
 - d. none of the above methods.
- _____ 2. Kurt receives from Lee a check that is made out “Pay to the order of Kurt.” Kurt turns it over and writes on the back, “Pay to Adam. [Signed] Kurt.” Kurt’s indorsement is a
 - a. blank indorsement.
 - b. special indorsement.
 - c. restrictive indorsement.
 - d. qualified indorsement.
- _____ 3. Ray is the owner of Espresso Express. Dan’s Office Supplies sells Ray supplies for Espresso Express. To pay, Ray signs a check “Espresso Express” in the lower left-hand corner. The check is
 - a. not negotiable because “Espresso Express” is a trade name.
 - b. not negotiable because Ray signed the check in the wrong location.
 - c. negotiable, and Ray is bound.
 - d. negotiable, but Ray is not bound.
- _____ 4. Mukisa makes out a check “Pay to the order of Adroa.” Adroa indorses the check on the back by signing his name. Before Adroa signed his name, the check was
 - a. bearer paper.
 - b. order paper.
 - c. both a and b.
 - d. none of the above.

- _____ 5. Jules owes money to Vern. Vern owes money to Chris. Vern signs an instrument that orders Jules to pay to Chris the money that Jules owes to Vern. This instrument is a
- note.
 - check.
 - certificate of deposit.
 - draft.
- _____ 6. Don's checks are printed "Pay to the order of" followed by a blank space. On one of the checks, Don writes in the blank space "Mac or bearer." The check is
- a bearer instrument.
 - an order instrument.
 - both a and b.
 - none of the above.
- _____ 7. Lisa writes out a check payable to the order of Jeff. Negotiation occurs when Jeff receives the check. Jeff subsequently negotiates the check by
- indorsing it only.
 - delivering it only.
 - indorsing and delivering it.
 - none of the above methods.
- _____ 8. Ann receives an instrument that reads, "May 1, 2018. Sixty days after date, I promise to pay to the order of bearer \$1,000 with interest at an annual rate of 5 percent. Due on June 30, 2018. [Signed] Bob Smith." This instrument is
- a draft and negotiable.
 - a draft and nonnegotiable.
 - a promissory note and negotiable.
 - a promissory note and nonnegotiable.

Answering More Legal Problems

1. Marit worked for Town & Garden, a landscape design service owned by Donald. Marit signed a note payable to Donald to purchase an ownership interest in Town & Garden. The note, which was undated, required installment payments, but Donald never asked for them. One year later, Marit quit Town & Garden. Donald tried to terminate Marit's interest in the business, asserting that the note had not been paid.

Was Marit's note a demand note? Yes. Instruments that are payable on demand may state "payable on demand," or the nature of an instrument may indicate that it is payable on demand. In addition, if no time for _____ is specified, then the instrument is payable on demand. Here, the note required installments but did not state a date for their _____.

Was the nonpayment of the note a proper reason for the termination of Marit's interest in Town & Garden? No. Donald did not demand _____ on the note. Thus, Marit's obligation to make it had not arisen, and

the attempted termination of her interest in Town & Garden was improper.

2. Bryce borrowed funds from Rock Canyon Bank for his education and signed a note for the amount payable to the bank. The bank indorsed the note and transferred it by delivery to the U.S. Department of Education. When Bryce did not pay the note, the government asked a court for an order to garnish his wages. Bryce argued that he had not signed any document promising to pay the government and thus its claim was invalid.

Was the government entitled to enforce the note? Yes. Negotiation is the transfer of an instrument in such form that the transferee becomes a holder—a person who, by the terms of the instrument, is entitled to enforce it. If the instrument is an order instrument, it is negotiated by delivery with any necessary indorsements. In the facts of this problem, the bank _____ the note with the necessary _____ by _____ to the government.

23

Negotiable Instruments: Transfer and Liability

Conflict Presented

Marcia Morrison issues a \$500 note payable to Reinhold Smith in payment for a Microsoft Surface Pro tablet. Smith negotiates the note to Judy Larson, who promises to pay Smith for it in thirty days. Larson soon learns that Smith has breached the contract by delivering a defective device and that Morrison will not honor the \$500 note. Smith has left town.

Q Can Larson hold Morrison liable on the note?

A holder is a person who, by the terms of a negotiable instrument, is legally entitled to enforce payment of it. When a negotiable instrument is transferred, an ordinary holder obtains only those rights that the transferor had in the instrument. In the event that there is a conflicting, superior claim to or defense against the instrument, an ordinary holder will not be able to collect payment.

In contrast, a **holder in due course (HDC)** is a holder who, by meeting certain acquisition requirements, takes a negotiable instrument free of most defenses and all claims to it. Stated another way, an HDC normally can acquire a higher level of immunity than can an ordinary holder in regard to defenses against payment of the instrument and claims to ownership of the instrument by other parties.

23-1 Requirements for HDC Status

First, an HDC must be a holder of a negotiable instrument. In addition, they must have taken the instrument under the following conditions:

1. For value.
2. In good faith.
3. Without notice that it is defective.

23-1a Taking for Value

For holders to become HDCs, they first must have given value for the instrument. A holder takes an instrument for value if the holder has done any of the following:

1. Performed the promise for which the instrument was issued or transferred.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 List the requirements for holder-in-due-course status.
- 2 Describe signature liability.
- 3 Identify transfer warranties.
- 4 Understand the defenses against the payment of negotiable instruments.

holder in due course (HDC)

A holder who takes a negotiable instrument free of most defenses and all claims.

Learning Outcome 1

List the requirements for holder-in-due-course status.

2. Acquired a security interest or other lien in the instrument (other than a lien obtained by a judicial proceeding).
3. Taken the instrument in payment of, or as security for, a preexisting debt. **Example 23.1** Ivan owes Marta \$2,000 on a past-due account. Ivan negotiates a \$2,000 note signed by Gordon to Marta, and she accepts it to discharge Ivan's overdue account balance. Marta has given value for the instrument. ■
4. Given a negotiable instrument as payment for the instrument.
5. Given, as payment, a commitment that cannot be revoked.

A person who receives an instrument as a gift or who inherits it has not met the requirement of value. In these situations, the person becomes an ordinary holder and does not possess the rights of an HDC.

Note that the concept of value in the law of negotiable instruments is not the same as the concept of consideration in the law of contracts. A promise to give value in the future is valid consideration for a contract. It is not normally enough, however, to make a holder an HDC.

Instead, a holder exchanging a promise for an instrument takes the instrument for value only to the extent that the promise has been performed. If the holder plans to pay for the instrument later, for instance, the holder has not yet given value and is not yet an HDC.

23–1b Taking in Good Faith

The second requirement for HDC status is that the holder take the instrument in good faith. That is, the holder must have acted honestly in acquiring the instrument. Good faith is honesty in fact and the observance of reasonable commercial standards of fair dealing. The good faith requirement applies only to the holder. It is immaterial whether the transferor acted in good faith.



Highlighting the Point

Cassie works as a bookkeeper for Jonah, who owns Arctic Arcade, Inc. One day, Jonah discovers that Cassie is stealing company funds, and he fires her. Jonah demands repayment. Cassie then goes to work for her father's firm, Metro Fixtures, where she has some authority to write checks. Without authorization, Cassie writes Jonah a check on Metro's account to repay him. She tells Jonah her father is loaning her the money. Taking the check in good faith, Jonah deposits it in Arctic's account. When Metro uncovers Cassie's theft, it files a suit against Jonah to recover the funds.

Is Jonah liable to Metro for the loss? No. Jonah has HDC status and is not liable to Metro. To be an HDC, a holder must take the instrument in good faith. Jonah had no reason to know that Cassie lied about the check. Cassie is the wrongdoer. Therefore, Metro bears the loss, not Jonah.

Because of the good faith requirement, the purchaser must honestly believe that the instrument is not defective. **Example 23.2** If Hawa purchases a \$10,000 note for \$200 from a stranger on a street corner, the issue of good faith can be raised on the grounds of the suspicious circumstances. ■

23–1c Taking Without Notice

The final requirement for HDC status involves lack of notice that the instrument is defective. A person will not be afforded HDC protection when acquiring an instrument knowing, or having reason to know, that it is defective in any one of the following ways:

1. It is overdue.
2. It has been dishonored.
3. There is an uncured (uncorrected) default with respect to another instrument issued as part of the same series.
4. The instrument contains an unauthorized signature or has been altered.
5. There is a defense against the instrument or a claim to it.
6. The instrument is so irregular or incomplete as to call into question its authenticity.

What Constitutes Notice? A holder will be deemed to have notice if there is (1) actual knowledge of the defect, (2) receipt of a notice about a defect, or (3) reason to know that a defect exists, given all the facts and circumstances known at the time in question.

The holder must also have received the notice at a time and in a manner that gives the holder a reasonable opportunity to act on it. A purchaser's knowledge of certain facts, such as bankruptcy proceedings against the instrument's maker or drawer, does not constitute notice that the instrument is defective.

Overdue Instruments Any negotiable instrument is either payable at a definite time (time instrument) or payable on demand (demand instrument). What constitutes notice that an instrument is overdue will vary depending on whether it is a time or a demand instrument.

Anyone who takes a time instrument the day after its expressed due date is on notice that it is overdue. **Example 23.3** Eduardo signs a promissory note due on May 15. Duarte purchases it on May 16. Duarte has notice that the note is overdue. He is an ordinary holder, not an HDC. ■ If an instrument reads, "Payable in thirty days," counting begins on the day after the instrument is dated. Thus, a note dated December 1 that is payable in thirty days is due by midnight on December 31. If the payment date falls on a Sunday or holiday, the instrument is payable on the next business day.

Sometimes, a debt is to be paid in installments or through a series of notes. In this situation, the maker's default on any installment of principal (not interest) or on any one note of the series will constitute notice to the purchaser that the instrument is overdue.

Purchasers have notice that a demand instrument is overdue if they take the instrument knowing that payment was demanded the day before. Purchasers also have notice if they take a demand instrument that has been outstanding for an unreasonable period of time after its date. A reasonable time for a check is ninety days or less. A reasonable time for other demand instruments depends on the circumstances.

Dishonored Instruments An instrument is **dishonored** when it is presented in a timely manner for payment or acceptance (whichever is required), and payment or acceptance is refused. If a holder knows or has reason to know that an instrument has been dishonored, the holder is on notice and cannot claim HDC status. **Example 23.4** Travis takes a check clearly stamped "insufficient funds." Travis is on notice that the bank has dishonored the check. He cannot become an HDC. ■

dishonor

To refuse to pay or accept a negotiable instrument.

23–2 Signature Liability

Learning Outcome 2

Describe signature liability.

The key to liability on a negotiable instrument is a signature. Every party who signs a negotiable instrument is either primarily or secondarily liable for payment of that instrument when it comes due. Persons are not liable on an instrument unless they have signed it personally or through an agent (who is an authorized representative). For instance, corporate officers and the officers of limited liability companies (LLCs) often act as agents on behalf of their employers. The corporate officers are not personally liable on instruments signed on their firms' behalf unless they guarantee payment.



Real Case

Red Rhino Market Group, LLC, owed Envision Printing, LLC, a certain amount for services rendered. A Red Rhino employee told Envision that Bernie Evans, Red Rhino's chief executive officer, was authorized to sign a note on the company's behalf for the amount owed. Envision sent a note with the instruction to "have Bernie sign it." He did, in a signature box titled "Red Rhino Market Group, LLC." When the note was not paid, Envision filed a suit in a Georgia state court against Evans, alleging default. Evans contended that he was not personally liable because he had signed the note in his capacity as a Red Rhino officer. The court issued a judgment in the defendant's favor. Envision appealed.

Was Evans personally liable on the note? No. In *Envision Printing, LLC v. Evans*, a state intermediate appellate court affirmed the judgment of the lower court. Envision had notice that Evans was not intended to be personally liable on the note. The court stated, "The represented person (Red Rhino Market Group, LLC) is clearly identified in the instrument."

—336 Ga.App. 635

The following sections discuss the types of liability that apply to negotiable instruments and the conditions that must be met before liability can arise.

23–2a Primary Liability

A person who is primarily liable on a negotiable instrument is absolutely required to pay the instrument, subject to certain defenses. The liability is immediate when the instrument is signed or issued and effective when the instrument becomes due.

acceptor

A drawee who accepts an instrument when it is presented.

Only makers and **acceptors** are primarily liable. The maker of a promissory note, for instance, unconditionally promises to pay the note when it becomes due. An acceptor—such as a drawer bank that stamps "Accepted" on the face of the check and signs it—agrees to pay the instrument when it is presented later for payment.

Even when a promissory note is incomplete at the time the maker signs it, the maker is still obligated to pay. The maker must pay according to the note's terms at the time of signing, or according to its terms when it is completed as authorized.

Example 23.5 Tristan executes a preprinted promissory note to Sharon, without filling in the blank for a due date. If Sharon does not complete the form by adding the date, the note will be payable on demand. If Sharon fills in a due date that Tristan authorized, the note is payable on the stated due date. In either situation, Tristan (the maker) is obligated to pay the note. ■

23–2b Secondary Liability

Drawers and indorsers have secondary liability. That is, a drawer or indorser is liable only if the party who is primarily liable for paying the instrument refuses to do so.

In the case of notes, an indorser's secondary liability does not arise until the maker, who is primarily liable, has defaulted on the instrument. With regard to drafts (and checks), a drawer's secondary liability does not arise until the drawee fails to pay or to accept the instrument, whichever is required.

Example 23.6 Liza writes a check on her account at Universal Bank payable to the order of Valerie. If Universal Bank does not pay the check when Valerie presents it for payment, then Liza is liable to Valerie. ■

Parties who are secondarily liable on a negotiable instrument promise to pay on that instrument only if the following events occur:

1. The instrument is properly and timely presented.
2. The instrument is dishonored.
3. Timely notice of dishonor is given to the secondarily liable party.

Proper and Timely Presentment Presentment occurs when a holder brings an instrument to the appropriate party for payment or acceptance. Presentment must be made to the proper person, in a proper manner, and in a timely fashion.

The party to whom the instrument must be presented depends on what type of instrument is involved. A note or certificate of deposit must be presented to the maker for payment. A draft is presented by the holder to the drawee for acceptance, payment, or both, whichever is required. A check is presented to the drawee (bank) for payment.

Presentment can be properly made in any of the following ways, depending on the type of instrument involved:

1. By any commercially reasonable means, including oral, written, or electronic communication. (Presentment is not effective until the demand for payment or acceptance is received.)
2. Through a clearinghouse procedure used by banks, such as for deposited checks.
3. At the place specified in the instrument for acceptance or payment.

One of the most crucial criteria for proper presentment is timeliness. The time for proper presentment for different types of instruments is shown in Exhibit 23.1.

Dishonor and Proper Notice As mentioned, an instrument is dishonored when the required acceptance or payment is refused. Once this has occurred, notice must be given to hold secondary parties liable. **Example 23.7** Oman writes a check on his account at State Bank payable to Leah. Leah indorses the check in blank and cashes it at Midwest Grocery, which transfers it to State Bank for payment. If State Bank refuses to pay it, Midwest must timely notify Leah to hold her liable. ■

Exhibit 23.1 Time for Proper Presentment

Type of Instrument	For Acceptance	For Payment
Time	On or before due date.	On due date.
Demand	Within a reasonable time (after date or issue or after secondary party becomes liable on the instrument).	Within a reasonable time.
Check	Not applicable.	Within thirty days of date to hold drawer secondarily liable. Within thirty days of indorsement to hold indorser secondarily liable.

Notice may be given in any reasonable manner. This includes oral, written, or electronic notice, or notice written or stamped on the instrument itself. Any necessary notice must be given by a bank before its midnight deadline (midnight of the next banking day after receipt). Notice by any party other than a bank must be given within thirty days following the day on which the person receives notice of dishonor.

23–2c Unauthorized Signatures

Unauthorized signatures arise in two situations (1) when a person forges another person's name on a negotiable instrument and (2) when an agent who lacks the authority signs an instrument on behalf of a principal. The general rule is that an unauthorized signature is defective and will not bind the person whose name is signed or forged.

There are two exceptions to this rule:

1. When the person whose name is signed ratifies (affirms) the signature, that person will be bound.
2. When the negligence of the person whose name was forged substantially contributed to the forgery, a court may not allow the person to deny the effectiveness of an unauthorized signature. **Example 23.8** Vicente writes and signs a check, leaves blank the amount and the name of the payee, and then leaves the check in a place available to the public. Joan finds the check, fills it in, and cashes it. Vicente, on the basis of his negligence, can be prevented from denying liability for payment of the check. ■ If a drawer can demonstrate that the bank was negligent in paying the check, the bank may have to bear a portion of the loss as well.

A person who forges a check or signs an instrument without authorization can be held personally liable for payment by an HDC. This is true even if the name of the person signing the instrument without authorization does not appear on the instrument.



Highlighting the Point

Michel Vuillard finds a blank check belonging to Paul Richman. Without Paul's authorization, Michel makes the check payable to his landlord, Donna Shinn, and signs "Paul Richman" on the signature line of the check. He then gives the check to Donna stating that his best friend, Paul, is paying his overdue rent for him. Donna takes the check in good faith and for value.

Is Michel personally liable to Donna? Yes. Michel is personally liable to Donna just as if he had signed his own name on the check. Donna is an HDC because she took the check in good faith and for value. (If, however, Donna knows that Paul's signature is unauthorized, she cannot recover from Michel on the check.)

23–2d Special Rules for Unauthorized Indorsements

Generally, when an indorsement is forged or unauthorized, the burden of loss falls on the first party to take the instrument with the unauthorized indorsement. This is because the first party to take an instrument is in the best position to prevent the loss.

There are two exceptions to this rule—when an indorsement is made by an imposter or by a fictitious payee.

The Imposter Rule An **imposter** induces a maker or drawer to issue an instrument in the name of an impersonated payee. If the maker or drawer believes the imposter to be the named payee, the imposter's indorsement is not treated as unauthorized. This is because the maker or drawer intended the imposter to receive the instrument.

Example 23.9 Carol impersonates Donna and induces Edward to write a check payable to the order of Donna. Carol, continuing to impersonate Donna, negotiates the check to First National Bank as payment on her loan there. As the drawer of the check, Edward is liable for its amount to First National Bank. ■

If a bank fails to exercise ordinary care in cashing a check made out to an imposter and this failure substantially contributes to the drawer's loss, the drawer may have a valid claim against the bank.

imposter

A person who, with the intent to deceive, pretends to be somebody else.

The Fictitious Payee Rule The **fictitious payee** rule concerns the intent of a maker or drawer to issue an instrument to a payee who has no interest in the instrument. This most often takes place in two situations:

1. A dishonest employee deceives the employer into signing an instrument payable to a party with no right to receive the instrument.
2. A dishonest employee or agent has the authority to issue an instrument on behalf of the employer. This employee or agent issues a check to a person who has no interest in the instrument.

fictitious payee

A payee on a negotiable instrument who is not intended to have an interest in the instrument.

In these situations, the payee's indorsement is not treated as a forgery, and the employer can be held liable on the instrument by an innocent holder.

23-3 Warranty Liability

In addition to signature liability, transferors make certain implied warranties regarding the instruments that they are negotiating. Warranties fall into two categories: those that arise from the transfer of a negotiable instrument and those that arise on presentment.

23-3a Transfer Warranties

A person who transfers an instrument for consideration makes the following five **transfer warranties**:

1. The transferor is entitled to enforce the instrument.
2. All signatures are authentic and authorized.
3. The instrument has not been materially altered.
4. The instrument is not subject to a defense or claim of any party that can be asserted against the transferor.
5. The transferor has no knowledge of any bankruptcy proceedings against the maker, the acceptor, or the drawer.

These warranties can be disclaimed with respect to any instrument except checks.

The manner of transfer and the type of negotiation used determine how far and to whom a transfer warranty will extend. Transfer by indorsement and delivery of order instruments extends warranty liability to any subsequent holder who takes the instrument in good faith. The warranties of a person who transfers without indorsement (by delivery of bearer paper) extend only to the immediate transferee.

Learning Outcome 3

Identify transfer warranties.

transfer warranty

A guaranty made by a person who transfers a negotiable instrument for consideration to subsequent transferees and holders who take the instrument in good faith.



Highlighting the Point

Tino forges Kim's name as a maker of a promissory note. The note is made payable to Tino. Tino indorses the note in blank, negotiates it to Bret, and then leaves the country. Bret, without indorsement, delivers the note to Fern. Fern, in turn without indorsement, delivers the note to Rick. On Rick's presentment of the note to Kim, the forgery is discovered.

Can Rick hold Fern (the immediate transferor) liable for breach of warranty that all signatures are genuine? Yes. The note is a bearer instrument. Rick cannot hold Bret liable, however, because Bret is not Rick's immediate transferor and did not indorse the note.

23–3b Presentment Warranties

A person who obtains payment or acceptance of an instrument makes the following warranties to anyone who in good faith pays or accepts the instrument:

1. The person obtaining payment or acceptance is entitled to enforce the draft or is authorized to do so on behalf of a person who is entitled to enforce the draft. (This is, in effect, a warranty that there are no missing or unauthorized indorsements.)
2. The draft has not been altered.
3. The person obtaining payment or acceptance has no knowledge that the signature of the drawer of the draft is unauthorized.

presentment warranty

A warranty made by any person who presents an instrument.

These warranties are called **presentment warranties**, because they protect the person to whom the instrument is presented. Like transfer warranties, they cannot be disclaimed with respect to checks. A claim for breach must be given to the warrantor within thirty days after the claimant knows, or has reason to know, of the breach and the identity of the warrantor.

The second and third presentment warranties do not apply to makers, acceptors, and drawers. It is assumed that a drawer or a maker will recognize their own signature and that an acceptor will recognize whether an instrument has been materially altered.

23–4 Defenses

Learning Outcome 4

Understand the defenses against the payment of negotiable instruments.

Defenses can bar collection from persons who would otherwise be primarily or secondarily liable on an instrument. There are two general categories of defenses—universal defenses and personal defenses.

23–4a Universal Defenses

universal defense

A defense effective against all holders of a negotiable instrument.

Universal defenses (also called real defenses) are valid against all holders, including holders in due course (HDCs). Several universal defenses are discussed next.

1. Forgery of a signature on the instrument. A forged signature cannot bind the person whose name is used unless that person validates the signature or is barred from denying it.
2. Fraud in the execution. If persons are deceived into signing a negotiable instrument, believing that they are signing something else, fraud in the execution is committed against the signer.

3. **Material alteration.** An alteration is material if it changes the contract terms between any two parties in any way. Any unauthorized addition of words or numbers, for instance, is a material alteration.
4. **Discharge in bankruptcy.** Bankruptcy is a defense on any instrument regardless of the status of the holder.
5. **Illegality, mental incapacity, or extreme duress.** Universal defenses apply to void instruments. If a law says that any instrument issued in connection with certain illegal conduct is void, then such an instrument is void. Similarly, an instrument is void if it was issued by a person judged by a court to be mentally incompetent. Lastly, the same is true when a person under an immediate threat of force or violence (for example, at gunpoint) issues an instrument.

23–4b Personal Defenses

Personal defenses are used to avoid payment only to ordinary holders. Some personal defenses include the following:

1. **Breach of contract or breach of warranty.** When there is a breach of warranty or a breach of the contract for which the instrument was issued, the maker of a note can refuse to pay it, or the drawer of a check can stop payment.
2. **Fraud in the inducement (ordinary fraud).** A person who issues a negotiable instrument based on false statements by the other party can avoid payment.
3. **Lack or failure of consideration.** The absence of consideration can be a successful defense in some instances. **Example 23.10** Tony gives Cleo, as a gift, a note that states, “I promise to pay you \$100,000.” Cleo accepts the note. No consideration is given in return for Tony’s promise. Thus, a court will not enforce the promise. ■
4. **Illegality, mental incapacity, or ordinary duress.** When instruments are voidable, then personal defenses apply. A law may, for instance, make an instrument resulting from illegal activity voidable rather than void. An instrument issued by a person who is mentally incompetent but has not been adjudged so by a court is voidable. So is an instrument issued by a person under ordinary duress (which does not involve force or violence).

personal defense

A defense effective only against ordinary holders.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Marcia Morrison gives a \$500 note to Reinhold Smith to pay for a Microsoft Surface Pro tablet. Smith delivers defective goods, and Morrison refuses to pay the note. In the meantime, Smith has negotiated the note to Judy Larson, who promised to pay Smith for it in thirty days. Larson learns of Smith’s breach and Morrison’s refusal to pay the \$500 note. Smith has left town.

A Can Larson hold Morrison liable on the note? That depends on whether Larson is a holder in due course (HDC). Because Larson had not yet given value at the time she learned of Morrison’s defense to payment of the note (breach of contract), Larson is an ordinary holder, not an HDC. Thus, Morrison’s defense is valid against Larson. If Larson had paid Smith for the note at the time of transfer, she would be an HDC and could hold Morrison liable on the note.

23–4c Federal Limitations on the Rights of HDCs—FTC Rule 433

The federal government limits the rights of HDCs in certain circumstances because of the harsh effects that the HDC rules can sometimes have on consumers. Under the HDC doctrine, a consumer who purchased a defective product (such as a defective automobile) would continue to be liable to HDCs even if the consumer returned the defective product to the retailer.

To protect consumers who purchase defective products, the Federal Trade Commission (FTC) adopted Rule 433, which effectively abolished the HDC doctrine for consumer transactions. Under the rule, any negotiable instrument created as a result of a consumer purchase must have the following 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.

Thus, consumers who are parties to consumer credit transactions can bring any defense they have against the seller of a product against a subsequent holder of a promissory note as well. In essence, the FTC Rule 433 places an HDC of the negotiable instrument in the position of a contract assignee. The rule makes the buyer's duty to pay conditional on the seller's full performance of the contract. The rule clearly reduces the degree of transferability of negotiable instruments resulting from consumer credit contracts.

23–5 Discharge

Discharge from liability on an instrument can occur in several ways. They include payment, cancellation, or surrender. The liability of all parties is discharged when the party primarily liable on an instrument pays to a holder the full amount due. Payment by any other party discharges only the liability of that party and later parties.

In addition, the holder of an instrument can discharge any party to the instrument by cancellation. **Example 23.11** Glenda, a loan officer for Consumer Loan Center, writes the word “Paid” across the face of an instrument. This constitutes cancellation. ■

Destruction or mutilation of a negotiable instrument is considered cancellation only if it is done with the intention of eliminating an obligation on the instrument. Thus, if destruction occurs by accident, the instrument is not discharged, and the original terms can be established.

The holder of a note may also discharge the obligation by surrendering the note to the person to be discharged. Here again, though, the holder must have intended to eliminate the obligation.

Chapter Summary—Negotiable Instruments: Transfer and Liability

Learning Outcome 1: List the requirements for holder-in-due-course status.

To be a holder in due course, a holder must take an instrument (1) for value, (2) in good faith, and (3) without notice that it is defective.

Learning Outcome 2: Describe signature liability.

Every party who signs a negotiable instrument is either primarily or secondarily liable for payment of the instrument when it comes due. Primary liability requires payment on a negotiable instrument according to its terms. Secondary liability requires payment on an instrument only if presentment is proper and timely, the instrument is dishonored, and a timely notice of dishonor is received.

Learning Outcome 3: Identify transfer warranties.

There are five transfer warranties: (1) The transferor is entitled to enforce the instrument, (2) all signatures are authentic and authorized, (3) the instrument has not been altered, (4) the instrument is not subject to a defense or claim of any party that can be asserted against the transferor, and (5) the transferor has no knowledge of any bankruptcy proceedings against the maker, the acceptor, or the drawer of the instrument.

Learning Outcome 4: Understand the defenses against the payment of negotiable instruments.

Universal defenses are valid against all holders and HDCs. These include forgery, fraud in the execution, material alteration, discharge in bankruptcy, and situations involving instruments that are void because of illegality, mental incapacity, or extreme duress. Personal defenses are valid against ordinary holders but not HDCs. These include breach of contract or warranty, fraud in the inducement, lack or failure of consideration, and situations involving instruments that are voidable because of illegality, mental incapacity, or ordinary duress.

Straight to the Point

1. What does it mean to take an instrument in good faith? (See Learning Outcome 1.)
2. In what circumstances will a holder be considered to have notice that an instrument is defective? (See Learning Outcome 1.)
3. What is the key to liability on a negotiable instrument? (See Learning Outcome 2.)
4. What are two situations in which unauthorized signatures arise? (See Learning Outcome 2.)
5. When an indorsement is forged or unauthorized, who bears the burden of loss? (See Learning Outcome 2.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Adam issues a \$500 note to Bill due six months from the date issued. One month later, Bill negotiates the note to Carol for \$250 in cash and a check for \$250. To what extent is Carol a holder in due course of the note? (See Learning Outcome 1.)
2. Roy signs corporate checks for Standard Corporation. Roy makes a check payable to U-All Company, to whom Standard owes no money. Roy signs the check, forges U-All's indorsement, and cashes the check at First State Bank, the drawee. Does Standard have any recourse against the bank for the payment? Explain your answer. (See Learning Outcome 2.)

Real Law

23–1. FTC Rule 433. Miguel Vilarinho purchased a used Maserati from Palmetto Sports Cars, Inc., for \$66,895. He made an \$18,000 down payment and financed the rest with World Financing Group, LLC. Vilarinho claimed years later

that when he brought the car to a Maserati dealership for servicing, he was told for the first time that the car had been previously purchased back by the manufacturer as a “lemon.” Vilarinho sued both Palmetto Sports Cars and

World Financing for fraud and negligent misrepresentation. World Financing asserted a counterclaim against Vilarinho for breach of contract. Vilarinho claimed that World Financing was subject to all claims and defenses that Vilarinho had against the seller because of FTC Rule 433. Did World Financing have holder in due course status? [*Vilarinho v. Palmetto Sports Cars, Inc.*, 2020 WL 3772012 (U.S. Dist. Ct., S. Dist. Fla. 2020)] (See Learning Outcome 4.)

23–2. Signature Liability. Guillermo and Guadalupe Albarran and their sons, Ruben and Rolando, owned R. Cleaning Impact, Inc. (RCI). Neresh Kumar owned Amba II, Inc., a check-cashing business. The Albarrans cashed checks through Amba on a regular basis, often delivering a stack of employee paychecks to Amba for cashing. Later, the Albarrans' bank refused payment on some of the checks. Kumar learned that the items were payable to fictitious payees with fictitious addresses or for amounts greater than real employees' pay. Among these

parties, who is liable for the loss on the unpaid checks? Explain. [*Albarran v. Amba II, Inc.*, 2016 WL 688924 (2016)] (See Learning Outcome 2.)

23–3. Holder in Due Course. New Houston Gold Exchange, Inc. (HGE), issued a \$3,500 check to Shelly McKee to buy a purportedly genuine Rolex watch. The check was post-dated—that is, assigned a date later than the actual one. McKee indorsed the check and presented it to RR Maloan Investments, Inc., a check-cashing service. Without verifying that the check was valid, RR Maloan cashed it. Meanwhile, HGE issued a stop-payment order on the check based on information that the watch was counterfeit. When RR Maloan presented the check to HGE's bank for payment, the bank refused to honor (cash) it. Is RR Maloan entitled to payment as a holder in due course? Why or why not? [*RR Maloan Investments, Inc. v. New HGE, Inc.*, 428 S.W.3d 355 (Tex.App.—Houston 2014)] (See Learning Outcome 1.)

Ethical Questions

23–4. Fictitious Payees. Should a bank that acts in “bad faith” be barred from raising the fictitious payee rule as a defense? Explain your answer. (See Learning Outcome 2.)

23–5. Taking in Good Faith. JAMS Technologies, Inc., owed \$77,000 to Easy Luck Company in Miami, Florida. To pay the debt, JAMS presented a check drawn on the account of Lanco Manufacturing Corporation in Banco Bilbao Vizcaya Argentaria (BBVA). Easy Luck deposited the check in its account at SunTrust Bank, and BBVA paid the amount. The

next day, Lanco notified its bank, BBVA, that the check to Easy Luck was a forgery. Thus, BBVA credited Lanco's account the \$77,000 and filed a suit in a Florida state court against Easy Luck to recover the amount. Until Easy Luck was served with BBVA's complaint, it had not known that the check was forged. Is Easy Luck legally required to refund the \$77,000 to BBVA? Should Easy Luck repay the funds on ethical grounds? Discuss. [*Banco Bilbao Vizcaya Argentaria v. Easy Luck Co.*, 208 So.3d 1241 (Fla. 2017)] (See Learning Outcome 1.)

Chapter 23—Work Set

True-False Questions

- _____ 1. Every person who possesses an instrument is a holder.
- _____ 2. A holder who takes an instrument for value, in good faith, and without notice is a holder in due course (HDC).
- _____ 3. Personal defenses can be raised to avoid payment to an HDC.
- _____ 4. For HDC status, good faith means an honest belief that an instrument is not defective.
- _____ 5. Knowing that an instrument has been dishonored puts a holder on notice, and the holder cannot become an HDC.
- _____ 6. Generally, no one is liable on an instrument unless their signature appears on it.
- _____ 7. Drawers are secondarily liable.
- _____ 8. An unauthorized signature usually binds the person whose name is forged.

Multiple-Choice Questions

- _____ 1. Don signs a note that states, “Payable in thirty days.” The note is dated March 2, which means it is due April 1. Jo buys the note on April 12. She is
 - a. an HDC to the extent that she paid for the note.
 - b. an HDC to the extent that the note is not yet paid.
 - c. not an HDC.
 - d. none of the above.
- _____ 2. Jack’s sister Paula steals one of Jack’s checks, makes it payable to herself, signs Jack’s name, and cashes it at First National Bank. Jack tells the bank that he will pay it. If Jack later changes his mind, he will
 - a. be liable on the check.
 - b. be liable only to the extent of the amount in his checking account.
 - c. not be liable on the check.
 - d. be none of the above.
- _____ 3. Anna, who cannot read English, signs a promissory note after Ted, her attorney, tells her that it is a credit application. Anna has
 - a. a defense of fraud maintainable against a holder or an HDC.
 - b. a defense of fraud maintainable against a holder only.
 - c. a defense against payment on the note under the imposter rule.
 - d. no defense against payment on the note.
- _____ 4. Kasuma contracts with Amy to fix her roof. Amy writes Kasuma a check, but Kasuma never makes the repairs. Kasuma negotiates the check to Carl, who knows Kasuma breached the contract, but Carl cashes the check anyway. Carl cannot attain HDC status in regard to
 - a. any defense Amy might have against payment.
 - b. any personal defense Amy might have against payment.
 - c. only Kasuma’s breach, which is Amy’s personal defense against payment.
 - d. none of the above.

- _____ 5. Great Bread Company issues a draft for \$1,000 on July 1, payable to the order of Baker Supplies Corporation. The draft is drawn on First National Bank. Before the bank accepts the draft, who has primary liability for payment?
- Great Bread Company.
 - Baker Supplies Corporation.
 - First National Bank.
 - No one.
- _____ 6. Bill issues a check for \$4,000, dated June 1, to Enzo. The check is drawn on Liberty Home Bank. Enzo indorses the check and transfers it to Jane. Which of the following will trigger the liability of Bill and Enzo on the check, based on their signatures?
- Presentment only.
 - Dishonor only.
 - Both presentment and dishonor.
 - Neither presentment nor dishonor.
- _____ 7. Jake's Plumbing issues a draft for \$500 on May 1, payable to the order of Business Credit Corporation. The draft is drawn on First State Bank. If the bank does not accept the draft, who is liable for payment?
- Jake's Plumbing.
 - Business Credit Corporation.
 - First State Bank.
 - No one.
- _____ 8. Administrative Services Corporation authorizes Vic to use company checks to buy office supplies. Vic writes a check to Wholesale Supplies, Inc., for \$100 over the actual price of a purchase, for which the seller returns cash. When Wholesale presents the check for payment, it may recover
- nothing.
 - the amount stated in the check.
 - the amount of the overpayment only.
 - the price of the supplies only.

Answering More Legal Problems

1. Skye asked Jim to buy a textbook for her at the County Community College campus bookstore. Skye wrote a check payable to the bookstore and left the amount blank for Jim to fill in the price of the book. The cost of the book was \$100. Jim filled in the check for \$200 before he got to the bookstore. The clerk at the bookstore took the check for \$200 and gave Jim the book, plus \$100 in cash.
2. Eva bought a GMC Sierra 1500 pickup. To finance the purchase, she signed a note and an agreement to pay the note with Ranch & Farm Credit Union. After she had made half of the sixty payments on the loan, she received the agreement and the note with "Paid" stamped on the face of each document. The documents had been returned due to a clerical error in Ranch & Farm's office. The lender had not intended to discharge the note. Eva stopped making payments. Ranch & Farm filed a suit to collect.

Was the bookstore a holder in due course (HDC) of Skye's check? Yes. One of the requirements for HDC status is a lack of _____ that an instrument is defective. A party will not attain this status if they know, or have reason to know, that an incomplete instrument was later completed in an unauthorized manner. _____ of a defective instrument is given when a holder has reason to know that a defect exists, given all of the facts known at the time. Here, the bookstore did not have _____ that Skye's check was incomplete when it was issued. The bookstore saw only a properly completed instrument.

Was Ranch & Farm entitled to the unpaid amount of the note? Yes. The holder of a note can discharge the obligation by surrendering the note to the person to be discharged if the holder _____ to eliminate the obligation. In this problem, Ranch & Farm delivered the agreement and the note stamped "Paid" to Eva. But the lender did not _____ to discharge the obligation. The documents were returned due to a clerical error. The surrender thus did not constitute a valid discharge of the note.



24 | Banking

Conflict Presented

O'Banion was the owner and operator of Superior Construction. When Superior ran into financial problems, O'Banion arranged with Merchants Bank to honor overdrafts on the corporate account. O'Banion continued to write checks. When the account became overdrawn, however, the bank refused to pay the checks. O'Banion developed a bad credit reputation, and Superior eventually went out of business.

Q Can O'Banion hold the bank liable for failing to pay the checks?

Many people today use debit cards rather than checks for their retail transactions, and payments are increasingly being made via smartphones, tablets, and other mobile devices. Nonetheless, commercial checks remain an integral part of the U.S. economic system. In fact, checks—which serve as a substitute for cash—are the most common type of negotiable instrument regulated by the Uniform Commercial Code (UCC). The UCC also governs the relationships of banks with their customers and with one another as they process checks for payment.

24–1 Checks and the Bank–Customer Relationship

In this section, we look first at some basic characteristics of checks. We then outline the special relationship between banks and their checking-account customers. Note that under the UCC, a bank is “a person engaged in the business of banking,” such as a credit union or a commercial bank.

24–1a Checks

A check is a special type of draft that is drawn on a bank, ordering the bank to pay a fixed amount of money on demand. Recall that a person who writes a check is the drawer. The drawer is usually a depositor in the bank on which the check is drawn. The person to whom the check is payable is the payee. The bank on which the check is drawn is the drawee. **Example 24.1** When Anita writes a check from her checking account to pay her college tuition, she is the drawer, her bank is the drawee, and her college is the payee. ■

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 List the types of relationships between banks and customers.
- 2 Discuss liability for forged drawers' signatures.
- 3 Outline a bank's duty to accept deposits.
- 4 Define an electronic fund transfer.
- 5 Describe the role of artificial intelligence (AI) in digital lending.

Between when a check is written and the time it reaches the drawee, the effectiveness of the check may change in some way. For instance, the account on which the check is drawn may no longer have enough funds to pay the check. To avoid such problems, a payee may insist on receiving a cashier's check or a certified check.

Cashier's Check When a bank draws a check on itself, the check is called a cashier's check. It is a negotiable instrument at the moment it is issued. In effect, with a cashier's check, the bank assumes the responsibility for paying the check, making it more readily acceptable as a substitute for cash. Banks may be requested to verify the validity of a cashier's check to protect themselves and their customers against fraud.



Real Case

The victim of an elaborate scam, Roy Elizondo unwittingly deposited a counterfeit cashier's check for nearly \$500,000 into his Cadence Bank account. The drawee for the cashier's check was Chase Bank. At Elizondo's request, Cadence then completed a wire transfer of \$400,000 from his account to the holder of a Japanese bank account. Soon thereafter, Chase dishonored the counterfeit cashier's check. Cadence sued Elizondo to recover the \$400,000 overdraft. Elizondo countersued, arguing that Cadence Bank had caused the overdraft by failing to verify that the funds from the counterfeit cashier's check had actually been deposited into his account.

Should Elizondo's bank have verified the validity of the cashier's check? Yes. In *Cadence Bank v. Elizondo*, a Texas court of appeals ruled that Cadence's breach of its wire transfer agreement caused the \$400,000 overdraft. Elizondo was therefore not liable for the amount of the overdraft.

—606 S.W.3d 802 (Ct. App. TX-1st Dist.)

Certified Check A certified check is a check that has been accepted in writing by the bank on which it is drawn. When a drawee (bank) certifies (accepts) a check, it immediately charges the drawer's (customer's) account with the amount of the check and transfers those funds to its own certified checking account. In other words, certification is a promise that enough funds have been set aside to cover the check when it is presented for payment.

24–1b The Bank–Customer Relationship

Learning Outcome 1

List the types of relationships between banks and customers.

The bank–customer relationship begins when the customer opens a checking account and deposits funds that the bank will use to pay checks written by the customer. The customer becomes the signatory, or authorized party, on the account. That is, the customer is the only person from whom the bank should take instructions regarding the account. Essentially, three types of relationships are established at this time between the bank and the customer:

1. A creditor–debtor relationship is created when, for instance, a customer makes cash deposits into a checking account. When a customer makes a deposit, the customer becomes a creditor, and the bank a debtor, for the amount deposited.
2. An agency relationship arises between the customer and the bank when the customer writes a check. In an agency relationship, one party (an agent) agrees to represent or act for the other party (a principal). In effect,

the customer orders the bank to pay the amount on the check. The bank becomes the customer's (principal's) agent and is obligated to honor the customer's request.

3. Finally, certain contractual rights and duties arise. The contractual rights and duties of the bank and the customer depend on the nature of the transaction. For instance, a bank has specific contractual duties when honoring checks, accepting deposits, and transferring funds.

24-2 Honoring Checks

In general, a bank and its customers have a duty to act in good faith with one another. When a bank provides checking services, for instance, it agrees to honor the checks written by its customers. Of course, there must also be sufficient funds available in the account to pay each check. The customer's agreement with the bank includes a general obligation to keep sufficient funds on deposit to cover all checks written.

If a check is not honored, the customer is liable to the payee or to the holder in a civil suit. If intent to defraud can be proved, the customer can also be subject to criminal prosecution for writing a bad check.

24-2a Check Dishonor

If a customer's checking account does not have enough funds to cover a check, the bank may dishonor the check. In other words, the bank may return the check to the payee, informing them that the drawer's account has insufficient funds. When a bank properly dishonors a check for insufficient funds, it has no liability to the customer. When a drawee-bank wrongfully dishonors a check, however, it is liable to the customer for any resulting damages.

Example 24.2 Suha owns his own electronics store and has a business checking account at Wilson Bank. He writes a \$5,000 check to Auto Palace Wholesalers for a shipment of new car sound systems. When Auto Palace properly presents the check at Wilson Bank, the bank fails to honor the check. The bank claims that Suha's account does not have sufficient funds, but this claim is based on a banking error. As a result, Auto Palace charges Suha a \$75 fee for a returned check and demands the shipment's return. Wilson Bank is liable to Suha for the \$75 fee and any other damages he suffers from its wrongful dishonoring of the check. ■

24-2b Overdrafts

In addition to dishonoring a check, a bank has another option when a customer's checking account has insufficient funds. The bank can opt to pay the check, creating an **overdraft**, and then charge the customer's checking account an overdraft fee. (Overdraft fees average around \$30 per check, depending on the bank.) To be liable for an overdraft, the customer must have preauthorized the payment of the overdrafts, and the payment must not have violated the bank-customer agreement, which includes contractual rights and duties.

overdraft

An extension of credit from a bank to a customer with insufficient funds.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, when Superior Construction ran into financial difficulties, Merchants Bank agreed to honor Superior's overdrafts. O'Banion, Superior's owner and operator, continued to write checks. When the account became overdrawn, the bank refused to pay the

(Continues)

checks. O'Banion developed a bad credit reputation, and Superior eventually went out of business.

A Can O'Banion hold the bank liable for failing to pay the checks? Yes. When a bank agrees with a customer to pay overdrafts and then does not, the bank has wrongfully failed to honor the customer's check. O'Banion can recover damages from the bank.

In addition, with a joint checking account, the bank normally cannot hold any joint-account owner liable for overdraft payments unless that customer signed the check or benefited from its proceeds. **Example 24.3** Aaron and Sarah are married and have a joint bank account. Aaron writes a check to pay the electric bill for their apartment. If the check results in an overdraft, both Aaron and Sarah will be liable. They both obviously benefit from having electricity in their apartment. ■

24–2c Stale Checks

stale check

A check that is presented for payment more than six months after its date.

A bank is not obliged to honor a stale check. A **stale check** is one presented for payment more than six months after its date. A bank has the option of paying or not paying on such a check without liability. The usual commercial banking practice is to consult the customer, who can then ask the bank not to pay the check. If a bank pays in good faith without consulting the customer, it has the right to charge the customer's account for the check's amount.

24–2d Death or Incompetence of a Customer

Neither the death nor the mental incompetence of a customer revokes the bank's authority to pay an item until the bank knows of the situation and has had reasonable time to act on the notice. Without this provision, banks would constantly be required to verify the continued life and competence of their customers.

Even when a bank knows of a customer's death, it can pay or certify checks drawn on that customer's account for ten days after the date of death. If, however, an heir or executor of the customer's estate orders the bank to stop payment, it must comply immediately.

24–2e Stop-Payment Orders

stop-payment order

A customer's order telling a bank not to pay a certain check.

A **stop-payment order** is an order by a customer to the bank not to pay or certify a certain check. Only a customer or a person authorized to draw on the account can order the bank not to pay the check when it is presented for payment.

Requirements The customer must issue the stop-payment order within a reasonable time and in a reasonable manner to permit the bank to act on it. Although a stop-payment order can be given orally, usually by phone, it is binding on the bank for only fourteen calendar days unless confirmed in writing. A written stop-payment order is effective for six months, at which time it must be renewed. Most banks also allow stop-payment orders to be submitted electronically via the bank's website.

Liability for Wrongful Payment If a bank pays a check in spite of a stop-payment order, the bank will be obligated to recredit the customer's account. If the bank's payment of a stop-payment order causes subsequent overdrafts, the bank is liable for the drawer's costs.

24–2f Checks With Forged Drawers' Signatures

The bank is responsible for determining whether the signature on a customer's (drawer's) check is genuine. The general rule is that the bank must recredit the customer's account when it pays on a forged signature. A bank, however, may be able to recover some of the loss from a customer whose negligence contributed to the forgery, from the check's forger, or from the holder who cashes the check.

Learning Outcome 2

Discuss liability for forged drawers' signatures.

Customer Negligence When the customer's negligence substantially contributes to the forgery, the bank normally is not obliged to recredit the customer's account for the amount of the check. To avoid liability for negligence, a customer must examine monthly bank statements and canceled checks promptly and with reasonable care and report any forged signatures promptly. This review also includes making sure there are no unauthorized items—such as unfamiliar purchases or suspicious withdrawals—on the account's statement. The failure to examine statements and report forged drawer signatures—or any carelessness by the customer that results in a loss to the bank—makes the customer liable for the loss.

Discovery of forgeries and notice to the bank must take place within one year from the date that the statement was made available for inspection. Otherwise, the customer loses the right to have the bank recredit their account.

Sometimes, the same wrongdoer forges a customer's signature on a series of checks. To recover for all the forged, unauthorized items, the customer must discover and report the first forged check to the bank within thirty calendar days of the receipt of the bank statement. Failure to notify the bank within this period of time discharges the bank's liability for all similar forged checks and unauthorized items that it pays before notification.

Bank Negligence If the customer can prove that the bank was also negligent, then the bank will also be liable for the loss. In this situation, even though a customer may have been negligent, if the bank also failed to exercise reasonable care, then it will have to recredit the customer's account for a portion of the loss.

24–2g Checks Bearing Forged Indorsements

A bank that pays a customer's check bearing a forged indorsement must recredit the customer's account or be liable to the customer for breach of contract.

Highlighting the Point



Simon writes a \$500 check "to the order of Rosario." That night, Charlie breaks into Rosario's car and steals the check. Charlie takes the check to a local check-cashing service store, where he forges Rosario's indorsement and cashes the check. When the check reaches Simon's bank—Front Street Bank—it pays the check and debits Simon's account for \$500. The following week, Rosario tells Simon the check was stolen, and Simon realizes the check had a forged indorsement when Front Street Bank cashed it.

Must Front Street Bank recredit \$500 to Simon's account? Yes. The bank must recredit the \$500 to Simon's account because it failed to carry out Simon's order to pay "to the order of Rosario." In turn, Front Street Bank can recover the \$500 from the check-cashing service where Charlie first presented and cashed the check.

Eventually, the loss usually falls on the first party to take the instrument bearing the forged indorsement, because a forged indorsement does not transfer title. Thus, no one who takes an instrument with a forged indorsement can become a holder.

The customer, in any event, has a duty to report forged indorsements promptly. Failure to report forged indorsements within a three-year period after the forged items have been made available to the customer relieves the bank of liability.

24–3 Accepting Deposits

Learning Outcome 3

Outline a bank's duty to accept deposits.

Another fundamental service a bank provides is that of accepting deposits of cash and checks. Most deposited checks involve parties who do business at different banks, but sometimes checks are written between customers of the same bank. Either situation brings into play the bank collection process.

24–3a The Traditional Collection Process

The bank collection process is the process by which a bank that accepts a check for deposit collects the amount from the issuing bank. The first bank to receive a check for payment is the **depository bank**. For instance, when a person deposits a check into a personal checking account at the local bank, that bank is the depository bank. The bank on which a check is drawn (the drawee bank) is the **payor bank**. Any bank (except the payor bank) that handles a check during the collection process is a **collecting bank**. Any bank (except the payor bank or the depository bank) to which an item is transferred in the course of collection is an **intermediary bank**.

Example 24.4 A buyer in New York writes a check on her New York bank and sends it to a seller in San Francisco. The seller deposits the check in her San Francisco bank account. The seller's bank is both a depository bank and a collecting bank. The buyer's bank in New York is the payor bank. As the check travels from San Francisco to New York, any collecting bank handling it (other than the depository bank and the payor bank) is also an intermediary bank. ■

Exhibit 24.1 illustrates how banks function in the collection process.

depository bank

The first bank to receive a check for payment.

payor bank

The bank on which a check is drawn.

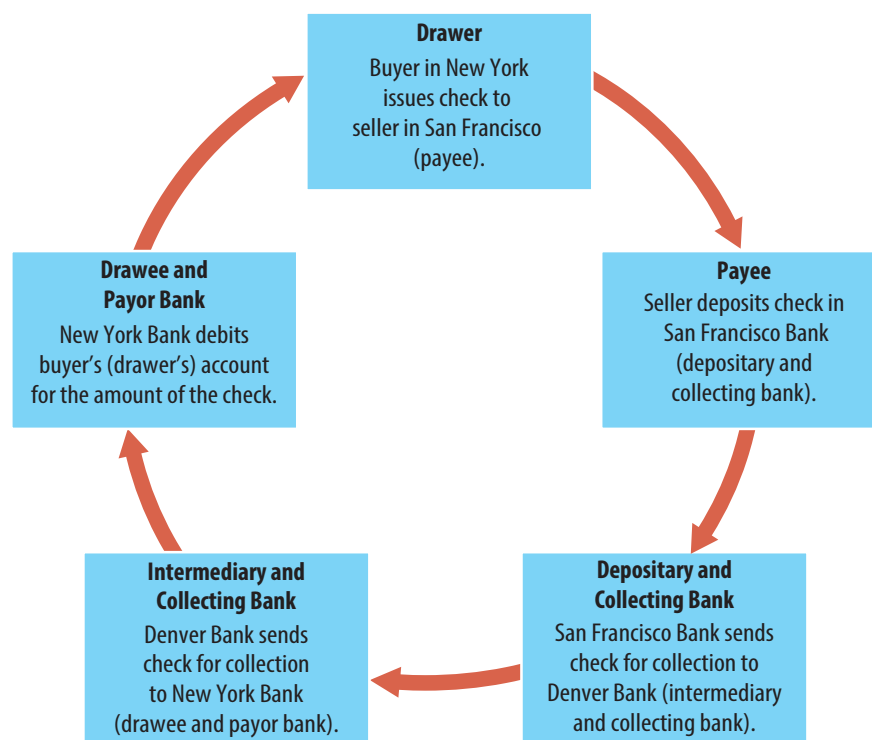
collecting bank

Any bank handling an item for collection, except the payor bank.

intermediary bank

Any collecting bank, except the depository or payor bank.

Exhibit 24.1 The Check Collection Process



Check Collection Between Customers of the Same Bank An item that is payable by the same bank that receives it is an “on-us” item. In this situation, the bank is both the depository bank and the payor bank. Usually, a bank issues a provisional (temporary) credit for an “on-us” item within the same day. If the bank does not dishonor the check by the opening of the second banking day following its receipt, the check is considered paid.

Highlighting the Point



Both Otterley and Merkowitz have checking accounts at First State Bank. On Monday morning, Merkowitz deposits a \$300 check from Otterley into his checking account. That same day, the bank issues Merkowitz a provisional (temporary) credit for \$300.

When is Otterley's check considered honored, and when is Merkowitz's provisional credit considered final? When the bank opens on Wednesday, Otterley's check is considered honored, and Merkowitz's provisional credit becomes a final payment.

Check Collection Between Customers of Different Banks Each bank in the collection chain must pass the check on before midnight of the next banking day following its receipt. For instance, a collecting bank that receives a check on Monday must forward it to the next collection bank before midnight Tuesday.

Unless the payor bank dishonors the check or returns it by midnight on the next banking day following receipt, the payor bank is accountable for the amount. Deferred posting is permitted, so checks received after a certain time can be deferred for posting until the next day. (A check is posted when it is entered on the bank's records.)

The Role of the Federal Reserve System The **Federal Reserve System** is a network of twelve district banks located around the country and headed by the Federal Reserve Board of Governors. Most banks in the United States have Federal Reserve accounts. The Federal Reserve System acts as a clearinghouse—a place where banks exchange checks drawn on each other and settle daily balances.

Example 24.5 Pamela Moy of Philadelphia writes a check to Jeanne Sutton in San Francisco. When Jeanne receives the check in the mail, she deposits it in her bank. Her bank then deposits the check in the Federal Reserve Bank of San Francisco, which transfers it to the Federal Reserve Bank of Philadelphia. That Federal Reserve bank then sends the check to Moy's bank, which deducts the amount of the check from Moy's account. Exhibit 24.2 illustrates this process. ■

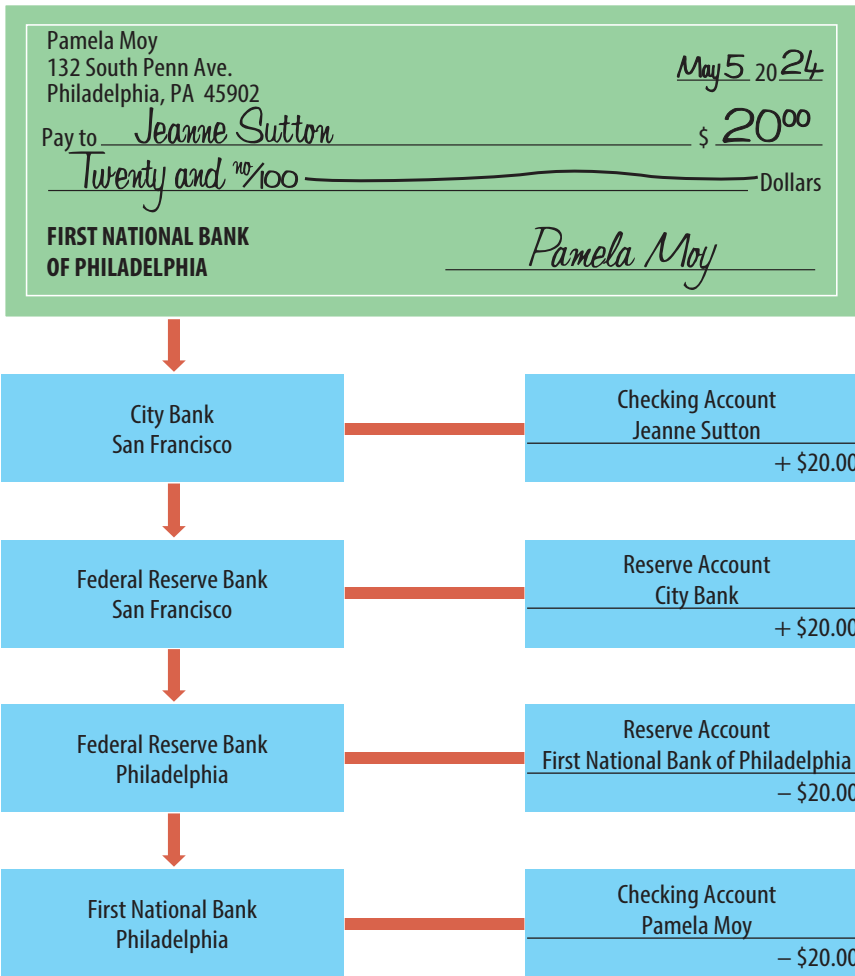
Federal Reserve System

The central banking system of the United States.

Electronic Presentment Most checks are processed electronically. With electronic check presentment, items are encoded with information (such as the amount of the check) that is read and processed by banks' computers. In some situations, a check may be retained at its place of deposit and only its image or description presented for payment.

A bank that encodes information on an item after the item has been issued warrants to any subsequent bank or payor that the encoded information is correct. Similarly, a bank that retains an item and presents an image or description of the item for payment warrants that the image or description is accurate.

Exhibit 24.2 How a Check Is Cleared



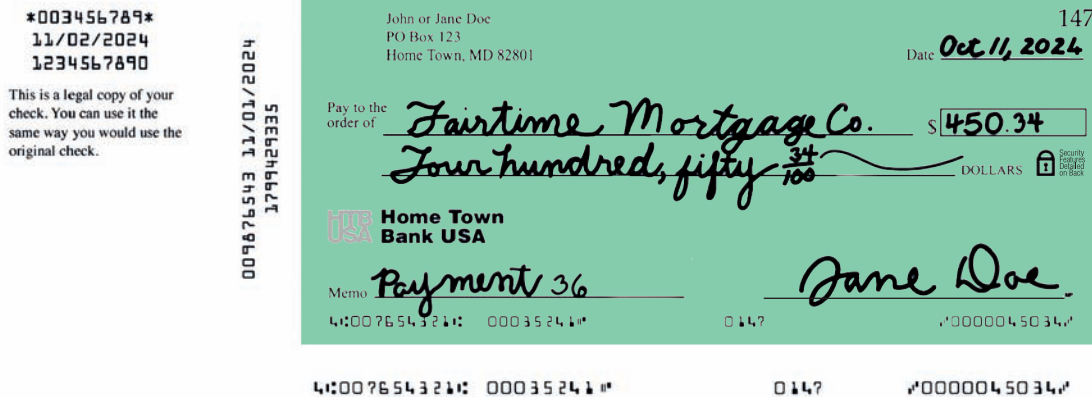
24–3b The Check 21 Act

To streamline the costly and time-consuming traditional method of check collection, Congress enacted the Check Clearing in the 21st Century Act (Check 21). Check 21 changed the collection process by creating a new negotiable instrument called a substitute check.

substitute check
A negotiable instrument that is a paper reproduction of an original check.

A **substitute check** is a paper reproduction of the front and back of an original check that contains all of the information required for electronic processing. A bank creates a substitute check from a digital image of an original check. Every substitute check must include the following statement: “This is a legal copy of your check. You can use it in the same way you would use the original check.” (See Exhibit 24.3 for an example of a substitute check.)

Basically, financial institutions that exchange digital images of checks do not have to send the original paper checks. They can simply transmit the information electronically and replace the original checks with the substitute checks. Banks that do not exchange checks electronically are required to accept substitute checks in the same way that they accept original checks.

Exhibit 24.3 An Example of a Substitute Check

24-4 Electronic Fund Transfers

An **electronic fund transfer (EFT)** is a transfer of funds through the use of an electronic terminal, a phone, a computer, or magnetic tape. Transferring funds electronically offers numerous benefits, but it also poses difficulties on occasion. For instance, it has increased the possibilities for tampering with private banking information.

Learning Outcome 4

Define an electronic fund transfer.

electronic fund transfer (EFT)

A transfer of funds through the use of an electronic terminal, a phone, a computer, or magnetic tape.

24-4a Types of EFT Systems

The most common types of EFT systems include the following:

1. Automated teller machines (ATMs)—With an ATM or debit card and a personal identification number, a customer can access accounts and conduct banking transactions.
2. Point-of-sale systems—Online terminals allow consumers to transfer funds to merchants to pay for purchases using a debit card.
3. Direct deposits and withdrawals—Customers can authorize the bank to allow another party—such as the government or an employer—to make direct deposits into their accounts. Similarly, customers can request the bank to make automatic payments to a third party at regular, recurrent intervals from the customers' funds.
4. Online payment systems—Many financial institutions permit their customers to access the institution's computer system via the internet and direct a transfer of funds between accounts or pay a particular bill.

24-4b Consumer Fund Transfers

The Electronic Fund Transfer Act (EFTA) provides a basic framework for the rights, liabilities, and responsibilities of users of EFT systems. The EFTA governs financial institutions that offer electronic fund transfers involving consumer accounts. The EFTA is essentially a disclosure law benefiting consumers. The act requires financial institutions to inform consumers of their rights and responsibilities with respect to EFT systems. For instance, a bank must provide a monthly statement for every month in which there is an electronic transfer of funds.

An important provision of the act relates to lost or stolen cards. If a customer's debit card is lost or stolen and used without their permission, the customer is required to pay no more than \$50. The customer, however, must notify the bank of the loss or theft within two days of learning about it. Otherwise, the liability increases to \$500. The customer may be liable for more than \$500 if they do not report the unauthorized use within sixty days after it appears on the customer's statement.

The EFTA also clearly defines what constitutes an unauthorized transfer. Under the act, a transfer is unauthorized if the following conditions are met:

1. It is initiated by a person (other than the consumer) who has no actual authority to initiate the transfer.
2. The consumer receives no benefit from it.
3. The consumer did not furnish the person "with the card, code, or other means of access" to the account.

24–5 Banking in the Digital Age

One of the most significant trends in banking today is the emergence of fintech. This is a combination of the words financial and technology. Fintech is an umbrella term used to describe financial services that rely on technological (the internet, computers, smartphones) rather than on the physical (bank branches, cash, paper checks) interactions to meet consumer needs. Fintech provides levels of speed and convenience that have become the expected norm in the banking industry.

24–5a Online and Mobile Banking

Especially for younger consumers, the notion of visiting a bank branch to make a deposit or writing a paper check has become outdated. Indeed, about 90 percent of Americans use online and mobile banking on a regular basis.

online banking

Traditional banking services, such as account management and transfers, that are provided on the financial institution's website.

Online banking gives customers access to their bank accounts on the internet.

Online banking programs enable customers to transfer funds between accounts, receive digital payments, manage investments, track loans, and make numerous other transactions on their computers.

mobile banking

A version of online banking that is carried out with apps on smartphones or tablets.

Mobile banking takes this level of fintech one step further, giving customers the ability, through apps, to conduct online banking from smartphones and tablets. In addition to the traditional banking services discussed throughout this chapter, mobile banking apps allow users to scan a fingerprint to access their accounts, to place temporary holds on credit cards, and to view recurring and unauthorized charges.

24–5b Electronic Payment Systems

Online and mobile banking facilitates the use of electronic billing. An electronic bill or **eBill** is a digital version of a paper bill. EBills contain the same information as paper bills. The difference is that they can be viewed and paid online. Banks now routinely offer fintech services that enable customers to take advantage of this technology.

eBill

An electronic version of a paper bill for goods or services that is issued online and can be paid online.

EBill services include electronic bill payment and presentment (EBPP). One type of EBPP is offered directly by companies that provide goods or services to consumers. Another type allows consumers to pay multiple bills electronically through their banks' online banking system. Merchants still pay about half of their bills using paper checks. Gradually, they will eliminate anything on paper. Many fintech companies have made internet-based payment systems available.

24–5c Artificial Intelligence (AI) in Fintech

Artificial intelligence (AI) refers to a branch of computer science that gives machines the ability to perform tasks that used to require human-level intelligence. The role of AI in fintech is sure to increase exponentially over the next few years. Its presence is already being felt. Some banks, for instance, have developed AI-based software that gives customers advice on how their spending and saving habits impact short- and long-term financial goals.

Digital Lending AI is also a crucial component in digital lending, which is the use of fintech to originate and renew loans. The AI program is “taught” the parameters of a financial institution’s lending practices, such as which factors determine a potential borrower’s creditworthiness. Then the program uses a problem-solving platform called an algorithm to determine whether a loan is warranted, and if so, at what terms. For banks that have instituted this AI lending strategy, the time taken to process smaller loans has dropped from 20 days to less than 10 minutes. Fintech also has the potential to make the lending process more equitable. The digital mortgage lender Better.com reported a 400 percent increase in loans to single, minority women borrowers in the first year it used an algorithm-based lending program.

Neobanks Increased access to AI is a crucial component in the growth of **neobanks**, or banks that exist only as digital entities. In practical terms, a neobank is an app that helps customers store and manage their funds. These financial institutions offer traditional services, such as banking and checking accounts, as well as the array of mobile banking options discussed earlier. Additional benefits include no monthly maintenance fees, fewer surprise charges and overdraft problems, and digital lending. The main drawback of neobanks is that, at least for now, funds deposited with them are not insured by the federal government.

Learning Outcome 5

Describe the role of artificial intelligence (AI) in digital lending.

neobanks

Banks that operate exclusively online without traditional physical branch networks.

Chapter Summary—Banking

Learning Outcome 1: List the types of relationships between banks and customers.

The three types of bank–customer relationships are (1) creditor–debtor, (2) agency, and (3) contractual.

Learning Outcome 2: Discuss liability for forged drawers’ signatures.

The general rule is that the bank must recredit the customer’s account when it pays on a forged signature. To avoid liability for forged signatures or unauthorized items, a customer has a duty to examine account statements with reasonable care on receipt and to notify the bank promptly of any forged signatures or unauthorized items. On a series of forged signatures or unauthorized items by the same wrongdoer, examination and report must be made within thirty calendar days of receipt of the first statement containing a forged item. The customer’s failure to comply with these rules releases the bank from liability unless the bank failed to exercise its own reasonable care.

Learning Outcome 3: Outline a bank’s duty to accept deposits.

A bank has a duty to accept deposits made by its customers into their accounts. A bank also has a duty to collect payment on any checks deposited by its customers. Funds represented by checks deposited must be made available to customers according to the following rules:

- (1) A check payable by the same bank that receives it is an “on-us” item. If the bank does not dishonor the check by the opening of the second banking day following its receipt, the check is considered paid.

- (2) Each bank in the collection process must pass the check on to the next appropriate bank before midnight of the next banking day following its receipt.
- (3) Most checks are processed electronically. When checks are presented electronically, they are encoded with information that is read and processed by other banks' computers.

Learning Outcome 4: Define an electronic fund transfer.

An electronic fund transfer (EFT) is a transfer of funds through the use of an electronic terminal, a phone, a computer, or magnetic tape.

Learning Outcome 5: Describe the role of artificial intelligence (AI) in digital lending.

Fintech, a term that refers to a combination of finance and technology, relies on computerized decision making, or artificial intelligence (AI), to carry out digital lending in which loan applications are processed by computers rather than bank employees.

Straight to the Point

1. What is the difference between a cashier's check and a certified check? (See Learning Outcome 1.)
2. Who suffers the loss when a bank pays a check bearing a forged indorsement? (See Learning Outcome 2.)
3. What is a substitute check? (See Learning Outcome 3.)
4. If a customer loses a debit card and others use it to make unauthorized purchases, how much is the customer required to pay? (See Learning Outcome 4.)
5. What constitutes an unauthorized transfer under the Electronic Fund Transfer Act (EFTA)? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Makena draws a check for \$900 payable to the order of Jan. Jan indorses the check in blank and transfers it to Owen. Owen presents the check to First National Bank, the drawee bank, for payment. If the bank does not honor the check, is Makena liable to Owen? Could Makena also be subject to criminal prosecution? Explain your answers. (See Learning Outcome 2.)
2. Herb steals a check from Kay's checkbook, forges Kay's signature, and transfers the check to Will for value. Unaware that the signature is not Kay's, Will presents the check to First State Bank, the drawee. The bank cashes the check. Kay discovers the forgery and insists that the bank recredit her account. Can the bank refuse to recredit Kay's account? If not, can the bank recover the amount paid to Will? Why or why not? (See Learning Outcome 2.)

Real Law

24–1. Consumer Fund Transfers. Truist Bank's "customer agreements" require a customer to promptly notify the bank of any problems with an account. The agreement also limits the bank's liability for transactions by the same unauthorized party if the customer does not notify the bank within 60 days. Further, a customer cannot commence a legal action based on an unauthorized transfer more than one year from the date of the statement containing the

transaction. James Binns had a commercial account and a personal account with Truist Bank. His daughter illegally used the routing and account numbers for the commercial account to request hundreds of electronic transfers to pay her personal bills. Truist sends Binns monthly statements, but he never reconciled the charges. Four years after his daughter first made these unauthorized transfers, Binns also learned that she had made withdrawals from his

personal account. He then reconciled his statements for his commercial account and filed a claim in a federal district court against Truist Bank for reimbursement. The trial court granted a summary judgment in the bank's favor. Did the customer agreement bar Binns' claim? [803 Fed.Appx. 618 (U.S. Ct. App., 3d Circuit, 2020)] (See Learning Outcome 4.)

24-2. The Bank–Customer Relationship. Euro International Mortgage, Inc. (EIM), held two accounts—Account 9378 and Account 3998—at Bank of America. Ravi Kadiyala was an authorized signatory on Account 9378 but not on Account 3998. Through EIM, Kadiyala obtained a username and password to gain access to Account 3998, transferring \$200,000 to Account 9378. Kadiyala then instructed the bank to issue cashier's checks against the new balance in Account 9378. Meanwhile, Mark Pupke, an authorized signatory on both accounts, learned what Kadiyala had done. Pupke told the bank to cancel the checks and reverse the transfer

of the \$200,000. Does the bank have a duty to honor either party's request? If so, whose? Why? [*Kadiyala v. Bank of America*, 630 Fed.Appx. 633 (7th Cir. 2016)] (See Learning Outcome 1.)

24-3. Consumer Fund Transfers. Stephen Patterson held an account with Suntrust Bank in Alcoa, Tennessee. Juanita Wehrman—with whom Patterson was briefly involved in a romantic relationship—stole his debit card and used it for sixteen months (well beyond the length of their relationship) to make unauthorized purchases in excess of \$30,000. When Patterson learned what was happening, he closed his account. The bank refused to reimburse him more than \$677.46—the amount of unauthorized transactions that occurred within sixty days of the transmittal of the bank statement that revealed the first unauthorized transaction. Is the bank's refusal justifiable? Explain. [*Patterson v. Suntrust Bank*, __ S.W.3d __, 2013 WL 139315 (Tenn.App. 2013)] (See Learning Outcome 4.)

Ethical Questions

24-4. Forged Signatures and Unauthorized Indorsements. Why should a customer have to report a forged or unauthorized signature on a paid check within a certain time to recover the amount of the payment? (See Learning Outcome 2.)

24-5. Customer Negligence. While working as David Ducote's assistant, Michelle Freytag fraudulently obtained a credit card in his name from Whitney National Bank in Louisiana. Freytag told the bank to pay the credit card balances with funds from Ducote's bank account. The bank sent

Ducote monthly account statements that included a "debit memo" of each payment. Ducote never contacted the bank about any unauthorized items on these statements, however. As a result, Freytag's fraudulent scheme was not discovered for five years. Does a bank customer have an ethical duty to examine monthly account statements and notify the bank of any forged checks or other unauthorized items? Does a bank have an ethical duty to recredit its customer's account without notice? Discuss. [*Ducote v. Whitney National Bank*, 212 So.3d 729 (La.App. 5 Cir. 2017)] (See Learning Outcome 2.)

Chapter 24—Work Set

True-False Questions

- _____ 1. If a bank pays a stale check in good faith without consulting the customer, the bank cannot charge the customer's account.
- _____ 2. If a bank receives an item payable from a customer's account in which there are insufficient funds, the bank cannot pay the item.
- _____ 3. A bank in the collection chain must normally pass a check on before midnight of the next banking day following receipt.
- _____ 4. The rights and duties of a bank and its customers are partly contractual.
- _____ 5. All funds deposited in all bank accounts must be available for withdrawal no later than the next business day.
- _____ 6. A forged drawer's signature on a check is as effective as the signature of the person whose name is signed.
- _____ 7. If a bank fails to honor a customer's stop-payment order, it may be liable to the customer for more than the amount of the loss suffered by the drawer because of the wrongful payment.

Multiple-Choice Questions

- _____ 1. Aston has a checking account in Banner Bank. He writes a check on the account payable to Charlotte. When the check is presented for payment, Banner will be liable to Aston if the bank
 - a. pays the check and the charge results in an overdraft.
 - b. refuses to pay the check on the ground that it is presented more than six months after its date.
 - c. wrongfully dishonors the check.
 - d. does all of the above.
- _____ 2. Xavier is paid with a check drawn on Pete's account at First State Bank. The check has a forged drawer's signature. Xavier indorses the check to Eve, who takes it in good faith and for value, and cashes it at the bank. When Pete discovers the forgery, he notifies the bank, which recredits his account. The bank can recover the amount of its loss from Eve
 - a. only if she has a bank account at any bank.
 - b. only if she has an account at First State Bank.
 - c. under any circumstances.
 - d. under no circumstances.
- _____ 3. Adriana buys three \$300 television sets from Gail, paying with a check. That night, one of the sets explodes. Adriana phones City Bank, the drawee, and orders a stop payment. The next day, Gail presents the check to the bank for payment. If the bank honors the check, it must recredit Adriana's account for
 - a. \$300.
 - b. \$900.
 - c. nothing because the stop-payment order was oral.
 - d. nothing because Gail did not present the check until the next day.
- _____ 4. Paulo draws a check for \$500 payable to the order of Mary. Mary indorses the check in blank and transfers it to Sam. Sam presents the check to First National Bank, the drawee, for payment. If the bank does not pay the check, the bank is liable to
 - a. Sam.
 - b. Paulo.
 - c. Mary.
 - d. none of the above.

- _____ 5. On July 1, Liz steals two blank checks from her employer, Dave's Market. On July 3, Liz forges Dave's signature and cashes the first check. The check is returned with Dave's monthly statement from First National Bank on August 1. Dave does not examine the statement or the checks. On August 24, Liz forges Dave's signature and cashes the second check. This check is returned with Dave's monthly statement on September 1. Dave examines both statements, discovers the forgeries, and insists that the bank recredit the account for both checks. Assuming that the bank was not negligent in paying the checks, the bank must recredit Dave's account for
- both checks.
 - the first check only.
 - the second check only.
 - neither of the checks.
- _____ 6. Delta Company uses its computer system to issue payroll checks. Ed, a Delta employee, uses the system without authorization to issue himself a check for \$5,000. City Bank, Delta's bank, cashes the check. The bank need not recredit Delta's account for the entire \$5,000
- if Delta owed Ed \$5,000 in unpaid wages.
 - if the bank took reasonable care to determine whether the check was good.
 - if Delta took reasonable care to limit access to its payroll system.
 - under any of these circumstances.
- _____ 7. Jay arranges with First National Bank to make automatic monthly payments on his student loan. More than three days before a scheduled payment, Jay can stop the automatic payments by notifying the bank
- orally.
 - in writing.
 - online.
 - in any of the above ways.

Answering More Legal Problems

1. Anton, an employee of Tango Fabrication, LLC, used stolen software and blank checks to print forged company checks on his home computer. Tango's check-handling process lacked audit controls, so Tango did not discover the forgeries for more than two years. By then, the series of forged checks totaled \$446,000. When the scam was discovered, Tango immediately contacted Merchants Bank and requested that it recredit the account on which the checks were drawn.
2. On an automated teller machine (ATM) belonging to USA Bank, Sven placed a card-skimming device to pull information from the magnetic strips of users' debit cards. The device then transmitted the stolen data to thieves who used them to gain access to, and empty, the bank accounts of the users, including Megan. Megan learned of the theft the next day and promptly notified USA Bank.

Did Merchants have to recredit Tango's account? No. When a series of forgeries by the same wrongdoer takes place, the customer, to recover for all of the forged items, must discover and _____ the first forged check to the bank within thirty calendar days of the receipt of the bank statement. Failure to _____ the bank within this period discharges the bank's liability for all similar forged checks that it pays before being _____. Here, Tango's weak monitoring of its account meant that it did not _____ the first forged item to Merchants until at least two years after it appeared on Tango's statement. This was well beyond the thirty-day deadline.

Was Megan entitled to have the bank recredit her account for most of the loss due to the theft? Yes. Under the Electronic Fund Transfer Act, if a customer's debit card is lost or stolen and used without permission, the customer may be required to pay no more than \$50. The customer must _____ the bank of the loss or theft within two days of learning about it. Otherwise, the liability increases to \$500. The customer may be liable for more than \$500 if they do not _____ the unauthorized use within sixty days after it appears on the customer's statement. In this situation, Megan promptly _____ USA Bank, so her liability will be no more than \$50.



Unit 5

Agency and Employment

Unit Contents

Chapter 25

Agency Relationships

Chapter 26

Employment, Immigration, and Labor Law

Chapter 27

Employment Discrimination

25 | Agency Relationships

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Describe how an agency relationship is created.
- 2 List the duties of agents and principals.
- 3 Define the scope of an agent's authority.
- 4 Identify the parties' liability in agency relationships.
- 5 Explain how an agency relationship is terminated.

agency relationship

A relationship in which one party (the agent) acts for another (the principal).

agent

A person authorized to act for another.

principal

A person who authorizes an agent to act on their behalf.

Conflict Presented

Bruce is hired as a booking agent for the rock band, The Crash. As the band's agent, Bruce can negotiate and sign contracts for the band to appear at concerts and other venues.

Q Are the contracts that Bruce negotiates and signs binding and thus legally enforceable against The Crash?

One of the most common, important, and pervasive legal relationships is that of agency. In an **agency relationship**, one party called the **agent**, agrees to represent or act for another called the **principal**. The principal has the right to control the agent's conduct in matters entrusted to the agent.

By using agents, a principal can conduct multiple business operations simultaneously in various locations. A familiar example of an agent is a corporate officer, who serves in a representative capacity for the owners of a corporation. In this capacity, the officer has the authority to bind the principal (the corporation) to a contract.

25–1 Principal–Agent Relationships

In a principal–agent relationship, the parties agree that the agent will act on behalf and instead of the principal in dealing with third persons. An agent is empowered to (1) perform legal acts that are binding on the principal and (2) bind the principal in a contract with a third person.

Agency relationships commonly exist between employers and employees. Agency relationships also may sometimes exist between employers and independent contractors who are hired to perform special tasks or services.

25–1a Employer–Employee Relationships

An employee is one whose physical conduct is controlled, or subject to control, by the employer. Normally, employees who deal with third parties are deemed to be agents. **Example 25.1** Kayla works as a salesperson at Norris Running. She is an agent of the store (the principal) and acts on its behalf. Any sale of goods that Kayla makes to a customer is binding on Norris. ■

25–1b Employer–Independent Contractor Relationships

An **independent contractor** contracts with a principal to do something but is not subject to the principal's right to control the performance. Because those principals who hire independent contractors have no control over the details of their performance, independent contractors are not considered employees.

The relationship between a principal and an independent contractor may or may not involve an agency relationship.

independent contractor

A person whose working conditions are not controlled by an employer.

Highlighting the Point



Brooke is ready to sell her cattle ranch in Texas. She hires Mateo, a real estate broker, to negotiate a sale of her property by entering into a contract for his services. Her neighbor, Henry, is considering selling his ranch as well. Henry hires Millie, a real estate appraiser, to estimate the value of his property.

Do Brooke and Mateo have an agency relationship? Yes. Brooke's contract with Mateo—who is an independent contractor—establishes an agency relationship. Mateo can act on Brooke's behalf in order to sell the ranch to a third party. Mateo is Brooke's agent.

Do Henry and Millie have an agency relationship? No. Henry's contract with Millie—who is also an independent contractor—does not establish an agency relationship. Millie has no power to transact any business on Henry's behalf. She is not his agent.

The greater the employer's control over the work, the more likely it is that the worker is an employee. (For a further discussion about hiring independent contractors, see this chapter's Linking Business Law to Your Career feature.)

25–2 Agency Formation

Agency relationships normally are consensual—that is, they come about by voluntary consent and agreement of the parties. An agreement to enter into an agency relationship generally need not be in writing. There are, however, two main exceptions:

1. When an agent is empowered to enter into a contract that the Statute of Frauds requires to be in writing, the agent's authority from the principal must be in writing. (This is the equal dignity rule, which will be discussed later in this chapter.)
2. A power of attorney—a document authorizing another to act as one's agent or attorney—must be in writing.

A person must have contractual capacity to be a principal. Those who cannot legally enter into contracts directly cannot do so indirectly through an agent. Any person can be an agent, however, regardless of whether they have the capacity to contract.

An agency relationship can be created for any legal purpose. One created for a purpose that is illegal, however, is unenforceable. **Example 25.2** Janelle (as principal) contracts with McKenzie (as agent) to sell illegal narcotics. This agency relationship is unenforceable because selling illegal narcotics is a crime. ■

Agency relationships can arise by acts of the parties in one of four ways: by agreement of the parties, by ratification, by estoppel, or by operation of law.

Learning Outcome 1

Describe how an agency relationship is created.

25–2a Agency by Agreement of the Parties

An agency relationship requires an affirmative indication that the agent agrees to act for the principal and the principal agrees to have the agent so act. An agency agreement can take the form of an express written contract, or it can be oral. **Example 25.3** Reese asks Cary, a gardener, to contract with others for the care of his lawn on a regular basis. An agency relationship has been established for the lawn care. ■

An agency agreement can also be implied from conduct. **Example 25.4** The Dakota Springs Hotel has Boris, who is not an employee, park its guests' cars. The hotel manager tells Boris when to work and how to do the tasks. The hotel's conduct implies its willingness to have Boris park its customers' cars. In turn, Boris can infer that he has the authority to act as the hotel's parking valet. ■

25–2b Agency by Ratification

On occasion, a person who is not an agent (or who is an agent acting outside the scope of their authority) may contract on behalf of another (a principal). If the principal affirms that contract by word or by action, an agency relationship is created by **ratification**. Ratification is the affirmation of a previously unauthorized contract or act.

ratification

The confirmation of an act or contract performed by another.

25–2c Agency by Estoppel

A principal may cause third persons to reasonably believe that other persons are their agents when the other persons are not agents of the principal. In such a situation, the principal's actions create the appearance of an agency that does not exist. If the third person deals with the supposed agent, the principal is estopped (barred) from denying the agency relationship with respect to that third person.



Real Case

Aaron Reidel was experiencing severe back pain when he visited the emergency room at Lodi Community Hospital. The attending emergency room physician, an independent contractor, misdiagnosed Reidel's condition. Reidel filed suit against Lodi, alleging that the physician's negligence was the proximate cause of his subsequent paraplegia. Lodi Hospital argued that it was not liable because the physician was not the hospital's employee or agent. An Ohio jury disagreed, awarding Reidel \$5.2 million in damages.

Should Lodi Community Hospital be held responsible for one of its physician's misdiagnosis? Yes. In *Reidel v. Akron General Health System*, the Court of Appeals of Ohio, 8th District, affirmed the trial court's award. The hospital was liable under the doctrine of agency by estoppel for the negligence of an independent contractor physician. Crucially, the court noted, the public is rarely aware of the technical employment arrangements between a hospital and its staff. In this case, Reidel chose Lodi only because it was nearby at the time of his medical emergency. He reasonably expected to be treated by a physician employed by Lodi and to be able to hold Lodi responsible for any resulting negligence.

—97 N.E.3d 508 (Ct. App. OH, 8th Dist.)

25–2d Agency by Operation of Law

In some cases, the courts find an agency relationship where there is no formal agreement. This may occur in family relationships. **Example 25.5** Judy and Lee are married. If Judy purchases certain necessities and charges them to Lee's account, a court will find an agency relationship between them. ■

Agency by operation of law may also occur in emergency situations, when the agent is unable to contact the principal and the agent's failure to act outside the scope of their authority would cause the principal substantial loss. **Example 25.6** Linda's car is struck by a train, and she is injured. Jake, a railroad engineer, may contract for emergency medical care for Linda on behalf of his employer. ■

25-3 Duties of Agents and Principals

Agents and principals have various duties and rights. In general, for every duty of the principal, the agent has a corresponding right, and vice versa.

25-3a Agent's Duties to the Principal

The duties that an agent owes to a principal are set forth in the agency agreement or arise by operation of law. Generally, the agent owes the principal five duties—performance, notification, loyalty, obedience, and accounting. (See Exhibit 25.1.)

Learning Outcome 2

List the duties of agents and principals.

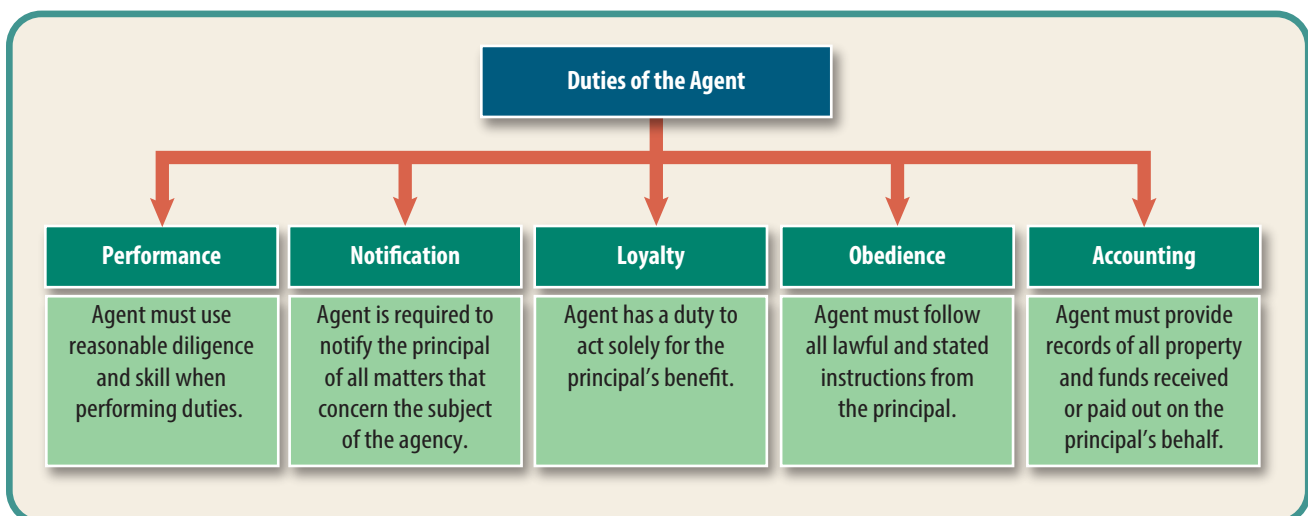
Performance An agent must use reasonable diligence and skill in performing the work. The degree of skill or care required of an agent is usually that expected of a reasonable person under similar circumstances. If agents have represented themselves as possessing special skills (such as those that an accountant or attorney possesses), the agents are expected to use them.

Notification An agent must notify the principal of all matters that come to the agent's attention concerning the subject matter of the agency. Under the law of agency, notice to the agent is notice to the principal. **Example 25.7** Annette, a grocery store manager (the agent), is notified of a spilled gallon of milk in one of the aisles. She fails to take steps to clean up the spill and a customer is injured. The store's owner (the principal) is liable for the injury. ■

Loyalty The duty of loyalty means that agents must act solely for the benefit of the principal and not in their own interests or in the interests of a third party. Any information (such as a customer list) acquired through the agency relationship is confidential. Disclosing such information either during the agency relationship or after its termination would be a breach of loyalty.

Agents employed by a principal to buy cannot buy from themselves. **Example 25.8** Verona asks Bamba to buy her an acre of land in Pebble Creek Estates. Bamba

Exhibit 25.1 Duties of the Agent



owns an acre in Pebble Creek Estates. He cannot take advantage of the relationship to secretly sell his own land to her. ■ Similarly, an agent employed to sell cannot become the purchaser without the principal's consent. **Example 25.9** If Gail asks Kurt to sell her Kindle, Kurt cannot buy the e-reader without Gail's consent. ■

Obedience When an agent is acting on behalf of the principal, the agent must follow all lawful and clearly stated instructions of the principal. During emergency situations, however, the agent may deviate from the instructions if the circumstances warrant it. This may occur, for instance, if the principal cannot be consulted and would suffer a financial loss if the agent failed to act.

Accounting The agent must keep and make available to the principal an account of all property and funds received and paid out on behalf of the principal. This includes gifts from third persons in connection with the agency.

Example 25.10 Marta is a salesperson for Roadway Supplies. Knife River Construction gives Marta a new tablet as a gift for prompt deliveries of Roadway's paving materials. The tablet belongs to Roadway. ■

In addition, the agent must maintain separate accounts for the principal's funds and for the agent's personal funds. The agent must not intermingle these accounts.

25–3b Principal's Duties to the Agent

The principal also has certain duties to the agent, either expressed or implied by law. Three such duties are compensation, reimbursement and indemnification, and cooperation.

Compensation The principal has a duty to pay the agent for services rendered. If the parties have agreed on the amount of compensation, the principal must pay that amount. If no amount is expressly agreed on, then the principal owes the agent the customary compensation for the agent's services.

Reimbursement and Indemnification A principal must reimburse an agent when the agent spends funds on the principal's behalf. In addition, when agents pay for necessary expenses in the course of reasonable performance of their duties, the principal must reimburse the agents. Agents cannot recover for expenses incurred by their own misconduct, however.

Further, a principal must also indemnify (compensate) an agent for liabilities incurred because of authorized acts. A principal must also indemnify an agent for losses suffered by the agent or others because of the principal's failure to perform their duties. For instance, if an agent orders supplies on the principal's behalf and the agent is held liable for the payment, the principal must indemnify the agent for the liability.

Cooperation A principal must assist the agent in performing the agent's duties. The principal must do nothing to prevent that performance. **Example 25.11** Valentina (the principal) creates an exclusive agency by granting Don (the agent) a territory within which only he may sell Valentina's products. If Valentina starts to sell the products herself within Don's territory—or permits another agent to do so—Valentina is not cooperating with the agent. By violating the exclusive agency, Valentina can be held liable for Don's lost sales or profits. ■

25–4 Agent's Authority

Learning Outcome 3

Define the scope of an agent's authority.

The liability of a principal to third parties with whom an agent contracts depends on whether the agent had the authority to enter into legally binding contracts on the principal's behalf. An agent's authority to act can be either actual (express or implied) or apparent. If an agent contracts outside the scope of their authority, the principal may still become liable by ratifying the contract.

25–4a Express Authority

Express authority is authority declared in clear, direct, and definite terms. Such authority can be given orally or in writing.

The Equal Dignity Rule The **equal dignity rule** requires that if the contract being executed is, or must be, in writing, then the agent's authority must also be in writing.

equal dignity rule

A rule requiring that an agent's authority be in writing if the contract to be made on the principal's behalf must be in writing.

Highlighting the Point



Zorba orally asks Parker to sell a warehouse that Zorba owns. Parker finds a buyer, Gloria, and signs a sales contract on behalf of Zorba to sell the warehouse. Under the Statute of Frauds, a contract for an interest in land must be in writing.

Can Gloria enforce the contract? No. The contract is unenforceable at this point. Because a contract to sell land must be in writing, Parker's authority to act as Zorba's agent must be in writing. (If Zorba subsequently ratifies Parker's agency status in writing, as discussed later, then the parties can enforce the contract.)

Power of Attorney Giving an agent a **power of attorney** confers express authority. A power of attorney normally is a written document. It can be special (permitting the agent to do specified acts only), or it can be general (permitting the agent to transact all business dealings for the principal).

power of attorney

A document authorizing another to act as one's agent.

25–4b Implied Authority

An agent has the implied authority to do what is reasonably necessary to carry out their express authority and accomplish the objectives of the agency relationship. Authority can also be implied by custom or inferred from the position the agent occupies.

Example 25.12 Crown Market employs Stephanie to manage one of its stores. Crown has not expressly stated that Stephanie has authority to contract with third persons. In this situation, though, authority to manage a business implies authority to do what is reasonably required (as is customary or can be inferred from a manager's position) to operate the business. Thus, it is reasonable to imply that Stephanie has the authority to hire employees, to buy merchandise and equipment, and to advertise the products sold at Crown. ■

Conflict Resolved

In the Conflict Presented feature set out at the beginning of this chapter, Bruce is hired as a booking agent for the rock band, The Crash. As the band's agent, Bruce negotiates and signs contracts for The Crash to appear at concerts.

A Are the contracts by Bruce legally enforceable against The Crash? Yes. In their principal-agent relationship, the parties agreed that Bruce would act on behalf of The Crash when negotiating and transacting business with third persons.

apparent authority

Authority that arises when a principal causes a third party to believe an agent has authority to act on the principal's behalf.

25-4c Apparent Authority

Actual authority (express or implied) arises from what the principal makes clear to the agent. **Apparent authority** arises when the principal, by either word or action, causes a third party to reasonably believe that an agent has authority to act, even though the agent has no express or implied authority. If the third party changes their position in reliance on the principal's representations, the principal may be estopped (barred) from denying that the agent had authority.



Highlighting the Point

Sook, a salesperson for Gold Products, has no authority to collect payments for orders solicited from customers. A customer, Martin, pays Sook for an order. Sook takes the payment to Gold's accountant, who accepts the payment and sends Martin a receipt. This procedure is followed for other orders by Martin. Finally, however, Sook disappears with one of Martin's payments.

Can Martin claim that the payment to Sook was authorized and thus was, in effect, a payment to Gold? Yes. Gold's repeated acts of accepting Martin's payments through Sook led Martin to believe that Sook had authority to receive payments. Although Sook did not have authority, Gold's conduct gave her apparent authority.

25-4d Ratification

Ratification is the affirmation of a previously unauthorized contract or act involving the agent and a third party. The principal is not bound by the agent's unauthorized act unless the principal ratifies it. The requirements for ratification are as follows:

1. The one who acted as an agent must have acted on behalf of a principal who subsequently ratifies.
2. The principal must know of all material facts involved in the transaction.
3. The agent's act must be affirmed in its entirety by the principal.
4. The principal must have the legal capacity to authorize the transaction at the time the agent engages in the act and at the time the principal ratifies.
5. The principal's affirmance must occur before the third party withdraws from the transaction or changes position in reliance on the contract.
6. The principal must observe the same formalities when approving the act as would have been required to authorize the act initially.

25-5 Liability in Agency Relationships

Frequently, an issue arises as to which party, the principal or the agent, should be held liable for contracts formed by the agent or torts committed by the agent. We look at this aspect of agency law next.

Learning Outcome 4

Identify the parties' liability in agency relationships.

disclosed principal

A principal whose identity is known by a third party when a contract is made by an agent.

25-5a Liability for Agent's Contracts

An important consideration in determining liability for a contract formed by an agent is whether the principal's identity was disclosed, partially disclosed, or undisclosed to the third party. A **disclosed principal** is a principal whose identity is known by the third party at the time the contract is made by the agent.

A **partially disclosed principal** is a principal whose identity is not known by the third party, but the third party knows that the agent is or may be acting for a principal at the time the contract is made.

partially disclosed principal
A principal whose identity is unknown by a third party, but that party knows the agent is acting for a principal when the contract is made.

Highlighting the Point



Tomax hired Mitsui Lines to deliver 50,000 pounds of frozen pork from Chicago to a supermarket chain in the Dominican Republic. Mitsui contracted with Conglobal to provide a refrigerated shipping container for the pork. Conglobal employees set the temperature of the container too high, causing the pork to thaw and be destroyed. Tomax's insurer sued Conglobal for breach of contract. Conglobal argued that it never had any direct contact with Tomax and therefore did not know that Mitsui was acting as Tomax's agent.

Should this case be dismissed against Conglobal? No. Conglobal had to be aware that Mitsui was acting as an agent for some other party. It was unlikely that Mitsui, a shipping company, owned the pork. Tomax was the partially disclosed principal and could properly sue Conglobal (the third party) to enforce a contract entered into by Mitsui (the agent).

An **undisclosed principal** is a principal whose identity is totally unknown by the third party at the time the contract is made, and the third party has no knowledge that the agent is acting in an agency capacity.

undisclosed principal
A principal whose identity is unknown by a third party, and that party has no knowledge the agent is acting in an agency capacity when the contract is made.

Authorized Acts When agents, acting within the scope of their authority, contract with a third party, a disclosed principal is liable to the third party. Ordinarily, the agent is not liable. In the same circumstances, a partially disclosed principal is also liable, and so is the agent.

Undisclosed principals (but not the agents) are liable except in the following circumstances:

1. They are expressly excluded as parties to the contract.
2. The contract is a negotiable instrument, such as a check, signed by the agent with no indication that they are signing in a representative capacity.
3. The performance of the agent is personal to the contract, thus allowing the third party to refuse the principal's performance.

Unauthorized Acts If the agent exceeds the scope of authority, and the principal fails to ratify the contract, the principal cannot be held liable to a contract by a third party. Hence, the agent generally is liable unless the third party knew of the agent's lack of authority.

25–5b Liability for Agent's Torts

A principal may be liable for an agent's (or an employee's) torts under the doctrine of **respondeat superior** (pronounced ree-spahn-dee-uht soo-peer-ee-your). This is a Latin term meaning "let the master respond." For the doctrine to apply, the torts must be committed within the scope of the agency (or employment). The doctrine imposes vicarious (indirect) liability on a principal without regard to the personal fault of the principal.

respondeat superior
A principle of law whereby a principal or an employer is held liable for the wrongful acts committed by agents or employees acting within the scope of their agency or employment.

25–6 Termination of Agency Relationships

Learning Outcome 5

Explain how an agency relationship is terminated.

An agency can terminate by an act of the parties or by operation of law. Once the relationship between the principal and agent has ended, the agent no longer has the right to bind the principal.

25–6a Termination by Act of the Parties

An agency may be terminated by act of the parties in any of the following ways:

1. **Lapse of time.** An agency agreement may specify the time period during which the agency relationship will exist. If so, the agency ends when that period expires. If no definite time is stated, then the agency continues for a reasonable time and can be terminated by either party.
2. **Purpose achieved.** An agent is sometimes employed to accomplish a particular objective. In that situation, the agency ends when the objective is accomplished. Thus, if an agent is hired to purchase stock for a cattle rancher, the agency automatically ends after the cattle have been purchased.
3. **Occurrence of a specific event.** When an agency is created to terminate when a certain event occurs, the agency automatically ends when the event occurs. If a principal appoints an agent to handle the principal's business while the principal is away, for instance, the agency terminates when the principal returns.
4. **Mutual agreement.** The parties can mutually agree to terminate their relationship.
5. **Termination by one party.** As a general rule, either party can terminate an agency relationship. The agent's act of termination is a renunciation of authority (the agent abandons the right to act for the principal). The principal's act of termination is a revocation of authority (the principal takes back the right given to the agent to act on the principal's behalf).

Wrongful Termination Although both parties have the power to terminate an agency relationship, they may not possess the right. Terminating an agency relationship may require breaking an agency contract. Normally, no one has the right to break a contract.

Even in an agency that either party may terminate at any time, the principal who wishes to terminate must give the agent reasonable notice. The notice must be at least sufficient to allow the agent to recoup expenses and, in some situations, to make a normal profit.

Agency Coupled With an Interest An agency coupled with an interest is a relationship created for the benefit of the agent. The agent actually acquires a beneficial interest in the subject matter of the agency. Under these circumstances, it is not equitable to permit a principal to terminate the relationship at will. Hence, this type of agency is irrevocable.



Highlighting the Point

Ramira owns Green Hills Winery. She needs some cash right away, so she enters into an agreement with Jack. The agreement provides that Jack will lend her \$10,000. In return, Ramira will grant Jack a one-half interest in Green Hills Winery and the exclusive right to sell it, with the loan to be repaid out of the sale's proceeds. Jack is Ramira's agent.

Is Jack's agency coupled with an interest? Yes. Jack's power to sell Green Hills Winery is coupled with a beneficial interest of one-half ownership in the business. The interest was created when the loan agreement was made for the purpose of securing repayment of the loan. Thus, Jack's agency power is irrevocable.

25–6b Termination by Operation of Law

Termination of an agency by operation of law occurs in the following circumstances:

1. **Death or insanity.** The death or mental incompetence of either the principal or the agent automatically and immediately terminates an ordinary agency relationship. Knowledge of the death is not required. **Example 25.13** Greg sends Nina to China to purchase a rare vase. Before Nina makes the purchase, Greg dies. Nina's agent status is terminated at the moment of Greg's death, even if Nina does not know that Greg has died. ■
2. **Impossibility.** When the specific subject matter of an agency is destroyed or lost, the agency terminates. **Example 25.14** Katerina employs Axel to sell her house. Before a sale can be made, the house is destroyed by fire. Axel's agency and authority to sell Katerina's house terminates. ■ In addition, when it is impossible for the agent to perform the agency lawfully, the agency terminates.
3. **Changed circumstances.** Sometimes, an event occurs that has such an unusual effect on the subject matter of the agency that the agent can reasonably infer that the principal will not want the agency to continue. In such a situation, the agency terminates. **Example 25.15** Carter hires Rasmussen, a real estate agent, to sell a tract of land. Rasmussen learns that there is oil under the land, greatly increasing the value of the tract. The agency to sell the land is terminated. ■
4. **Bankruptcy.** Bankruptcy of the principal or the agent usually terminates the agency relationship.
5. **War.** When the principal's country and the agent's country are at war with each other, the agency is terminated, or at least suspended.

When an agency terminates by operation of law, there is no duty to notify third parties, unless the agent's authority is coupled with an interest. If the parties themselves have terminated the agency, however, it is the principal's duty to inform any third parties who know of the existence of the agency that it has been terminated. No particular form of notice of agency termination is required.



Linking Business Law to Your Career

Independent Contractors

In your career, you may at some point consider hiring an independent contractor. Hiring independent contractors instead of employees may help you reduce your business's potential tort liability and tax liability.

Tort Liability

One reason for using an independent contractor is that an employer usually is not liable for a tort that an independent contractor commits against a third party. Nevertheless, there are exceptions.

To minimize possible liability, you should check an independent contractor's qualifications carefully before hiring them. How extensively you should investigate depends on the nature of the work. For instance, hiring an independent contractor to maintain the landscaping around your building

should require relatively limited investigation. A more thorough investigation is necessary when the contractor's activities will present a potential danger to the public—for example, if the contractor will be delivering explosives.

Generally, the independent contractor should assume, in a written contract, liability for harms caused to third parties by the contractor's negligence. A contractor should buy liability insurance to cover these costs.

Tax Liability and Other Costs

Another reason for hiring an independent contractor is that you do not need to pay or withhold Social Security, income, or unemployment taxes on their behalf. Also, an independent contractor is not eligible for retirement or medical plans or other fringe benefits provided to employees.

A word of caution, though: simply designating a person an independent contractor does not make that person one. The Internal Revenue Service (IRS) will classify individuals as employees if it determines that they are employees, regardless of your designation. The penalty in such a case may be high. Usually, you will be liable for back Social Security and

unemployment taxes, plus interest and penalties. When in doubt, seek professional assistance in such matters.

To avoid these and other costs, document the independent contractor's status with their business identification number, business cards, and letterhead so that you can show the IRS that the contractor works independently.

Chapter Summary—Agency Relationships

Learning Outcome 1: Describe how an agency relationship is created.

In an agency relationship, an agent acts on behalf of, and instead of, a principal in dealing with third parties. Agency relationships may be formed by agreement, ratification, estoppel, and operation of law.

Learning Outcome 2: List the duties of agents and principals.

An agent's duties include performance, notification, loyalty, obedience, and accounting. The principal's duties include compensation, reimbursement and indemnification, and cooperation.

Learning Outcome 3: Define the scope of an agent's authority.

An agent's authority has the following sources:

- (1) Express authority—Can be oral or in writing but must be in writing if an agent is to execute a contract that must be in writing.
- (2) Implied authority—Customarily associated with the agent's position or deemed necessary for the agent to carry out expressly authorized tasks.
- (3) Apparent authority—Exists when a principal, by word or action, causes a third party to reasonably believe that an agent has authority to act, even though the agent has no express or implied authority.
- (4) Ratification—Occurs when a principal, aware of all material facts, affirms an agent's unauthorized act or promise.

Learning Outcome 4: Identify the parties' liability in agency relationships.

If a principal's identity is disclosed or partially disclosed at the time an agent forms a contract with a third party, and the agent is acting within the scope of their authority, the principal is liable to the third party under the contract. If the principal is disclosed, the agent is ordinarily not liable. If the principal is partially disclosed, the agent is usually liable. If a principal's identity is undisclosed at the time of contract formation, an agent is liable to the third party under the contract, and the principal is also bound except under limited circumstances.

If agents act beyond the scope of their authority, the principal is not liable unless the principal later ratifies the contract. Under the doctrine of *respondeat superior*, a principal is liable for any harm caused to another through an agent's torts if the agent was acting within the scope of employment at the time the harmful act occurred.

Learning Outcome 5: Explain how an agency relationship is terminated.

An agency relationship may be terminated by an act of the parties or by operation of law.

Straight to the Point

1. What is an agency relationship? (See Learning Outcome 1.)
2. How does an employer–employee relationship differ from an employer–independent contractor relationship? (See Learning Outcome 1.)

3. What is involved in an agent's duty of loyalty? (See Learning Outcome 2.)
4. Under what circumstances is a principal liable to a third party on a contract entered into by an agent? (See Learning Outcome 4.)
5. When is a principal not liable to a third party on a contract entered into by an agent? (See Learning Outcome 4.)
6. Once the relationship between a principal and agent ends, does the agent have the right to bind the principal? (See Learning Outcome 5.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Able Corporation wants to build a new mall on a specific tract of land. Able contracts with Ofelia to buy the property. When Ofelia learns of the difference between the price that Able is willing to pay and the price at which the owner is willing to sell, she wants to buy the land and sell it to Able herself. Can she do this? Discuss. (See Learning Outcome 2.)
2. Marie, owner of the Consumer Goods Company, employs Rachel as an administrative assistant. In Marie's absence, and without authority, Rachel represents herself as Marie and signs a promissory note in Marie's name. Under what circumstance is Marie liable on the note? (See Learning Outcome 4.)

Real Law

25-1. Liability for Agent's Torts. Jeff Doughty worked for Beta Land Services. He received two weeks mandatory training. Beta gave him a computer and required him to be at work between 8:00 a.m. and 5:00 p.m. every day. His pay was set at a daily rate for ongoing service. He retained the right to control his work scheduling. He could cancel his contract at any time without liability for breach. While he was bringing supplies to the company's main office, his vehicle rear-ended a vehicle driven by Brock Simon. Simon filed a suit in a Louisiana court against Doughty, his insurer, and Beta. Simon alleged that at the time of the accident Doughty was Beta's agent, rendering Beta vicariously liable for its agent's negligence. Was Beta vicariously liable for Doughty's negligence? [*Simon v. Farm Bureau Insurance Co., et al.*, 297 S.3d 147 (Ct. App. LA, 3rd Cir. 2020)] (See Learning Outcome 4.)

25-2. Agent's Authority. Kindred Nursing Centers East, LLC, owns and operates Whitesburg Gardens, a physical rehabilitation facility in Huntsville, Alabama. Lorene Jones was admitted to the facility following knee-replacement surgery. Jones's daughter, Yvonne Barbour, signed the admission forms as her mother's representative in Jones's presence. Jones did not object. The forms included an

"Alternative Dispute Resolution Agreement," which provided for binding arbitration in the event of a dispute. Six days later, Jones was transferred to a different facility. After recovering from the surgery, she filed a suit in an Alabama state court against Kindred, alleging negligence. Can Jones be compelled to submit her claim to arbitration? Explain. [*Kindred Nursing Centers East, LLC v. Jones*, 201 So.3d 1146 (Ala. 2016)] (See Learning Outcome 3.)

25-3. Determining Employee Status. Nelson Ovalles worked as a cable installer for Cox Rhode Island Telecom, LLC, under an agreement with a third party, M&M Communications, Inc. The agreement stated that no employer-employee relationship existed between Cox and M&M's technicians, including Ovalles. Ovalles was required to designate his affiliation with Cox on his work van, clothing, and identification badge, but Cox had minimal contact with him and limited power to control the manner in which he performed his duties. Cox supplied cable wire and similar items, but the equipment was delivered to M&M, not to Ovalles. Is Ovalles an employee of Cox or an independent contractor? Explain. [*Cayer v. Cox Rhode Island Telecom, LLC*, 85 A.3d 1140 (R.I. 2014)] (See Learning Outcome 1.)

Ethical Questions

25-4. Duty of Loyalty. Are there situations in which the duty of loyalty could conflict with other duties? Explain your answer. (See Learning Outcome 2.)

25-5. Agent's Authority. Devin Fink was the manager of Precision Tune Auto Care in Charlotte, North Carolina. Randall Stywall brought her car to the shop to have its

rear shocks replaced. Fink filled out the service order, which included a cost estimate. Later, Stywall returned for her car, and Fink collected payment for the repair work. When Stywall started to drive away, however, the car performed as if the shocks had not been replaced. A complaint to Precision's corporate office resulted in the discovery that, in fact, the repair work had not been done and that Fink

had kept Stywall's payment. Fink was charged with larceny against his employer. Fink argued that he had not committed this crime because Stywall was the victim, not Precision. Which agency principles support the larceny charge against Fink? What does Fink's defense suggest about his ethics? Explain. [*State of North Carolina v. Devin Way Fink*, 252 N.C.App. 379 (2017)] (See Learning Outcome 3.)

Chapter 25—Work Set

True-False Questions

- _____ 1. An agent can perform legal acts that bind the principal.
- _____ 2. An agent must keep separate accounts for the principal's funds.
- _____ 3. Any information or knowledge obtained through an agency relationship is confidential.
- _____ 4. A disclosed principal is liable to a third party for a contract made by an agent acting within the scope of authority.
- _____ 5. Generally, a principal whose agent commits a tort in the scope of their employment is not liable to persons injured.
- _____ 6. An agent is always liable for a contract they enter into on behalf of an undisclosed principal.
- _____ 7. Both parties to an agency have the power and the right to terminate the agency at any time.
- _____ 8. The only way a principal can ratify a transaction is with a written statement.
- _____ 9. When an agent enters into a contract on behalf of a principal, the principal must ratify the contract to be bound.

Multiple-Choice Questions

- _____ 1. National Supplies Company hires Linda and Brad as employees to deal with third-party purchasers and suppliers. Linda and Brad are
 - a. principals.
 - b. agents.
 - c. both a and b.
 - d. none of the above.
- _____ 2. Ann gives Haken the impression that Carol is Ann's agent, when in fact she is not. Haken deals with Carol as Ann's agent. Regarding any agency relationship, Ann
 - a. can deny it.
 - b. can deny it to the extent of any injury suffered by Haken.
 - c. can deny it to the extent of any liability that might be imposed on Ann.
 - d. cannot deny it.
- _____ 3. Dave is an accountant hired by Eagle Equipment Corporation to act as its agent. In acting as an agent for Eagle, Dave is expected to use
 - a. reasonable diligence and skill.
 - b. the degree of skill a reasonable person would use under similar circumstances.
 - c. the special skills he has as an accountant.
 - d. none of the above.
- _____ 4. EZ Sales Company hires Jill as a sales representative for six months at a salary of \$5,000 per month, plus a commission of 10 percent of sales. In matters concerning EZ's business, Jill must act
 - a. solely in EZ's interest.
 - b. solely in Jill's interest.
 - c. solely in the interest of the customers.
 - d. in none of the above ways.

- _____ 5. Bass Corporation hires Onika to manage one of its stores. Bass does not specify whether or to what extent Onika has the authority to contract with third parties. The express authority that Bass gives Onika to manage the store implies authority to do
- whatever is customary to operate the business.
 - whatever can be inferred from the manager's position.
 - both a and b.
 - none of the above.
- _____ 6. Ron orally engages Dian to act as his agent. During the agency, Ron knows that Dian deals with Mary. Ron also knows that Pete and Brad are aware of the agency but have not dealt with Dian. Ron decides to terminate the agency. Regarding notice of termination,
- Dian need not be notified in writing.
 - Dian's actual authority terminates without notice to her of Ron's decision.
 - Dian's apparent authority terminates without notice to Mary.
 - Pete and Brad must be directly notified.
- _____ 7. Smith Petroleum, Inc., contracts to sell oil to Jones Petrochemicals, telling Jones that it is acting on behalf of "a rich Saudi Arabian who doesn't want his identity known." Smith signs the contract, "Smith, as agent only." In fact, Smith is acting on its own. If the contract is breached, Smith may
- not be liable because Smith signed the contract as an agent.
 - not be liable unless Jones knew Smith did not have authority to act.
 - be liable unless Jones knew Smith did not have authority to act.
 - be liable because Smith signed the contract as an agent.
- _____ 8. Zuri is employed by American Grocers to buy and install a computer system for American's distribution network. When the system is set up and running, the agency
- terminates automatically.
 - terminates after fourteen days.
 - continues for one year.
 - continues indefinitely.

Answering More Legal Problems

1. Winona contracted with XtremeCast, a broadcast media firm, to cohost an internet-streaming sports program. Winona and XtremeCast signed a new contract for each episode. In each contract, Winona agreed to work a certain number of days for a certain salary. During each broadcast, Winona was free to improvise her performance. She had no other obligation to work for XtremeCast.
2. General Retail Associates (GRA) owned Valley Mall. Reliable Property Management Company operated the mall on GRA's behalf. Reliable leased the storefronts to tenants, including GameOn, and contracted with Sweep Clean, Inc., to remove ice and snow from the sidewalks around the mall. Each contract identified GRA as the mall's owner. Kiko, a GameOn employee, slipped on a patch of ice that Sweep Clean had negligently failed to remove.

Was Winona an independent contractor? Yes. Independent contractors are not employees, because those who hire them have no _____ over the details of their performance. An independent contractor is a person who contracts with another—the principal—to do something but who is neither _____ by the other nor subject to the other's right to _____ with respect to the performance. Thus, whether a person hired by another is an employee or an independent contractor depends on the extent of _____. The greater the employer's _____ over the work, the more likely it is that the worker is an employee.

Was Reliable liable for Kiko's injury? No. A principal whose identity is known by a third party at the time that party enters into a contract with an agent is a(n) _____ principal. This type of principal is liable under a contract that an agent, acting within the scope of their authority, enters into with a third party on the principal's behalf. Ordinarily, the agent is not liable under the contract. In this case, because the identity of the principal (GRA) was fully _____ in the contracts that Reliable entered into on GRA's behalf, the agent could not be held liable under those contracts for Kiko's injury. Of course, GRA and Sweep Clean may be liable.

26

Employment, Immigration, and Labor Law

Conflict Presented

A U.S. Department of Transportation rule requires employees engaged in oil and gas pipeline operations to submit to random drug testing. An employee need not be suspected of drug use to be tested under this rule.

Q If the employees challenge this rule in court, will the rule be upheld?

Until the early 1900s, most employer–employee relationships were governed by the common law. Even today, under the common law employment-at-will doctrine, private employers are generally free to hire and fire workers at will, unless doing so violates an employee’s contractual or statutory rights. Now, however, there are numerous statutes and administrative agency regulations that affect the workplace.

26–1 Employment at Will

Traditionally, employment relationships have been governed by the **employment-at-will doctrine**. Under this doctrine, the employee or employer may terminate the employment relationship at any time and for any reason. Most U.S. employees are considered “at-will employees.”

Federal statutes, however, have modified the employment-at-will doctrine to protect some employees who report employer wrongdoing. Additionally, court rulings have carved out exceptions to the doctrine, including those discussed next.

26–1a Statutory Exceptions

To encourage workers to report employer wrongdoing, such as fraud, most of the states and the federal government have enacted whistleblower statutes. These statutes protect **whistleblowers** (employees who report wrongdoing) from employer retaliation (such as being fired). These statutes may also provide an incentive to disclose information by providing the whistleblower with a reward.

Highlighting the Point

Rebecca is the staff coordinator at a nursing home. One of the patients is wheelchair-bound and can be moved only by two persons using a special belt. Rebecca discovers that the patient has been improperly moved and has been injured as a result. She reports the incident to state authorities, as she is required to do by state law. Rebecca’s supervisor confronts her about the report and fires her.

(Continues)

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 State exceptions to the employment-at-will doctrine.
- 2 Describe the major provisions of the Fair Labor Standards Act.
- 3 Identify the benefits of the Social Security Act.
- 4 Name the two most important federal statutes governing immigration.
- 5 Identify the federal law allowing workers to organize unions and to engage in collective bargaining.

employment-at-will doctrine

A doctrine under which an employment contract may be terminated at any time and for any reason.

Learning Outcome 1

State exceptions to the employment-at-will doctrine.

whistleblower

An employee who publicly reveals an employer’s unsafe or illegal activity.



Is Rebecca entitled to be reinstated in her job? Yes. Even though Rebecca is an employee at will, she is protected in this instance from retaliatory discharge under her state's whistleblower statute. Because Rebecca was required by state law to report the improper treatment of the patient, she cannot be fired from her job.

26–1b Contract-Based Exceptions

An express employment contract can protect an employee from discharge without good cause. Some courts also have held that an implied employment contract exists between the employer and the employee. If an employee is fired outside the terms of this implied contract, they may succeed in an action for breach of contract.

Example 26.1 Budge Enterprise's employee manual states that, as a matter of policy, workers will be dismissed only for good cause. Martin, an employee, reasonably expects Budge to follow this policy, but Martin is fired for no stated reason. Because there is an implied contract based on the terms stated in the employee manual, Martin may prevail in a subsequent lawsuit. ■

26–1c Public-Policy Exceptions

The most common exception to the employment-at-will doctrine is the public-policy exception. Under this rule, an employer may not fire a worker for reasons that violate a fundamental public policy of the jurisdiction.

Example 26.2 Rihanna works for Coastal Wholesalers. When Rihanna serves as a juror and misses her regular work shift, Coastal cannot fire her. Similarly, if Coastal fires Rihanna for refusing a management order to do something illegal, in most states, her firing would be held to violate public policy. ■

26–2 Worker Protections

A number of important state and federal laws are aimed at protecting workers. For instance, workers' health and safety are protected by workers' compensation laws at the state level and by the Occupational Safety and Health Act at the federal level. Other laws address additional aspects of the work environment. These include such diverse federal laws as the Family and Medical Leave Act, the Fair Labor Standards Act, and the Electronic Communications Privacy Act.

26–2a State Workers' Compensation Laws

State **workers' compensation laws** establish an administrative procedure for compensating workers who are injured on the job or in the course of their employment, regardless of fault or negligence. Under such a law, an employee injured on the job does not sue the employer. Instead, the injured worker files a claim with the state administrative agency that handles local workers' compensation claims.

Requirements For the worker to recover monetary benefits under a state's workers' compensation law, the injury must have been accidental and must have occurred in the course of employment. Recovery under a workers' compensation statute is limited to the specific amount designated in the statute for the employee's injury.

workers' compensation laws
State statutes to compensate workers for on-the-job injuries, regardless of fault.

Highlighting the Point



Kiana is a computer programmer for Regional Electric Corporation. After too many consecutive hours working on a computer, she begins to suffer pain in her wrists and numbness in her fingers. Howard, a Regional lineman, breaks his foot in a fall from a utility pole. While working in Regional's cafeteria, Winnie, who is an assistant cook, spills a pot of boiling water on her legs, causing severe burns.

Are Kiana, Howard, and Winnie eligible for workers' compensation benefits? Yes. All three Regional employees are eligible because their injuries occurred in the course of employment.

Noncompensable Injuries Intentionally inflicted self-injury is not considered accidental and hence is not covered by workers' compensation law. Additionally, if an injury occurs while an employee is commuting to or from work, it usually is not considered to have occurred in the course of employment and hence is not covered.

Example 26.3 Fabien, an employee of Ellson Electronics, drives to and from his job in his personal vehicle each workday. During one morning commute, an uninsured driver hits Fabien's car after running a red light. Fabien suffers serious injuries. His injuries are not compensable under state workers' compensation law. ■

26–2b Occupational Safety and Health Act

At the federal level, the primary legislation for employee health and safety protection is the Occupational Safety and Health Act. The act requires that businesses be maintained free from recognized hazards. Employers with eleven or more employees are required to keep occupational injury and illness records for each employee.

Whenever a work-related injury or disease occurs, employers are required to make reports directly to the Occupational Safety and Health Administration (OSHA). An employer cannot discharge an employee who files a complaint or who, in good faith, refuses to work in a high-risk area (if bodily harm or death might result).

26–2c Family and Medical Leave

The Family and Medical Leave Act (FMLA) requires employers with fifty or more employees to provide employees with up to twelve weeks of unpaid family or medical leave for any twelve-month period. An eligible employee may take unpaid leave under the FMLA to care for family members for any of the following reasons:

1. To care for a newborn baby within one year of birth.
2. To care for an adopted or foster child within one year of the time the child is placed with the employee.
3. To care for the employee's spouse, child, or parent who has a serious health condition.
4. If the employee suffers from a serious health condition and is unable to perform the essential functions of her or his job.
5. For any qualifying non-medical emergency arising out of the fact that the employee's spouse, son, daughter, or parent is a covered military member on active duty.

Example 26.4 An employee can take leave to arrange for childcare or to deal with financial or legal matters when a spouse is being deployed overseas. ■

During the employee's leave, the employer must continue the worker's health care coverage and guarantee employment in the same (or a similar) position when the employee returns to work.

Learning Outcome 2

Describe the major provisions of the Fair Labor Standards Act.

minimum wage

The lowest hourly wage that an employer can legally pay an employee.

26–2d Wage and Hour Laws

In the 1930s, Congress enacted several laws regulating the wages and working hours of employees. The most significant of these laws was the Fair Labor Standards Act (FLSA). The FLSA is concerned with child labor, minimum wages, and overtime.

Child Labor Restrictions To protect children from exploitation and to ensure their health and safety, the FLSA sets forth many restrictions on the use of child labor. In particular, the law protects all children under eighteen from working in hazardous jobs. Children under fourteen can work only in certain jobs, such as delivering newspapers. For children who do work, total working hours per week are very limited.

Minimum Wage Requirement A federal **minimum wage** of a specified amount must be paid to employees in covered industries. Note that many states require a minimum wage that is higher than the federal wage. Employers must pay the higher minimum wage in those states.

Overtime Provisions and Requirements Under the FLSA, an employee who works more than the maximum of forty hours per week must be paid no less than 1.5 times their regular pay rate for all hours over forty. Employees who are covered include manual laborers and other blue-collar workers who perform tasks involving repetitive operations with their hands.

Employees whose jobs are categorized as executive, administrative, or professional, as well as outside salespersons, are exempt from the FLSA's overtime provision. Questions may sometimes arise as to whether an employee should be classified as exempt. The answer depends on the employee's primary duty. An executive employee, for instance, is one whose primary duty is management. An employee's primary duty is determined by what task they do that is of most value to the employer, not by how much time the employee spends doing particular tasks. Regulations also provide that employers are not required to pay overtime to workers who make more than \$35,568.



Highlighting the Point

Kevin, a manager at Oakdale Coffee House, works seventy hours a week for \$650 to \$800, a 10 to 20 percent bonus, and paid sick leave. Kevin asks Oakdale to pay him overtime, claiming that he spends 70 to 80 percent of his time waiting on customers and thus is not an executive employee.

Is Kevin entitled to be paid overtime? No. Kevin is the single highest-ranking employee in his store and is responsible for that store's on-site day-to-day operations. Because his primary duty is managerial, Oakdale is not required to pay him overtime.

26–2e Employee Privacy

Concerns about the privacy rights of employees have increased as employers use more invasive tactics to monitor and screen workers. In the past, areas of privacy concern included lie-detector tests and drug testing. More recently, the electronic monitoring of employees' activities at work has become a hot-button topic.

Lie-Detector Tests Today, the Employee Polygraph Protection Act generally prohibits employers from requiring employees or job applicants to take lie-detector

tests or requesting that they do so. The act also restricts employers' ability to use or ask about the results of any lie-detector test or to take a negative employment action based on the test results.

Drug Testing In many states, the state constitution or a state statute may protect employee privacy by restricting drug testing by private (nongovernment) employers. Additionally, a collective bargaining agreement—a contract between a union and a company's management—may also provide protection against employee drug testing.

Federal constitutional limitations apply to the testing of government employees. The Fourth Amendment provides that individuals have the right to be “secure in their persons” against “unreasonable searches and seizures” conducted by the government. Drug tests, however, have been held constitutional when (1) there was a reasonable basis for suspecting a government employee's use of drugs and (2) drug use in a particular government job could threaten public safety.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, a U.S. Department of Transportation rule requires employees engaged in oil and gas pipeline operations to submit to random drug testing. An employee need not be suspected of drug use to be tested under this rule.

A **If the employees challenge this rule in court, will the rule be upheld?** Yes. The government's interest in promoting public safety in the pipeline industry outweighs the employees' privacy interests.

Electronic Monitoring More than half of employers engage in some form of electronic monitoring of their employees. Employees of private employers have some privacy protection under tort law and state constitutions. In addition, state and federal statutes may limit an employer's conduct in certain respects. For instance, the Electronic Communications Privacy Act prohibits the intentional interception of any wire, oral, or electronic communications—which today, includes e-mail, social media posts, cell phone conversations and texting, and voice messages.

There is an important business-extension exception to this act. When an employer provides electronic devices to employees for ordinary business use, the employer is allowed to intercept and monitor all business communications made on those devices. The company cannot, however, monitor its employees' personal communications (unless given permission).

When determining whether an employer should be held liable for violating an employee's privacy rights, the courts generally weigh the employer's interests against the employee's reasonable expectation of privacy. In most situations, if an employer has informed its employees that their electronic communications on company devices and equipment are being monitored, they cannot reasonably expect their exchanges and messages on those devices to be private.

26–3 Retirement Income and Security

Federal and state governments participate in insurance programs designed to protect employees and their families by covering the financial impact of retirement, disability, death, hospitalization, and unemployment.

Learning Outcome 3

Identify the benefits of the Social Security Act.

26–3a Social Security

The Social Security Act of 1935 provides for old-age (retirement), survivors, and disability insurance. This act created government programs to ensure income security (through monthly monetary benefits) for retirees, people too disabled to work, and for children of workers who have died. These social insurance programs are administered by the Social Security Administration.

To pay for the programs, both employers and employees must contribute under the Federal Insurance Contributions Act (FICA). The basis for the employee's contribution is the employee's annual wage base—the maximum amount of wages that are subject to the tax. Benefits are fixed by statute but increase automatically with increases in the cost of living.

26–3b Medicare

Another social insurance program is Medicare, which provides health insurance to older U.S. citizens. The Social Security Administration administers Medicare, which is available to people sixty-five years of age and older and for some under age sixty-five who have disabilities. Medicare covers hospital costs and other medical expenses, such as visits to doctors' offices. Both employers and employees must contribute to help pay for the cost of Medicare.

26–3c Private Retirement Plans

Significant legislation has been passed to regulate retirement plans set up by employers to supplement Social Security benefits. The major federal act covering these retirement plans is the Employee Retirement Income Security Act (ERISA). The Labor Management Services Administration of the U.S. Department of Labor enforces the ERISA provisions that cover employer-provided private pension funds.

26–3d Unemployment Compensation

The U.S. system of unemployment insurance was established by the Federal Unemployment Tax Act. The act created a state system that provides unemployment compensation to eligible individuals who lose their jobs. Under this system, employers pay into a fund, and the proceeds are paid out to qualified unemployed workers.

To be eligible for unemployment compensation, a worker must be willing and able to work. A worker who has been fired for misconduct or who has voluntarily left the job does not qualify for benefits. When disputes arise over whether an employee qualifies for benefits, courts often refer to state statutes, as well as the unique circumstances surrounding the employee's reasons for leaving, to help them decide.

Example 26.5 Martha works for Bailey Snowboards in Vermont. One day at work, Martha receives a text from her son saying that he has been taken to the hospital. Martha rushes to the hospital and does not return to work for several days. Bailey hires someone else for Martha's position, and Martha files for unemployment compensation benefits. Martha's claim is denied because she left her job voluntarily and made no effort to maintain contact with her employer. ■

26–3e Group Health Plans

The Health Insurance Portability and Accountability Act (HIPAA) establishes requirements for employers that choose to provide health insurance coverage for their employees. Under HIPAA, an employer cannot exclude persons from coverage for "preexisting conditions" (conditions for which medical advice, diagnosis,

care, or treatment was recommended or received within the previous six months). Covered employers must also ensure that employees' health information is not disclosed to unauthorized parties.

Example 26.6 Mack receives a medical diagnosis of diabetes. Less than six months later, Northeast Mills hires Mack. Northeast Mills cannot exclude Mack from employer-subsidized group health insurance on the basis of his preexisting condition of diabetes. ■

26–3f The Affordable Care Act

The Affordable Care Act (ACA, commonly referred to as Obamacare) requires most employers with fifty or more fulltime employees to offer health insurance benefits. Under the act, any business offering health benefits to its employees, even if it is not legally required to do so, may be eligible for tax credits up to 35 percent to offset the cost.

Under the “50/30 Rule,” the ACA applies to businesses that employ at least fifty workers for at least thirty hours a week. The ACA also applies to any mathematical equivalent of fifty workers for thirty hours, so a business that employs one hundred workers for fifteen hours a week falls under the ACA requirements. An employer who fails to provide health benefits as required can be fined up to \$2,000 for each employee. An employer who offers a plan that costs an employee more than 9.5 percent of the employee's income may have to pay a penalty of \$3,000 per insured worker.

26–3g COBRA

The Consolidated Omnibus Budget Reconciliation Act (COBRA) prohibits an employer from eliminating a worker's medical, optical, or dental insurance coverage on the voluntary or involuntary termination of the worker's employment. The act includes most workers who have either lost their jobs or had their hours decreased and are no longer eligible for coverage under the employer's health plan. Only workers fired for gross misconduct are excluded from protection.

Highlighting the Point



Elena and Jim are employees of Kitchen Crafts, an employer subject to COBRA. Elena loses her job as part of a company-wide layoff. Jim loses his job as a consequence of hitting Laredo, his supervisor, in anger (considered a gross misconduct).

Are Elena and Jim eligible for continued health insurance coverage under COBRA? Yes for Elena. No for Jim. Workers who lose their jobs with Kitchen Crafts—or any other employer subject to COBRA—have a right to continued health care coverage under the company's group plan unless they are fired for gross misconduct.

26–4 Immigration Law

Immigration law has become increasingly important in recent years. Over eleven million undocumented immigrants live in the United States. Because U.S. employers face serious penalties if they hire undocumented workers, it is necessary for businesspersons to understand immigration laws. The most important laws governing immigration and employment of noncitizens are the Immigration Reform and Control Act and the Immigration Act.

Learning Outcome 4

Name the two most important federal statutes governing immigration.

26–4a The Immigration Reform and Control Act

The Immigration Reform and Control Act (IRCA) makes it illegal to hire, recruit, or refer for a fee someone not authorized to work in this country. The federal government conducts random compliance audits and engages in enforcement actions against employers who hire undocumented workers.

To comply with the IRCA, an employer must complete Form I-9, Employment Eligibility Verification, for each new hire within three days of the start of employment. The three-day period allows an employer to check the form's accuracy and to review and verify documents establishing the worker's identity and eligibility for employment in the United States.

The employer must attest that an employee produced documents establishing their identity and legal employability. Employers must be honest when verifying an employee's documentation. If an employer "should have known" that a worker was unauthorized, the employer has violated the rules.

26–4b The Immigration Act

U.S. immigration laws have long made provisions for businesses to hire foreign workers with special qualifications. Nevertheless, limits have been placed on this practice. The Immigration Act limits the number of legal immigrants entering the United States by capping the number of visas (entry permits) that are issued each year.

Employers recruiting workers from other countries must satisfy the U.S. Department of Labor that there is a shortage of qualified U.S. workers capable of performing the required work. The employer must also establish that bringing foreign workers into this country will not adversely affect the existing labor market in the employer's particular area.

26–5 Labor Law

Learning Outcome 5

Identify the federal law allowing workers to organize unions and to engage in collective bargaining.

In the 1930s, Congress enacted several laws to protect employees' rights to join labor unions, to bargain with management over the terms and conditions of employment, and to conduct strikes. Four major federal statutes regulating union–employer relations are as follows:

1. The Norris-LaGuardia Act—This act restricts the power of federal courts to issue injunctions against unions engaged in peaceful strikes. In effect, this act declares a national policy permitting employees to organize.
2. The National Labor Relations Act (NLRA)—The NLRA establishes the rights of private-sector employees to form unions, to negotiate with employers over employment conditions, and to strike. The act also defines a number of unfair labor practices. The National Labor Relations Board (NLRB) has the power to investigate employee charges of unfair labor practices and to issue complaints against employers in response to those charges.



Real Case

Ozburn-Hessey Logistics (OHL) had a discipline policy under which an employee could be fired for accumulating thirteen tardiness and absent "points." Shortly after OHL replaced its push-button clocks with touchscreen logs, employee Laura Keel checked in one minute late. She claimed that the new system confused her, causing the delay. Nonetheless, OHL assessed Keel a tardiness point, her thirteenth, and she was fired.

Should the NLRB file a complaint against OHL? And if so, will it prevail? Yes. And no. The NLRB did file a complaint for unfair labor practices, asserting that the upgrade in clocks should have been negotiated with Keel's union. Because it was not, her firing violated federal labor law. An administrative law judge, though, determined that pushing the touchscreen rather than a plastic button did not represent a "significant" change in the terms of Keel's employment. In *Ozburn-Hessey Logistics, LLC v. NLRB*, the U.S. Court of Appeals for the 6th Circuit agreed. OHL's decision to switch clocks did not require collective bargaining, and Keel's firing was not an unfair labor practice.

—803 F.Appx. 876 (U.S. Ct. of App. 6th Cir.)

3. The Labor-Management Relations Act (LMRA)—The LMRA was passed to prohibit certain unfair union practices. For instance, the act outlaws the **closed shop**, which requires union membership as a condition of obtaining employment. The act preserves the legality of the **union shop**, which does not require membership as a prerequisite for employment but usually requires that workers join the union after a specified amount of time on the job. The act also allows individual states to pass **right-to-work laws**—laws making it illegal for union membership to be required for continued employment.
4. The Labor-Management Reporting and Disclosure Act—This act establishes an employee bill of rights and reporting requirements for union activities to prevent corruption. The act strictly regulates internal union business procedures, such as elections for union officers.

closed shop

A firm that requires union membership as a condition of employment.

union shop

A firm in which all workers must become union members within a specified period of time.

right-to-work law

State law prohibiting union membership as a job requirement.

26–5a Union Organization

Typically, the first step in organizing a union at a particular firm is to have the workers sign authorization cards. An **authorization card** states that a worker desires to have a certain union represent the workforce. If a majority of the workers sign authorization cards, the union organizers present the cards to the employer and ask for formal recognition of the union.

If the employer refuses—or if fewer than 50 percent of the workers sign authorization cards—the union organizers present the cards to the NLRB with a petition for an election.

For an election to be held, the organizers must show that at least 30 percent of the workers support a union or an election on unionization. The proposed union must also represent an appropriate bargaining unit—that is, employees whose skills, duties, and pay are similar. The NLRB supervises the election. If the proposed union receives a majority of the votes, the NLRB certifies the union as the bargaining representative of the employees.

authorization card

A card permitting a union to act for an employee.

26–5b Collective Bargaining

After the NLRB certifies a union, the union's local office will be authorized to negotiate with management on behalf of the workers in the bargaining unit.

Collective bargaining—the process by which labor and management negotiate the terms and conditions of employment—is at the heart of the federal labor laws.

collective bargaining

The process by which labor and management negotiate the terms and conditions of employment.

Negotiating Terms and Conditions Wages, hours of work, and certain other conditions of employment may be discussed during collective bargaining sessions. Subjects for negotiation may include workplace safety, employee discounts, health care plans, pension funds, and apprentice programs.

Good Faith Once an employer and a union sit down at the conference table, they must negotiate in good faith and make a reasonable effort to come to an agreement. They are not obligated to reach an agreement. They must, however, approach the negotiations with the idea that an agreement is possible. Both parties may engage in hard bargaining, but the bargaining process itself must be geared to reaching a compromise.

Employer Unfair Labor Practices Recall that the NLRA defines a number of unfair labor practices. For employers, the most significant unfair labor practices include the following:

1. Refusal to recognize and negotiate—An employer's failure to recognize and bargain in good faith with a union over issues affecting all employees in the bargaining unit is an unfair labor practice.
2. Interference in union activities—An employer may not interfere with, restrain, or coerce employees in the exercise of their rights to form a union and bargain collectively. For instance, it is an unfair practice for an employer to make threats that may interfere with an employee's decision to join a union. Even asking employees about their views on the union may be considered coercive. In addition, employers may not prohibit certain forms of union activity in the workplace.
3. Discrimination—Employers cannot discriminate against workers because they are union officers or are otherwise associated with a union. When workers must be laid off, for instance, the company cannot consider union participation as a criterion for deciding whom to fire.

strike

Unionized workers' refusal to work when collective bargaining fails.

Strikes Sometimes, a union and an employer may approach the bargaining table in good faith but simply be unable to reach an agreement because of genuine differences of opinion. If the parties are deadlocked, the union may call a **strike** against the employer. The right to strike is of fundamental importance to the collective bargaining process because it is a threat that the union can use to offset the disparity in bargaining power between management and labor.

Chapter Summary—Employment, Immigration, and Labor Law

Learning Outcome 1: State exceptions to the employment-at-will doctrine.

Under the employment-at-will doctrine, either party may terminate an employment relationship at any time and for any reason. Both statutes and court decisions have carved out exceptions to the doctrine. These include whistleblower statutes, contract-based exceptions, and public-policy exceptions.

Learning Outcome 2: Describe the major provisions of the Fair Labor Standards Act.

The Fair Labor Standards Act (FLSA) is concerned with child labor, minimum wage, and overtime provisions. For instance, the law protects all children under eighteen from working in hazardous jobs. A federal minimum wage must be paid to all covered employees. Employees are entitled to 1.5 times their regular hourly pay for any hours worked in excess of forty hours per workweek. Employees who are categorized as executive, administrative, or professional are exempt from the FLSA's overtime pay requirements.

Learning Outcome 3: Identify the benefits of the Social Security Act.

The Social Security Act of 1935 helps U.S. retirees, disabled citizens, and children (survivors) of deceased workers by providing income security through monthly monetary benefits.

Learning Outcome 4: Name the two most important federal statutes governing immigration.

The most important federal statutes governing immigration and the employment of noncitizens are the Immigration Reform and Control Act (IRCA) and the Immigration Act. The IRCA prohibits the hiring of illegal immigrants. Employers must verify the employment eligibility of each new employee.

The Immigration Act limits legal immigration. Under this act, to bring workers into the United States, an employer must show that there is a shortage of such workers and that the foreign workers' presence will not affect the relevant labor market.

Learning Outcome 5: Identify the federal law allowing workers to organize unions and to engage in collective bargaining.

The National Labor Relations Act is the federal statute that gives employees the right to organize unions and bargain collectively.

Straight to the Point

1. What are the eligibility requirements for unemployment compensation? (See Learning Outcome 3.)
2. How much unpaid family or medical leave must an employer with fifty or more employees provide? (See Learning Outcome 2.)
3. Which federal law is concerned with child labor, minimum wages, and overtime? (See Learning Outcome 2.)
4. When are employers allowed to monitor employees' use of electronic devices? (See Learning Outcome 2.)
5. When can an employer legally hire someone not authorized to work in this country? (See Learning Outcome 4.)
6. What process is at the heart of the federal labor laws? (See Learning Outcome 5.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. American Manufacturing Company (AMC) issues an employee handbook that states that employees will be discharged only for good cause. One day, Greg, an AMC supervisor, says to Larry, "I don't like your looks. You're fired." Can AMC be held liable for breach of contract? If so, why? If not, why? (See Learning Outcome 1.)
2. Erin, an employee of Fine Print Shop, is injured on the job. For Erin to obtain workers' compensation, does her injury have to have been caused by Fine Print's negligence? Does it matter whether the action causing the injury was intentional? Explain. (See Learning Outcome 2.)

Real Law

26–1. Occupational Safety and Health Act. Packers Sanitation Services, Inc., provides cleaning service to a poultry processing facility in Georgia. At the facility is a machine known as a quill puller, which is used to remove chickens' tail feathers. A Packers employee, when hosing down the quill puller, stepped too close to the machine. Its rotating augers caught the employee's glove, pulled in his hand, and amputated a fingertip. The Occupational Safety and Health Administration cited Packers for failing to appropriately guard the quill puller. Packers contested the citation, arguing that the

injured employee had violated a workplace rule requiring each employee to stay at least two feet away from an active quill puller. An administrative law judge affirmed the violation. Packers appealed to the U.S. Court of Appeals for the 11th Circuit. Did Packers violate the machine-guarding standard? [*Packers Sanitation Services, Inc., v. Occupational Safety and Health Review Commission*, 795 F.Appx. 18 (U.S. Ct. of App. 11th Cir., 2020)] (See Learning Outcome 2.)

26–2. Unemployment Compensation. Jefferson Partners entered into a collective bargaining agreement (CBA)

with the Amalgamated Transit Union. Under the CBA, employees had to either join the union or pay a fair share—85 percent—of union dues, which were used to pay for administrative costs incurred by the union. An employee who refused to pay was subject to discharge. Jefferson hired Tiffany Thompson to work as a bus driver. When told of the CBA requirement, she refused either to join the union or to pay the dues. She was fired on the ground that her refusal constituted misconduct. Is Thompson eligible for unemployment compensation? Explain. [*Thompson v. Jefferson Partners*, 2016 WL 953038 (Minn.App. 2016)] (See Learning Outcome 3.)

26-3. Unemployment Compensation. Fior Ramirez worked as a housekeeper for Remington Lodging & Hospitality, a

hotel in Florida. When her father, who lived in the Dominican Republic, had a stroke, Ramirez asked her manager, Katie Berkowski, for time off to be with him. Berkowski refused the request. Two days later, Berkowski got a call from Ramirez to say that she was with her father. He died about a week later. When Ramirez returned to work, Berkowski claimed Ramirez had voluntarily abandoned her position. Ramirez then applied for unemployment compensation. Under the applicable Florida statute, “an employee is disqualified from receiving benefits if he or she voluntarily left work without good cause.” Does Ramirez qualify for benefits? Explain. [*Ramirez v. Reemployment Assistance Appeals Commission*, 135 So.3d 408 (Fla.App. 2014)] (See Learning Outcome 3.)

Ethical Questions

26-4. Workers’ Compensation. Should workers’ compensation be denied to a worker who is injured off the employer’s premises, regardless of the reason the worker is off the premises? Why or why not? (See Learning Outcome 2.)

26-5. Immigration Law. Split Rail Fence Company sells and installs fencing materials in Colorado. U.S. Immigration and Customs Enforcement (ICE) sent Split Rail a list of the company’s employees whose documentation did not satisfy the Form I-9 employment eligibility verification requirements. The list included long-term workers who had been

involved in company activities, parties, and picnics. They had bank accounts, driver’s licenses, cars, and mortgages. At Split Rail’s request, the employees orally verified that they were eligible to work in the United States. Unwilling to accept the oral verifications, ICE filed a complaint against Split Rail for its continued employment of the individuals. Identify Split Rail’s ethical dilemma. What steps might the company take to resolve it? Explain. [*Split Rail Fence Co. v. United States*, 852 F.3d 1228 (10th Cir. 2017)] (See Learning Outcome 4.)

Chapter 26—Work Set

True-False Questions

- _____ 1. Employment “at will” means that employers can fire employees only with good cause.
- _____ 2. Employers are required by federal statute to establish health insurance and pension plans.
- _____ 3. Management serves as the representative of the employees in bargaining with the union over the rights of the employees.
- _____ 4. Strikes are protected under federal law.
- _____ 5. In most states, an employer is justified in firing an employee who refuses to do something illegal.
- _____ 6. Workers’ compensation laws set up administrative procedures through which employees recover for work-related injuries.
- _____ 7. Qualifying employers must provide employees with up to twelve weeks of family or medical leave during any twelve-month period.
- _____ 8. A closed shop requires union membership as a condition of employment.
- _____ 9. Employers must complete Form I-9 within three days of a new hire’s start of employment to comply with the Immigration Reform and Control Act.

Multiple-Choice Questions

- _____ 1. Fast Jack is a fast-food restaurant that employs minors. Fast Jack is subject to the federal child labor, minimum wage, and overtime provisions in
 - a. the Family and Medical Leave Act.
 - b. the Consolidated Omnibus Budget Reconciliation Act.
 - c. the Fair Labor Standards Act.
 - d. none of the above.
- _____ 2. Noelia works on the assembly line for Frozen Foods. Noelia and other Frozen Foods employees designate the International Union of Food Workers (IUFW) as their bargaining representative. Without violating federal labor law, Frozen Foods can
 - a. prohibit the IUFW from participating in any union activity in the workplace.
 - b. discharge Noelia for supporting the IUFW.
 - c. refuse to bargain with the IUFW.
 - d. do none of the above.
- _____ 3. U.S. Goods, Inc. (USG) recruits workers from other countries to work in its U.S. plant. To comply with the Immigration Act, USG must show
 - a. that there is a shortage of qualified U.S. workers to perform the work.
 - b. that bringing aliens into the country will not adversely affect the existing labor market in that area.
 - c. both a and b.
 - d. none of the above.
- _____ 4. Josip is an employee of National Sales Company. Contributions to the federal Social Security system are made by
 - a. Josip only.
 - b. National only.
 - c. Josip and National.
 - d. none of the above.

- _____ 5. ABC Box Corporation provides health insurance for its 150 employees, including Eleni. When Eleni takes twelve weeks' leave to care for her new baby, she
- a. can continue her health insurance at her expense.
 - b. can continue her health insurance at ABC's expense.
 - c. loses her health insurance immediately on taking leave.
 - d. is entitled to "leave pay" equal to twelve weeks of health insurance coverage.
- _____ 6. Metalworkers Union represents the workers of National Fabrication Corporation. The employer refuses to bargain with the union over workplace safety. This most likely violates
- a. federal labor law.
 - b. state right-to-work laws.
 - c. federal wage-and-hour laws.
 - d. no federal or state law.
- _____ 7. Norma Jean wants to unionize her fellow workers at Metro West Ambulance Company. She gets a majority of the workers who will be represented by the union to sign authorization cards, but despite this result, Metro West refuses to recognize the union. To hold an election to unionize the workforce, what percentage of the workers must have signed authorization cards?
- a. At least 25 percent.
 - b. At least 30 percent.
 - c. At least 50 percent.
 - d. none of the above.
- _____ 8. Regal Products sets up a pension fund for its employees. Regal's operation of the fund is regulated by
- a. the Federal Unemployment Tax Act.
 - b. the Federal Insurance Contributions Act.
 - c. the Employment Retirement Income Security Act.
 - d. none of the above.

Answering More Legal Problems

1. Mercer Management is a consulting firm that operates an information technology (IT) center to bring greater efficiencies to other businesses and thereby help those companies cut costs. In Mercer's IT center, the firm employs a number of noncitizen temporary programmers with specialized skills, mostly recruited from India.

Do federal immigration laws limit Mercer's hiring practices? Yes. U.S. immigration laws include provisions for businesses to hire _____ workers with _____ qualifications. But these laws also place limits on the practice. For instance, the Immigration Act caps the number of _____ that the federal government issues each year. Employers, such as Mercer, that recruit workers from other countries must show the U.S. Department of Labor that there is a shortage of qualified _____ workers who can perform the work. An employer must also show that bringing the workers into the United States will not adversely affect the existing labor market in the employer's area.

2. Lucy, an emergency medical technician (EMT), was issued a cell phone by her employer, Mercy Ambulance Service. Mercy had a policy that prohibited employees from using work phones and other devices for personal matters. Lucy exceeded Mercy's limit on text messages for the month, so without Lucy's knowledge, Mercy management read her stored messages to determine whether all of the text messages were indeed work-related.

Did Mercy's action violate Lucy's privacy rights? No. When an employer provides an employee with a cell phone or other tech device and has a stated policy about its use, the employee is not considered to have a reasonable expectation of _____ in the data. The employee should anticipate that anything in the device, including texts, is subject to _____. The employer can avoid potential legal restrictions by telling the employees that they are subject to _____. Because Mercy had a stated policy that limited employees' use of tech devices to work-related matters, Lucy had no reasonable expectation of _____ in her use of the phone.



27 | Employment Discrimination

Conflict Presented

Liliana is a paralegal who works for Gable & Mendoza Law, Inc. After the Supreme Court effectively legalizes all same-sex marriages, she marries Diana. Liliana applies to enroll Diana in her employer's health plan, which provides for employees' immediate family members, including spouses. Coverage is denied.

Q Can the denial of coverage be intentional discrimination on the basis of sexual orientation?

Out of the 1960s civil rights movement grew a body of law protecting employees against discrimination in the workplace. In the past several decades, judicial decisions, administrative agency actions, and legislation have restricted the ability of employers to discriminate against workers on the basis of race, color, religion, national origin, gender, sexual orientation, age, or disability. A class of persons defined by one or more of these criteria is known as a **protected class**.

Examples of a member of a protected class include an African American or Native American (racial minority), a pregnant woman (gender), a wheelchair-bound individual (disability), and a homosexual man (sexual orientation). Federal law protects these groups from being discriminated against in the workplace.

Several federal statutes prohibit **employment discrimination** against members of protected classes. Although this chapter focuses on federal statutes, many states have their own laws that protect employees against discrimination. Sometimes, these state statutes provide protection for individuals who are not covered under federal statutes.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Distinguish between disparate-treatment and disparate-impact discrimination.
- 2 Identify the federal act that prohibits age discrimination.
- 3 Explain how employers can avoid liability for disability-based discrimination.
- 4 Identify the defenses to employment discrimination claims.

protected class

A group of persons protected by specific laws because of its defining characteristics.

employment discrimination

Treating employees or job applicants unequally on the basis of race, color, gender, sexual orientation, national origin, religion, age, or disability.

27-1 Title VII of the Civil Rights Act

Title VII of the Civil Rights Act of 1964 prohibits job discrimination against employees, job applicants, and union members on the basis of race, color, national origin, religion, gender, and sexual orientation at any stage of employment. The law applies to employers with fifteen or more employees, labor unions with fifteen or more members, employment agencies, and state and local governing agencies. A special section of Title VII forbids discrimination in most federal government employment.

Compliance with Title VII is monitored by the Equal Employment Opportunity Commission (EEOC). Before filing a lawsuit, a person who alleges discrimination must file a claim with the EEOC. The EEOC then investigates the facts and seeks to achieve a voluntary settlement between the employer and employee. If no

settlement is reached, the EEOC may sue the employer. If the EEOC chooses not to sue, the victim of discrimination may bring their own lawsuit.

27–1a Intentional Discrimination

Learning Outcome 1

Distinguish between disparate-treatment and disparate-impact discrimination.

disparate-treatment discrimination

Intentional discrimination against individuals on the basis of color, gender, sexual orientation, national origin, race, or religion.

prima facie case

A case in which plaintiffs produce sufficient evidence to prove their conclusion if no evidence rebuts it.

Title VII prohibits intentional discrimination. Intentional discrimination by an employer against an employee is known as **disparate-treatment discrimination**. The courts have established specific procedures for resolving disparate-treatment cases.

Prima Facie Case Plaintiffs who sue on the basis of disparate-treatment discrimination in hiring must show the following:

1. They were members of a protected class.
2. They applied and were qualified for the job in question.
3. They were rejected by the employer.
4. The employer continued to seek applicants for the position or filled the position with a person not in a protected class.

If these four requirements can be met, the plaintiff makes out a **prima facie case** of illegal discrimination. (*Prima facie* is Latin for “at first sight.” Legally, it refers to a fact that is presumed to be true, unless contradicted by evidence.) Note that when plaintiffs allege that an employer fired or took some other adverse employment action against them, the same basic requirements apply.



Highlighting the Point

Chloe, an African American, is a loan officer for Funds Reserve Bank. She applies for the position of branch manager. Chloe meets the job's requirements, including a college degree and a minimum of five years of experience in financial services. Funds Reserve rejects her application. One month later, the bank promotes Chloe's coworker, Garth, a white male with similar qualifications, to the position.

Can Chloe establish a prima facie case of illegal discrimination? Yes. Chloe is a member of two protected classes—she is an African American woman. She applies for the job of branch manager, a position for which she is qualified. Her employer rejects her and later fills the position with Garth, a person who is not a member of a protected class.

Burden-Shifting Procedure Once the *prima facie* case is established, the burden shifts to the employer, who must identify a legal reason for not hiring the plaintiff. If the employer did not have a legal reason, the plaintiff wins.

If the employer identifies a legal reason for the action, the burden shifts back to the plaintiff. The plaintiff must then show that the employer's reason is a pretext (not the true reason) and that the employer's decision was actually motivated at least, in part, by discriminatory intent.

27–1b Unintentional Discrimination

disparate-impact discrimination

Discrimination resulting from certain employer practices or procedures that, although not overtly discriminatory, have a discriminatory effect.

In addition to intentional discrimination, Title VII also prohibits unintentional discrimination. **Disparate-impact discrimination** occurs when a protected class is adversely affected by an employer's practices or procedures, even though they do not appear to be discriminatory. For instance, employers often use tests to select among applicants for job openings. These tests may have unintended discriminatory effects on a protected class.

In a disparate-impact discrimination case, the complaining party must first show statistically that the employer's practices or procedures were discriminatory in effect. Once the plaintiff has made out a *prima facie* case, the burden of proof shifts to the employer to show that the practices or procedures in question were justified.

Example 27.1 Shady Cove District Fire Department administers an exam to applicants for the position of firefighter. One hundred white applicants take the test, and fifty pass and are hired. Sixty people of color take the test, but only twelve pass and are hired. The test has excluded members of a protected class from the department at a substantially higher rate than nonmembers. Disparate-impact discrimination has therefore occurred. ■

27–1c Discrimination Based on Race, Color, and National Origin

Title VII prohibits employers from discriminating on the basis of race, color, or national origin. Race is interpreted broadly to apply to the ancestry or ethnic characteristics of a group of persons, such as Native Americans. National origin refers to a person's nationality, ancestry, or culture, such as Middle Eastern or Asian. **Example 27.2** Luis, who is of Puerto Rican heritage, is hired at Albertson's grocery store in San Diego. A training video instructs employees not to speak Spanish if there is a non-Spanish speaking customer present. On his third day at Albertson's, Luis is reprimanded by a supervisor for speaking Spanish to a Latinx customer. Later Luis is prohibited from speaking Spanish with his coworkers during breaks. He is also harassed by other employees for speaking Spanish at any time. Luis files a claim with the Equal Employment Opportunity Commission (EEOC) because of this treatment. In turn, the EEOC sues Albertson's, alleging that its enforcement of an unwritten, blanket "speak-English-only" policy is a form of national origin discrimination under Title VII. ■

If an employer's standards or policies for selecting or promoting employees have a discriminatory effect on employees or job applicants in these protected classes, then a presumption of illegal discrimination arises. To avoid liability, the employer must show that its standards or policies have a substantial, demonstrable relationship to realistic qualifications for the job.

27–1d Discrimination Based on Religion

Employers cannot treat employees more or less favorably based on the employees' religious beliefs or practices. Additionally, employers cannot require employees to participate in any religious activity (or forbid them from participating in one). **Example 27.3** Bailey is a salesperson for Country Village Car & Truck Sales when she is discharged for failing to attend the weekly prayer meetings of the dealership's employees. Bailey has a valid claim of religious discrimination. ■

27–1e Discrimination Based on Gender

Employers are also prohibited from classifying or advertising jobs as male or female, unless they can prove that the gender of the applicant is essential to the job. In addition, employers cannot have separate male and female seniority lists and cannot refuse to promote employees based on their gender.

Pregnancy Discrimination The Pregnancy Discrimination Act of 1978 expanded the definition of gender discrimination to include discrimination based on pregnancy. As a result, women affected by pregnancy, childbirth, or related medical conditions must be treated the same as persons who do not have these conditions and are similar in ability to work.

Wage Discrimination The Equal Pay Act of 1963 requires equal pay for male and female employees working at the same establishment doing similar work. To determine whether the Equal Pay Act has been violated, a court will look at the primary duties of the two jobs. In other words, the content rather than the formal job description controls.

Gender Discrimination Lawsuits To succeed in a lawsuit for gender discrimination in the workplace, a plaintiff must demonstrate that gender was a determining factor in the employer's hiring decisions or employment actions.

Conflict Resolved

Liliana is a paralegal who works for Gable & Mendoza Law, Inc. After the Supreme Court effectively legalizes all same-sex marriages, she marries Diana. Liliana applies to enroll Diana in her employer's health plan, which provides for employees' immediate family members, including spouses. Coverage is denied.

A Can the denial of coverage be intentional discrimination on the basis of sexual orientation? Yes. Most likely, the company's denial of health insurance is intentional discrimination on the basis of sexual orientation. Diana appears to have been treated differently than other spouses and to have been denied benefits because of her sexual orientation.

27-1f Discrimination Against Transgender Persons

In the past, most courts held that federal law (Title VII) does not protect transgender persons from discrimination. Until 2020, many courts started interpreting Title VII as applicable to discrimination because of sexual orientation. Then the Supreme Court, in the case of *Bostock v. Clayton County*, ruled that an employer who fires an individual merely for being gay, lesbian, or transgender violates Title VII. In other words, adverse employment decisions based on gender identity are necessarily a form of gender discrimination and therefore illegal.

27-1g Constructive Discharge

constructive discharge
When working conditions compel an employee to leave.

In some situations, employees who leave their jobs voluntarily can claim that they were "constructively discharged" by the employer. Under Title VII, **constructive discharge** occurs when the employer causes the employee's working conditions to be so intolerable that a reasonable person in the employee's position would feel compelled to quit.

Example 27.4 Asha's employer humiliates her in front of her coworkers by informing her that she is being demoted. Asha's coworkers then continue to insult her about her national origin, which is Iranian. The employer is aware of this discriminatory treatment but does nothing to stop it, despite repeated complaints by Asha. If Asha quits her job, she likely has sufficient evidence to maintain an action for constructive discharge. ■

27-1h Harassment in the Workplace

Title VII also concerns the treatment of employees in the workplace. These include complaints involving sexual harassment and online harassment, which can create a hostile work environment.

Sexual Harassment Title VII protects employees against **sexual harassment** in the workplace. Sexual harassment can take two forms:

1. *Quid pro quo* harassment occurs when sexual favors are demanded in return for job opportunities, promotions, salary increases, or other benefits.
2. Hostile work environment harassment occurs when a pattern of sexually offensive conduct permeates the workplace and is sufficiently severe or pervasive to alter the conditions of employment and create an abusive working environment.

For an employer to be held liable for a supervisor's sexual harassment, the supervisor normally must have taken a tangible employment action against the employee. A **tangible employment action** is a significant change in employment status or benefits, such as when an employee is fired, refused a promotion, demoted, or reassigned to a position with significantly different responsibilities. A constructive discharge also qualifies as a tangible employment action.

An employer normally will not be liable for a supervisor's harassment if the employer can show that both of the following have occurred:

1. The employer has taken reasonable care to prevent and promptly correct any sexually harassing behavior. For instance, the employer may have established complaint procedures and other policies aimed at dealing with sexual harassment.
2. The plaintiff-employee has unreasonably failed to take advantage of preventive or corrective opportunities provided by the employer.

Online Harassment Employees' online activities can also create a hostile working environment. For instance, racial jokes, ethnic slurs, or other such comments may be contained in e-mails, texts, blogs, and social media platforms. All of these online activities may lead to claims of hostile work environment harassment or other forms of discrimination.

sexual harassment

Language or conduct that creates a hostile working environment.

tangible employment action

A significant change in employment status or benefits.

27-1i Retaliation by Employers

Employers sometimes retaliate against employees who complain about harassment or other Title VII violations. Retaliation can take many forms. An employer might demote, fire, or otherwise change the terms, conditions, and benefits of the person's employment. Title VII prohibits such retaliation.

For more information on how to avoid employment discrimination in the workplace, see the Linking Business Law to Your Career feature at the end of this chapter.

27-1j Remedies Under Title VII

If plaintiffs successfully prove that unlawful discrimination occurred, they could be awarded reinstatement of their former positions or jobs, back pay, retroactive promotions, and damages. Compensatory damages are available in cases of intentional discrimination. Punitive damages may be recovered against a private employer if it acted with malice or reckless indifference to an individual's rights.

27-2 Discrimination Based on Age

Age discrimination is potentially the most widespread form of discrimination because anyone—regardless of race, color, national origin, or gender—could be a victim at some point. The Age Discrimination in Employment Act (ADEA) prohibits employment discrimination on the basis of age against individuals forty years of age or older.

Learning Outcome 2

Identify the federal act that prohibits age discrimination.

27–2a Which Employers Are Covered?

For the ADEA to apply, an employer must have twenty or more employees, and the employer's business activities must affect interstate commerce. The act also extends to federal government employers. Generally, a state employer is immune from a private suit brought by an employee under the ADEA, unless the state consents to the suit. This immunity stems from the United States Supreme Court's interpretation of the Eleventh Amendment.

27–2b Procedure Under the ADEA

Like Title VII, the ADEA offers protection against intentional (disparate-treatment) and unintentional (disparate-impact) age discrimination. As suggested earlier, Title VII requires a plaintiff to show that an employer was motivated at least in part by unlawful discrimination. Under the ADEA, however, a plaintiff must show that unlawful discrimination was not just “a” reason but “the” reason for an adverse employment action.

A Prima Facie Case To establish a *prima facie* case under the ADEA, plaintiffs must show that they were (1) members of the protected age group, (2) qualified for the position from which they were discharged, and (3) discharged because of age discrimination.

Employer Burden Once a *prima facie* case has been established, the burden then shifts to the employer. If the employer offers a legitimate reason for its action, then the plaintiff must show that the stated reason is only a pretext. In other words, despite the employer's stated reason, the plaintiff must show that the real reason for the employer's decision was the plaintiff's age.



Highlighting the Point

Victoria, who is sixty-two years old, is a longtime employee of Crooked River Outfitters. Yannick, the company's chief executive officer, fires Victoria. As the reason for her termination, Yannick refers to errors and issues with professionalism on Victoria's part. He also adds, “I need someone younger who I can pay less.” Later, Zach, a younger, lower-paid employee, takes Victoria's former position with the company.

Can Victoria establish a *prima facie* case of age discrimination against Crooked River? Yes. Victoria is a member of the protected age group and is qualified for the position from which she was discharged. Given that she was replaced by a younger worker, she can argue that she was discharged because of age discrimination.

Can Crooked River offer a legitimate reason for its action? Yes. When Victoria was discharged, Yannick cited errors and issues with professionalism on Victoria's part. Crooked River could offer these points as the reasons for its action. Victoria must then show that these reasons are only a pretext. She might do this by offering Yannick's comment about needing someone younger who would work for a lower salary.

27–3 Discrimination Based on Disability

Learning Outcome 3

Explain how employers can avoid liability for disability-based discrimination.

The Americans with Disabilities Act (ADA) prohibits disability-based discrimination in workplaces with fifteen or more workers. Basically, the ADA requires that employers reasonably accommodate the needs of persons with disabilities, unless doing so would cause undue hardship.

27–3a What Is a Disability?

The ADA is broadly drafted to cover persons with a wide range of disabilities. Specifically, the ADA defines disability to include any of the following:

1. A physical or mental impairment that substantially limits one or more major-life activities.
2. A record of such impairment.
3. Being regarded as having such an impairment.

Other disabilities under the ADA also include, among others, alcoholism, blindness, cancer, cerebral palsy, and heart disease. Today, disability is often determined on a case-by-case basis.

A separate provision in the ADA prevents employers from taking adverse employment actions based on stereotypes or assumptions about individuals who associate with people who have disabilities. **Example 27.5** Karlha, an employer, refuses to hire Edward, who has a daughter with a physical disability. She bases her decision on the assumption that because of his daughter's disability, Edward will miss too much work or be unreliable. ■

27–3b Claims Under the ADA

To prevail on a disability claim under the ADA, plaintiffs must show that they (1) have a disability, (2) are otherwise qualified for the employment in question, and (3) were excluded from the employment solely because of the disability.

As in Title VII cases, plaintiffs must pursue their claims through the EEOC before filing actions in court for a violation of the ADA. The EEOC may decide to investigate and perhaps even sue the employer on behalf of the employee.

If the EEOC decides not to sue, then the employee is entitled to sue in court. Plaintiffs in lawsuits brought under the ADA may obtain many of the same remedies available under Title VII. These include reinstatement, back pay, and a limited amount of compensatory and punitive damages (for intentional discrimination).

27–3c Reasonable Accommodation

The ADA does not require that employers accommodate the needs of job applicants or employees with disabilities who are not otherwise qualified for the work. If a job applicant or an employee with a disability can perform essential job functions with a reasonable accommodation, however, the employer must make the accommodation. Required modifications may include installing ramps for a wheelchair, establishing more flexible working hours, creating or modifying job assignments, and creating or improving training materials and procedures.

An employer who does not accommodate the needs of a person with disabilities must demonstrate that the accommodations would cause “undue hardship.” In other words, the employer must show that the accommodations would be significantly difficult or expensive.

Highlighting the Point



Tyrell, who uses a wheelchair, is hired as a salesperson at Loraine Software. The company provides parking for its employees. During his first week of work, Tyrell informs his supervisors that his company parking space is too narrow for him to exit his van using the specially designed ramp for his wheelchair. Tyrell asks his employer to reasonably accommodate his needs by paying a \$25 monthly fee for him to use a handicapped parking space in an adjacent private parking lot.

(Continues)

Does Tyrell's request represent an undue hardship for Loraine? No. In this situation, paying for Tyrell's parking is not an undue hardship for Loraine. It is a reasonable accommodation.

27-4 Defenses to Employment Discrimination

Learning Outcome 4

Identify the defenses to employment discrimination claims.

Once a plaintiff succeeds in proving discrimination, the burden shifts to the employer to justify the discriminatory practice. Possible justifications, or defenses, for the employer include the business necessity and bona fide occupational qualification defenses.

27-4a Business Necessity

An employer may defend against a claim of disparate-impact (unintentional) discrimination by asserting that a practice that has a discriminatory effect is a **business necessity**.

business necessity

A defense against discrimination based on genuine requirements of the business.

Example 27.6 EarthFix, Inc., an international consulting agency based in the United States, requires its applicants to be fluent in at least one foreign language. If this requirement is shown to have a discriminatory effect, EarthFix can defend it based on business necessity. That is, it can argue that a foreign language is necessary for its workers to perform the job at a required level of competence. If EarthFix can demonstrate a definite connection between foreign language fluency and job performance, it normally will succeed in this business necessity defense. ■

27-4b Bona Fide Occupational Qualification

Another defense applies when discrimination against a protected class is essential to a job—that is, when a particular trait is a bona fide occupational qualification (BFOQ). Race can never be a BFOQ. Generally, courts have restricted the BFOQ defense to instances in which the employee's gender is essential to the job. For instance, a women's clothing store might legitimately hire only female sales attendants if part of an attendant's job involves assisting clients in the store's dressing rooms.

27-4c Seniority Systems

An employer with a history of discrimination might have no members of protected classes in upper-level positions. Nevertheless, the employer may have a defense against a discrimination suit if promotion or other job benefits have been distributed according to a fair seniority system. In a **seniority system**, workers with more years of service are promoted first or laid off last.

seniority system

A system in which those who have worked longest are first in line for promotions, salary increases, and other benefits, and are last to be laid off.



Real Case

Charee Stanley worked as a flight attendant for ExpressJet Airline, Inc. A practicing Muslim, Stanley requested for religious reasons that she be excused from preparing and serving alcohol during flights. ExpressJet refused this accommodation, which would have been at odds with a collective bargaining agreement (CBA) between the airline and its employees. The CBA gives senior flight attendants the ability to choose work assignments, including whether to serve alcohol. Because of her short tenure with the airline, Stanley was frequently the junior attendant on a particular flight. Consequently, she was required by the CBA to serve alcohol if her senior partner declined to do so.

Was ExpressJet Airlines guilty of religious discrimination under Title VII? No. In *Stanley v. ExpressJet Airlines, Inc.*, the U.S. Court of Appeals for the Sixth Circuit ruled in favor of the airline. Had the airline complied with Stanley's request, the airline would have violated the seniority system. Therefore, her religious discrimination claim was preempted by the CBA.

—808 Fed.Appx 351 (U.S. Ct. App. 6th Cir.)



Linking Business Law to Your Career

Human Resources Management

If your career leads you to management, you may be responsible for employment decisions, including hiring and firing decisions. As a manager, you must also be sure that employees do not practice discrimination on the job. Enter the human resources management specialist.

Human Resources Management

Human resources management (HRM) is the acquisition, maintenance, and development of an organization's human resources. HRM involves the design and application of formal systems in an organization to ensure the effective and efficient use of human talent to accomplish organizational goals.

All managers need to be skilled in human resources management. Some firms require managers to play an active role in recruiting and selecting personnel, as well as in developing training programs. Those who work in a human resources department should be especially aware of the issues outlined in this chapter.

Hiring Employees

Acquiring talented employees is the first step in an HRM system. Recruitment must not violate any laws outlined in this chapter. For instance, when evaluating a job applicant with a disability, managers must consider only the applicant's qualifications, not the disability.

On-the-Job Issues

Sexual harassment is a major concern, and you may need to work with an employment law specialist to develop anti-harassment rules and policies. In addition, consider creating and supervising a reporting system so that harassment can be effectively and quickly stopped.

Firing Employees

Even in employment-at-will jurisdictions, lawsuits can arise for improper termination. Develop a system to protect your company, such as documenting an employee's misconduct and the employer's warnings, as well as knowing how much severance pay should be paid out on termination.

Chapter Summary—Employment Discrimination

Learning Outcome 1: Distinguish between disparate-treatment and disparate-impact discrimination.

Disparate-treatment discrimination is intentional discrimination. In contrast, disparate-impact discrimination is unintentional. Disparate-impact discrimination occurs when a protected class is adversely affected by an employer's practices or procedures, even though they do not appear to be discriminatory.

Learning Outcome 2: Identify the federal act that prohibits age discrimination.

The Age Discrimination in Employment Act prohibits discrimination in employment on the basis of age against individuals forty years of age or older.

Learning Outcome 3: Explain how employers can avoid liability for disability-based discrimination.

The Americans with Disabilities Act requires employers with fifteen or more workers to reasonably accommodate the needs of job applicants and employees with disabilities unless to do so would cause undue hardship. An employer does not have to hire unqualified applicants with disabilities. But if an applicant with a disability can, with reasonable accommodation, perform the essential functions of the job, the employer must make the accommodation.

Learning Outcome 4: Identify the defenses to employment discrimination claims.

Employers can justify discrimination on the ground that it was a result of a business necessity or a bona fide occupational qualification.

Straight to the Point

1. Who does Title VII of the Civil Rights Act protect? (See Learning Outcome 1.)
2. What are the elements of a *prima facie* case under Title VII of the Civil Rights Act? (See Learning Outcome 1.)
3. What are some protections afforded by the federal age-discrimination law? (See Learning Outcome 2.)
4. Under the ADA, what is a disability? (See Learning Outcome 3.)
5. To prevail on a disability claim, what must a plaintiff show? (See Learning Outcome 3.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Ruth is a supervisor for Subs & Suds, a restaurant. Tim is a Subs & Suds employee. The owner announces that some employees will be discharged. Ruth tells Tim that if he has sex with her, he can keep his job. Is this sexual harassment? Why or why not? (See Learning Outcome 1.)
2. Koko, a person with a disability, applies for a job at Lively Sales Corporation for which she is well qualified, but she is rejected. Lively continues to seek applicants and eventually fills the position with a person who does not have a disability. Could Koko succeed in a suit against Lively for discrimination? Explain. (See Learning Outcome 3.)

Real Law

27–1. Reasonable Accommodation. Tony Kassa suffers from bipolar disorder and intermittent explosive disorder. While working for Synovus Financial Corporation, his supervisor knew about his disorders and granted his request to take short breaks when he became frustrated. As part of a corporate restructuring, Kassa was transferred to the Automated Teller Machine (ATM) team to handle customer service calls. Worried about the possible effects that his disorders might have during calls, Kassa asked his new supervisor if he could take a short break whenever he was having an episode. This request was not granted. Several months later, after a “rude and unprofessional” comment during a call, Kassa was terminated. Kassa filed suit, alleging discrimination under the American with Disabilities Act (ADA) for his

employer’s failure to provide him with a reasonable accommodation for his disability. A federal trial court granted the company’s motion for summary judgment. Kassa appealed. Did Synovus violate the ADA by denying Kassa’s request to take short breaks? [*Kassa v. Synovus Financial Corporation*, 800 Fed.Appx. 804 (U.S. Ct. App. 11th Cir., 2020)] (See Learning Outcome 3.)

27–2. Discrimination Based on Disability. Dennis Wallace was a deputy sheriff for Stanislaus County, California, when he injured his left knee. After surgery, he was subject to limits on prolonged standing, walking, and running. The county assigned him to work as a bailiff. The sergeants who supervised him rated his performance above average. Less

than a year later, without consulting those supervisors, the county placed Wallace on an unpaid leave of absence under the mistaken belief that he could not safely perform the essential functions of the job. Did the county discriminate against Wallace on the basis of disability? Explain. [*Wallace v. County of Stanislaus*, 245 Cal.App.4th 109, 199 Cal. Rptr.3d 462 (5 Dist. 2016)] (See Learning Outcome 3.)

27-3. Discrimination Based on Disability. Cynthia Horn worked as a janitor for Knight Facilities Management–GM, Inc., in Detroit, Michigan. When Horn developed a sensitivity to cleaning products, her physician gave her a “no

exposure to cleaning solutions” restriction. Knight then discussed possible accommodations with her. Horn suggested that restrooms be eliminated from her cleaning route or that she be provided with a respirator. Knight explained that she would be exposed to cleaning solutions in any situation because they were airborne and concluded that there was no work available within her physician’s restriction. Has Knight violated the Americans with Disabilities Act by failing to accommodate Horn’s requests? Explain. [*Horn v. Knight Facilities Management–GM, Inc.*, 2014 WL 715711 (6th Cir. 2014)] (See Learning Outcome 3.)

Ethical Questions

27-4. Employment Discrimination. Should English-only policies in the workplace be considered a form of national-origin discrimination? Explain. (See Learning Outcome 1.)

27-5. Unintentional Discrimination. McLane Company supplies and distributes goods to retailers. McLane requires employees with physically demanding jobs to take physical evaluations. Damiana Ochoa had such a job with McLane for eight years before she took maternity leave. When she returned to work, she failed the evaluation and was fired. She filed a discrimination complaint with the Equal Employment

Opportunity Commission. The agency issued a subpoena—a document ordering a person or employer to attend court—seeking the names of employees who had taken the evaluation throughout McLane’s national operations. An employer has a legal obligation, and an ethical duty, to comply with a subpoena unless compliance would be “unduly burdensome.” What practical factors could affect an employer’s ethical choice not to comply? Discuss. [*McLane Co. v. Equal Employment Opportunity Commission*, __ U.S. __, 137 S.Ct. 1159, 197 L.Ed.2d 500 (2017)] (See Learning Outcome 1.)

Chapter 27—Work Set

True-False Questions

- _____ 1. Discrimination complaints under federal law must be filed with the Equal Opportunity Employment Commission.
- _____ 2. All employers are subject to Title VII of the Civil Rights Act of 1964 regardless of the number of their employees.
- _____ 3. Disparate-treatment discrimination occurs when an employer intentionally discriminates against an employee.
- _____ 4. *Quid pro quo* and hostile work environment are two forms of sexual harassment.
- _____ 5. Under the Age Discrimination in Employment Act, a plaintiff must show that the unlawful discrimination was the reason for an adverse employment action.
- _____ 6. The Americans with Disabilities Act requires that employers hire workers with disabilities whether or not they are otherwise qualified for the work.
- _____ 7. Employers that do not accommodate the needs of persons with disabilities must demonstrate that the accommodations would cause undue hardship.
- _____ 8. An employer may defend against a claim of unintentional discrimination by asserting that a practice that has a discriminatory effect is a business necessity.

Multiple-Choice Questions

- _____ 1. Odette believes that the Power Utility Corporation (PUC) discriminated against her on the basis of race. She files a suit against PUC under Title VII. To establish a *prima facie* case of employment discrimination, Odette must show that
 - a. she is a member of a protected class.
 - b. PUC has no legal defenses against the claim.
 - c. discriminatory intent motivated PUC.
 - d. no other firm in PUC's industry has committed a discriminatory act.
- _____ 2. Inez files an employment discrimination suit against Jiffy Delivery Service, under Title VII of the Civil Rights Act, based on Jiffy's discharge of Inez. If Inez prevails in her *prima facie* case, one possible remedy for her would be
 - a. an order to shutdown the employer's business.
 - b. fines.
 - c. imprisonment.
 - d. reinstatement.
- _____ 3. Tenishia believes that she has been discriminated against on the job because she is a woman. She attempts to resolve the dispute with her employer, who decides that her claim has no basis. Tenishia's best next step is to
 - a. file a lawsuit.
 - b. secretly sabotage company operations for revenge.
 - c. ask the Equal Employment Opportunity Commission whether a claim is justified.
 - d. forget about the matter.
- _____ 4. Janet, who has a hearing impairment, applies for a position with Alpenrose Dairy. Janet is qualified but is refused the job because, she is told, "We can't afford to accommodate you with an interpreter." If Janet sues Alpenrose, she will
 - a. win if Alpenrose has installed ramps for persons with disabilities.
 - b. win if an interpreter would be a "reasonable accommodation."

- c. lose if she is not more than forty years old.
 - d. lose if Alpenrose has never done anything to accommodate any person with a disability.
- _____ 5. Digital Software, Inc., prefers to hire Asian Americans, because, according to its personnel director, “they’re smarter and work harder” than others. Showing a preference for one group over another is prohibited by
- a. Title VII of the Civil Rights Act of 1964.
 - b. the Age Discrimination in Employment Act of 1967.
 - c. the Americans with Disabilities Act of 1990.
 - d. none of the above.
- _____ 6. Insurance Sales, Inc., requires that all its secretaries be able to touch type (use a computer keyboard without looking down). Alice, a person of color, applies to Insurance Sales for a secretarial job. She cannot type but tells the company that she is willing to learn. When the firm does not hire her, she sues. She will
- a. win if Insurance Sales workforce does not reflect the same percentage of members of a protected class that characterizes qualified individuals in the local labor market.
 - b. win because she was willing to learn and an employer is obligated to hire and train unqualified minority employees.
 - c. lose because in this case being a member of the majority is a BFOQ.
 - d. lose because Insurance Sales has a valid business necessity defense.
- _____ 7. U.S. Tech, Inc., fires Mike. He believes that he was discriminated against because of his age. To bring a suit based on age discrimination, Mike must show
- a. that he is forty years old or older and is qualified for the job.
 - b. that he was discharged in circumstances that imply discrimination.
 - c. both a and b.
 - d. none of the above.
- _____ 8. National Mining Company requires job applicants to pass certain physical tests. Only a few women who apply to work for National can pass the tests, but if they pass, they are hired. National’s best defense in a suit charging that the tests discriminate against women would be that
- a. gender is a BFOQ.
 - b. some men cannot pass the tests.
 - c. any discrimination is unintentional.
 - d. passing the tests is a business necessity.

Answering More Legal Problems

1. Luna Boutique had a dress code that required its male salespersons to wear slacks, a shirt, and a necktie. Female salespersons were required to wear a black smock. Melissa, a female employee, refused to wear the smock. Instead, she reported to work in business attire, like the male staff, and was fired for violating the dress code. All other conditions of employment, including salary, hours, and benefits, were the same for female and male employees.
2. Cerebral palsy limits Eli’s use of his legs, but with support, he can get on and off a stool. Eli applied for a cashier position at Mars Market. The job description required “no experience or qualification.” Eli’s application was rejected. According to Ravenna, the market’s human resources manager, her decision was based on the threat that Eli posed to his own safety and the safety of others. Eli claimed that Mars Market refused to hire him because of his disability.

Was Luna Boutique’s dress code discriminatory? Yes. Luna’s dress code policy was illegal discrimination on the basis of _____. Unlike hair and grooming codes, which are based on established social expectations, there is no justifiable basis for women to wear smocks in a workplace. There is a tendency to believe that women wearing smocks have lower professional status than their male coworkers wearing business attire. Thus, the smock requirement perpetuated a _____-based stereotype of inferiority. Therefore, the dress code policy violated _____ of the Civil Rights Act.

Can Eli prove his disability-discrimination claim? Yes. Eli needs to show that he (1) has a _____, (2) is otherwise _____ for the job, and (3) was excluded solely because of his _____. If Eli could perform the job’s essential functions with _____ accommodation, Mars Market would have to make that accommodation. Eli can show that he has cerebral palsy and that he is qualified for the job, which requires “no experience or qualification.” For Eli, reasonable accommodation might include a wheelchair, a stool with armrests, or a hand scanner. Additionally, it is unlikely that Mars Market could explain how Eli poses a safety threat to himself and others in the store.



Unit 6

Business Organizations

Unit Contents

Chapter 28

Types of Business Organizations

Chapter 29

Formation and Ownership of a Corporation

Chapter 30

Management of a Corporation

Chapter 31

Combining and Dissolving Corporations

28 | Types of Business Organizations

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Describe a sole proprietorship.
- 2 Identify the features of a general partnership.
- 3 Outline the elements of a limited partnership.
- 4 List the advantages of a limited liability company.

Learning Outcome 1

Describe a sole proprietorship.

sole proprietorship

The form of business in which the owner is the business.

Conflict Presented

Hailey and Felix jointly own three hundred acres of farmland in northern California. They lease the land to Natacha, the owner of Hillcrest Winery, who uses the land for growing her vineyards. Instead of fixed rental payments for the use of the land, Hailey and Felix receive a share of the profits from Hillcrest's operations. Only Natacha pays for the losses, however.

Q Are Hailey, Felix, and Reese partners?

One of the questions faced by anyone who wishes to start up a business is what form of business organization to choose. The options include a sole proprietorship, a partnership, a limited liability company, and a corporation. In this chapter, we examine the features of sole proprietorships, partnerships, and limited liability companies.

28–1 Sole Proprietorships

The simplest form of business is a **sole proprietorship**. In this form, the owner is the business. Anyone who does business without creating a separate business organization has a sole proprietorship. The sole proprietorship form is especially appropriate for businesses that are relatively small, employ few people, have modest profits, and are not likely to expand significantly in the immediate future.

28–1a Advantages of the Sole Proprietorship

A major advantage of the sole proprietorship is that the proprietor (owner) receives all the profits. In addition, it is often easier and less costly to start a sole proprietorship than to start any other kind of business, because few legal forms are involved. Sole proprietors are free to make any decisions they wish concerning the business—whom to hire, what kind of business to pursue, and so on.

A sole proprietor pays only personal income taxes on profits. A sole proprietor can be liable for other taxes, however, such as those collected and applied to the payment of unemployment compensation.

28–1b Disadvantages of the Sole Proprietorship

The major disadvantage of the sole proprietorship is that, as sole owner, the sole proprietor alone bears the burden of all liabilities incurred by the business. **Example 28.1** Lina operates a small golf shop as a sole proprietorship. One of her employees fails to secure

a display of golf clubs, and they fall on Dean, a customer, and seriously injure him. Dean sues Lina's shop and wins. If Lina's business insurance does not cover the judgment amount, she is personally responsible for paying the difference. ■

Another disadvantage is that the proprietor's opportunity to raise capital is limited to personal funds and the funds of those who are willing to make loans. A sole proprietorship also lacks continuity on the death of the proprietor. When the owner dies, the business is automatically dissolved. If the business is transferred to family members or other heirs, a new sole proprietorship is created.

28–2 Partnerships

A **partnership** arises from an agreement, express or implied, between two or more persons to carry on a business for profit. A partnership is based on a voluntary contract between two or more persons who agree to place funds, labor, and skill in a business with the understanding that profits and losses will be proportionately shared. There are two basic types of partnerships: general partnerships and limited partnerships.

The Uniform Partnership Act (UPA) governs the operation of partnerships in the absence of a different agreement among the partners. The UPA has been adopted in all of the states except Louisiana, as well as in the District of Columbia. In addition, in many instances, agency law governs the relationships among partners.

partnership

An association of two or more persons to carry on, as co-owners, a business for profit.

28–2a Elements of a General Partnership

The traditional partnership is an ordinary, or general, partnership. There are three essential elements to a general partnership:

1. A sharing of profits and losses.
2. A joint ownership of the business.
3. An equal right in the management of the business.

Joint ownership of property does not in and of itself create a partnership. In fact, the sharing of income and even profits from such ownership is usually not enough to create a partnership.

Example 28.2 Claudine and Owen own a retail building in the city of Morgantown's industrial district. They lease the building to Bogdan, who owns and operates Bricktowne Brewery on the premises. Instead of receiving a monthly rental fee from Bogdan, Claudine and Owen receive a certain share of Bricktowne's profits on a quarterly basis. This arrangement normally does not make Claudine, Owen, and Bogdan partners. ■

Note, though, that while the sharing of profits from ownership of property does not prove the existence of a partnership, sharing both profits and losses usually does. **Example 28.3** Jayden and his friend Isabel start a business that sells fruit smoothies and other beverages near Benton Community College. They open a joint bank account from which they pay for supplies and expenses, and they share the proceeds (and losses) that the business generates. Jayden and Isabel are presumed to have a partnership. ■

Partnership Characteristics Generally, the law recognizes a partnership as an independent entity. A partnership usually can sue or be sued, collect judgments, and have all accounting procedures performed in the name of the partnership entity. Partnership property can be held in the name of the partnership rather than in the names of the individual partners.

Tax Treatment In one circumstance (for federal income tax purposes), a general partnership is not treated as a separate legal entity. Rather, it is treated as an aggregate (or combination) of the individual partners.

pass-through entity

A business entity whose income tax liability is passed through to the owners.

In other words, a general partnership is a pass-through entity and not a tax-paying entity. A **pass-through entity** is a business entity that has no tax liability—meaning that the entity’s income is passed through to the owners, who pay income taxes on it. Thus, the income or losses of a general partnership are “passed through” to the partners. The partnership itself is responsible only for filing an information return with the Internal Revenue Service.

28–2b Partnership Formation

Learning Outcome 2

Identify the features of a general partnership.

A general partnership is ordinarily formed by an agreement among the parties. The law, however, recognizes another form of partnership called partnership by estoppel.

articles of partnership

A written agreement that sets forth partner rights and obligations.

Partnership by Agreement Agreements to form a partnership can be oral, written, or implied. Some partnership agreements must be in writing to be enforceable under the Statute of Frauds. For instance, a partnership agreement that, by its terms, is to continue for more than one year must be in writing. Similarly, a partnership that authorizes the partners to sell real estate must be in writing. When there is no formal, written partnership agreement, an agreement to form a partnership can be implied by conduct.

The partnership agreement, called **articles of partnership**, usually specifies the name and location of the business, the duration of the partnership, the purpose of the business, each partner’s share of the profits, how the partnership will be managed, and how assets will be distributed on dissolution, among other things.

partnership by estoppel

Partnership liability imposed by a court on nonpartners.

Partnership by Estoppel Occasionally, persons who are not partners hold themselves out as partners and make representations that third parties rely on in dealing with them. In such a situation, a court may conclude that a **partnership by estoppel** exists and impose liability—but not partnership rights—on the alleged partner or partners.

Similarly, a partner in a firm may represent that a nonpartner is a member of the firm. When a third person has reasonably and detrimentally relied on this representation, a partnership by estoppel is deemed to exist. In this situation, the nonpartner’s acts can be binding on the partnership.



Real Case

Sanitation District No. 1 (SD1) contracted with DCI Properties to upgrade several sewage systems. DCI contracted with Coppage Construction Company to provide the labor, goods, and services. After a falling out, DCI terminated its contract with Coppage. In a lawsuit against SD1, Coppage alleged that it had extended credit, consisting of goods and services, to DCI based on its belief that DCI and SD1 were partners.

Were SD1 and DCI partners? Yes, in *Coppage Construction Company, Inc. v. Sanitation District No. 1 and DCI Properties*, the Court of Appeals of Kentucky noted that SD1 had assured Coppage that it was backing the project financially. Indeed, on one occasion, SD1—not DCI—had made a payment to Coppage. Even if there was no express partnership between SD1 and DCI, Coppage could argue that there was an “apparent” partnership under the doctrine of partnership by estoppel.

___ S.W.3d ___, 2019 WL 6795706 (Ct. App. KY)

28–2c Rights of Partners

In the absence of provisions to the contrary in the partnership agreement, the law imposes on partners the rights discussed next.

Management Rights In a general partnership, all partners have equal rights in managing the partnership. Each partner in an ordinary partnership has one vote in management matters regardless of the size of the partner's interest in the firm.

The majority rule controls decisions in ordinary matters connected with partnership business, unless otherwise specified in the agreement. Unanimous consent of the partners is required, however, to make basic changes in the nature of the business or the partnership agreement.

Sharing Partnership Profits and Losses Each partner is entitled to the proportion of business profits and losses designated in the partnership agreement. If the agreement does not apportion profits or losses, profits are shared equally, and losses are shared in the same ratio as profits.

Highlighting the Point



Rico and Brent establish a partnership to open a new chocolate cookie business. Their partnership agreement provides for capital contributions of \$6,000 from Rico and \$4,000 from Brent. The agreement is silent as to how Rico and Brent will share profits and losses.

In what proportion will Rico and Brent share profits and losses? They will share profits and losses equally. If the agreement had provided for profits to be shared in the same ratio as capital contributions, the profits would be shared 60 percent for Rico and 40 percent for Brent. If that same agreement had been silent as to losses, though, they would be shared in the same ratio as profits (60 percent and 40 percent).

Compensation Partners, in general, devote time, skill, and energy on behalf of the partnership business, and are not generally paid for such services. Partners can, of course, agree otherwise. **Example 28.4** Julie, the managing partner of a law firm, performs special administrative duties for the firm. Under the partnership agreement, she receives a salary for performing these services in addition to her share of profits. ■

Inspection of Partnership Books Each partner has the right to complete information concerning all aspects of partnership business. The books containing this information must be kept at the firm's principal business office and cannot be removed without the consent of all the partners.

Highlighting the Point



Oxford, Walensa, and McKee are partners. Oxford dies.

In terms of the partnership, to what are Oxford's heirs entitled? Oxford's heirs are entitled to the value of Oxford's interest in the firm. The heirs do not become partners with Walensa and McKee, nor are they entitled to specific assets of the firm. Walensa and McKee must account to the heirs, however, for the value of Oxford's interest. For instance, they might hire an accountant to determine how much the interest is worth and then pay the heirs that amount.

Partner's Interest in the Firm A partner's interest in the firm is a personal asset consisting of a proportionate share of the profits earned and a return of capital after the partnership is terminated. On a partner's death, the partner's heirs are entitled only to the value of the partner's interest in the firm.

Partnership Property Property acquired by a partnership is the property of the partnership and not of the partners individually. This includes property that was acquired by the partnership or in the partnership's name after its formation. A partner may use or possess partnership property only on behalf of the partnership. A partner is not a co-owner of partnership property and has no interest in the property that can be transferred.

A partner's personal creditors therefore cannot force the sale of partnership property to satisfy the partner's debts. Creditors can, however, ask a court to order that payments due to partners from the partnership be paid to them. They can even ask a court to force partners to sell their interests in the firm.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Hailey and Felix jointly own farmland in northern California. They lease the land to Natacha, the owner of Hillcrest Winery. Instead of fixed rental payments for the use of the land, Hailey and Felix receive a share of the profits from Hillcrest's operations. Only Natacha pays for the losses.

A Are Hailey, Felix, and Natacha partners? No. Hailey and Felix may be partners, but Natacha is not a partner with them. Only Hailey and Felix jointly own the property and have an equal right to manage it. Also, the three do not share losses. Sharing profits alone does not prove a partnership.

28–2d Duties, Powers, and Liabilities of Partners

The duties and powers of partners discussed here are based on agency law. Basically, each partner owes a fiduciary duty to the others, and all partners exercise general agency powers.

fiduciary relationship

A relationship founded on trust and loyalty.

Fiduciary Duties Partners stand in a **fiduciary relationship**. A fiduciary relationship is one of extraordinary trust and loyalty. Each partner must act in good faith for the best interest of the partnership. Fiduciary duties include a duty of loyalty and a duty of care.

- A partner's duty of loyalty has two aspects. A partner must account to the partnership for any profit or benefit from the firm's business or the use of its property. A partner must also refrain from dealing with the firm as an adverse party or competing with it.
- A partner's duty of care is limited to refraining from negligent or reckless conduct, intentional misconduct, and violations of the law.

Partners can pursue their own interests without violating these duties. **Example 28.5** Shane, a partner who owns a shopping mall, can vote against a partnership proposal to open a competing mall. ■ In addition, the partnership agreement or the unanimous consent of the partners can permit a partner to engage in any activity.

Highlighting the Point



Hall, Banks, and Porter enter into a partnership. Porter undertakes independent consulting for an outside firm in competition with the partnership without the consent of Hall and Banks.

Has Porter breached the fiduciary duty that he owes to the partnership? Yes. In fact, even with noncompetitive activities, partners can breach their fiduciary duties if the partnership suffers a loss because of the time partners spend on those other activities.

Agency Powers Each partner is an agent of every other partner and acts as both a principal and an agent in any business transaction within the scope of the partnership. Each partner is a general agent of the partnership in carrying out the usual business of the firm. Every act of a partner concerning partnership business and every contract signed in the name of the partnership bind the firm.

Joint and Several Liability Partners are jointly and severally liable for partnership obligations. The term severally means separately, or individually. In other words, **joint and several liability** means that a third party can sue all of the partners together (jointly) or one or more of the partners separately (severally). Partners can be held liable even if they did not participate in, ratify, or know about whatever it was that gave rise to the cause of action.

joint and several liability

A doctrine under which a plaintiff may sue the partners together or individually.

If the third party is successful, they may collect on the judgment only against the assets of those partners named as defendants. A judgment against only some of the partners does not extinguish the others' joint liability, however.

Example 28.6 Zeneba and Julie are partners. Tom sues Zeneba for a debt on a partnership contract and wins. Tom can collect the amount of the judgment against Zeneba only. If Tom cannot collect enough from Zeneba, however, Tom can later sue Julie for the difference. ■ A partner who commits a tort that results in a judgment against the partnership may be required to repay the firm for any damages it pays.

28–2e Partner's Dissociation

Dissociation occurs when a partner ceases to be associated in the carrying on of the partnership business.

dissociation

The severance of the relationship between a partner and a partnership.

Events That Cause Dissociation A partner can dissociate from the general partnership at any time by giving notice to the partnership. A partner can dissociate by declaring bankruptcy or by assigning their interest in the partnership for the benefit of creditors. A partner may also dissociate by incapacity through physical inability or mental incompetence, or by death.

Actions by others may result in a partner's dissociation. A partnership agreement may specify an event that will cause dissociation. Sometimes, the other partners can expel a partner by unanimous vote. A court may expel a partner for wrongful conduct that affects the partnership business, breaches the partnership agreement, or violates a duty owed to the firm or the partners.

Effects of Dissociation Dissociation normally entitles partners to have their interests purchased by the partnership. On a partner's dissociation, their right to participate in the partnership business ends, as does their duty of loyalty. A partner's duty of care continues only with respect to events that occurred before dissociation unless the partner participates in winding up the firm's business.



Highlighting the Point

Gwen is a partner with Brewster & Jones, an accounting firm. Gwen has been a partner with the firm for five years when she resigns to start her own accounting practice. Her work for Brewster & Jones includes unfinished business for a client, Standing Stone Shops, Inc.

Can Gwen immediately compete with Brewster & Jones for new clients? Yes. On a partner's dissociation, her right to participate in the management and conduct of the partnership terminates. Her duty of loyalty to the firm also ends. Thus, Gwen can immediately compete with Brewster & Jones for new clients. In regard to Standing Stone's unfinished business, however, Gwen's duty of care continues. She must exercise care in completing the work for Standing Stone and account to Brewster & Jones for any fees received for that work.

dissolution

The formal disbanding of a partnership.

28–2f Partnership Termination

The same events that cause dissociation can result in the end of the partnership if the remaining partners no longer wish to continue the partnership. The formal termination of a partnership is referred to as **dissolution**. Dissolution can be brought about by acts of the partners, by operation of law, or by judicial decree.

Dissolution by Acts of the Partners A partnership can be dissolved by the partners' agreement. A partnership agreement may state a fixed term or a business objective, for example. In this situation, the passing of the date or the accomplishment of the objective terminates the partnership.

Dissolution by Operation of Law Any event that makes it unlawful for the partnership to continue its business will terminate the partnership. If the partners act within ninety days, however, they can decide to change the nature of their business and continue in the partnership.



Highlighting the Point

Mido and Amanda form a partnership—Norse Farms—to grow alfalfa from seed that consists of pesticide-resistant genetically modified organisms (GMOs). Less than two years later, the county in which the partnership's farmland is situated bans the use of GMO seed.

Is Norse Farms terminated by operation of law? Yes. The county's enactment of a ban on the use of GMO seed makes the partnership's use of the seed unlawful. This effectively terminates the partnership. But Mido and Amanda could continue Norse Farms if, within ninety days, they agree to change the nature of their business. They could decide to grow non-GMO alfalfa, for instance, or to raise cattle or other livestock, and thereby continue their partnership.

Dissolution by Judicial Decree A court may order a partnership to be dissolved when the court deems it impractical for the firm to continue—for example, if the business can be operated only at a loss. A partner's impropriety or fraud

involving partnership business or improper behavior reflecting unfavorably on the firm may provide grounds for terminating the partnership. If dissension between partners becomes so persistent and harmful as to undermine the confidence and cooperation necessary to carry on the firm's business, a court may order the firm to be dissolved.

Winding Up Once the partners have been notified that the partnership is ending, they cannot enter into new contracts on behalf of the partnership. Their only authority is to complete unfinished transactions and to wind up the business of the partnership. **Winding up** includes collecting and preserving partnership assets, discharging liabilities (paying debts), and accounting to each partner for the value of their interest in the partnership.

Creditors of the partnership and creditors of the individual partners can make claims on the partnership's assets at this time. Creditors of the partnership share proportionately with the partners' individual creditors in the partners' interests in the partnership. The priorities in the distribution of a partnership's assets on dissolution are as follows:

1. Payment of debts, including those owed to partner and nonpartner creditors.
2. Return of capital contributions and distribution of profits to partners.

winding up

The stage of dissolution in which the firm collects and distributes assets and discharges liabilities.

28–2g Limited Partnerships

A special form of partnership is the **limited partnership (LP)**, which consists of at least one general partner and one or more limited partners. A **general partner** assumes responsibility for the management of the partnership and liability for all partnership debts.

Learning Outcome 3

Outline the elements of a limited partnership.

Highlighting the Point



Leonardo, Michele, and Nicola are limited partners of Oakfield Estates, LP, a limited partnership in the business of developing real estate. Leonardo and Michele manage the firm. Without Leonardo's knowledge, Michele fraudulently transfers \$500,000 of Oakfield's funds to herself to buy a house. Later, Leonardo learns of the transfer but takes no action.

Can Leonardo be held liable to Nicola for Michele's fraud? Yes. Normally, a limited partner has no liability for partnership debts beyond the amount of capital that the partner contributes to the firm. A limited partner who participates in management, however, risks incurring the same liability for partnership debts as a general partner. Here, Leonardo will likely be held liable to Nicola because Leonardo participated in the management of Oakfield and took no action when he learned of Michele's fraud.

limited partnership (LP)

A partnership consisting of general partners and limited partners.

general partner

A partner responsible for the partnership's management and debts.

A **limited partner** has no right to participate in the management or operation of the partnership and assumes no liability for partnership debts beyond the amount of capital contributed. If limited partners participate in management, they risk having general-partner liability.

The formation of an LP involves more formalities than the formation of a general partnership. The agreement to form an LP must be written. In addition, a certificate of limited partnership must be filed appropriately with a state office, usually the secretary of state's office. All states allow LPs.

limited partner

A partner who contributes capital to the partnership but does not participate in its daily operations.

limited liability partnership (LLP)

A form of partnership that limits a partner's liability for other partners' malpractice.

28–2h Limited Liability Partnerships

The **limited liability partnership (LLP)** is designed for professionals who normally do business as partners in a partnership. LLPs must be formed and operated in compliance with state statutes. The appropriate form must be filed with a central state agency, usually the secretary of state's office. The business's name must include either Limited Liability Partnership or LLP.

The major advantage of the LLP is that it allows a partnership to continue as a pass-through entity for tax purposes but limits the personal liability of the partners. An LLP allows professionals, such as attorneys and physicians, to avoid personal liability for the malpractice of other partners. A partner in an LLP, however, is still liable for their own wrongful acts, such as negligence.



Highlighting the Point

Three physicians—Jerome, Kristin, and Loren—operate Central Point Urgent Care Clinic as an LLP. Jerome is sued by a client for malpractice and loses his lawsuit. Central Point's malpractice insurance coverage is insufficient to pay the judgment.

Can Kristin and Loren avoid personal liability for the unpaid portion of the judgment against Jerome? Yes. Because Central Point is organized as an LLP, no partner can be held liable for another partner's malpractice. Only Jerome's personal assets can be used to satisfy the judgment amount against him.

limited liability company (LLC)

A business form that offers the limited liability of a corporation and the tax advantages of a partnership.

28–3 Limited Liability Companies

A **limited liability company (LLC)** combines the limited liability of a corporation and the tax advantages of a partnership. Like LPs and LLPs, an LLC must be formed and operated in compliance with state law. To form an LLC, articles of organization must be filed with a central state agency, often the secretary of state's office. The business's name must include the words Limited Liability Company or the initials LLC.

28–3a Advantages of a Limited Liability Company

A major advantage of the LLC is that profits are “passed through” the LLC and taxes are paid personally by the owners of the company, who are called members. Another advantage is that corporations and partnerships, as well as foreign investors, can be LLC members.

Additionally, there is no limit on the number of members in an LLC. Members are allowed to participate fully in management activities, and the firm's managers need not be members. Yet another advantage is that the liability of the members is limited to the amount of their investments.

Another part of the LLC's attractiveness to businesspersons is its flexibility. The members can decide how to operate the business through a simple **operating agreement**. The agreement can, for instance, describe the procedures for choosing or removing members or managers.

28–3b Disadvantages of a Limited Liability Company

One disadvantage of the LLC is that state statutes are not uniform. Therefore, businesses that operate in more than one state may not receive consistent treatment in these states. Generally, though, in dealing with a foreign LLC—that is, an LLC formed in another state—a state will apply the law of the state where the LLC was formed.

Learning Outcome 4

List the advantages of a limited liability company.

operating agreement

A limited liability company's management agreement.



Linking Business Law to Your Career

“Doing Business As” a Sole Proprietor

Suppose that Maria Lopez wants to start a face-mask manufacturing business as a sole proprietor. Maria finds the name “Maria Lopez’s Face Masks” uninspiring. She would rather call her new venture “Masks Almighty.” She thinks this name will make for more effective online marketing. Because the business name is different from her name, in many states Maria will be required to file a “Doing Business As” (DBA) statement, which provides notice to the public of the true owner of the enterprise.

Simple, Inexpensive, and Separate

Even when it is not legally required, many sole proprietors file for DBAs, known in some jurisdictions as fictitious business names (FBNs). For the most part, DBAs are simple and inexpensive to create. As in the case of Maria Lopez, they allow the sole proprietor to match the name to the product or service provided in a marketing-friendly way. DBAs also provide privacy and a degree of separation for sole proprietors who

might not want their personal names easily connected to their businesses.

Regulations for DBAs vary from state to state. In most instances, the sole proprietor must go online to check a state database to ensure that the new trade name is not already being used. In many states, the entire DBA process can be completed on the internet, with costs as low as \$45 and approval-waiting times as short as one week.

The DBA Effect

The fact that the names of the business owner and the named businesses are different does not change the basic rule that, with sole proprietorships, the owner is the business. In any event, after filing a DBA or FBN, the sole proprietor must publish the statement in a newspaper to notify the public. For the most part, online DBA notification is not an option.

Chapter Summary—Types of Business Organizations

Learning Outcome 1: Describe a sole proprietorship.

A sole proprietorship is the simplest form of business organization, used by anyone who does business without creating a separate business organization. The owner is the business. The owner pays personal income taxes on all profits and is personally liable for all business debts.

Learning Outcome 2: Identify the features of a general partnership.

A general partnership is created by an agreement of the parties. It is treated as a pass-through entity for federal income tax purposes. Each partner has an equal voice in management unless the partnership agreement provides otherwise. Partners share in both the profits and losses of the partnership. They have unlimited liability for partnership debts. A partnership can be terminated by agreement or can be dissolved by action of the partners, operation of law, or a court decree.

Learning Outcome 3: Outline the elements of a limited partnership.

A limited partnership consists of one or more general partners and one or more limited partners. General partners have unlimited liability for partnership obligations. Limited partners are liable only to the extent of their financial contributions. Only general partners can participate in management. If limited partners participate in management, they risk having general partner liability.

Learning Outcome 4: List the advantages of a limited liability company.

A limited liability company (LLC) combines the limited liability of a corporation with the tax benefits of a partnership. LLC members may be corporations, partnerships, or residents of foreign countries. Members may participate in management, and nonmembers may be managers as well. Liability of members is limited to the amount of their investments. A simple operating agreement offers flexibility.

Straight to the Point

1. Why is a sole proprietorship the simplest form of business? (See Learning Outcome 1.)
2. What are some of the partnership rights of partners? (See Learning Outcome 2.)
3. What are the effects of a partner's dissociation from a partnership? (See Learning Outcome 2.)
4. What is the difference between a general partnership and a limited partnership? (See Learning Outcome 2.)
5. How does a limited liability partnership differ from a limited partnership? (See Learning Outcome 2.)
6. What is the principal advantage of a limited liability company? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Sam plans to open a sporting goods store and to hire Gil and Art. Sam will invest only his own capital. He does not expect to make a profit for at least eighteen months and to make little profit for the first three years. He hopes to expand eventually. Which form of business organization would be most appropriate? (See Learning Outcome 1.)
2. Hal and Gretchen are partners in a delivery business. When business is slow, without Gretchen's knowledge, Hal leases out the delivery vehicles as moving vans. The vehicles would otherwise be sitting idle in a parking lot. Can Hal keep the lease money, or does he have to account to Gretchen? (See Learning Outcome 2.)

Real Law

28-1. Partnership Termination. Will Sukenik and Irvin Fine formed PDC Office Park as general partners. Under the partnership agreement, on the death of one partner, the other had thirty days to elect to continue the partnership. Fine died, but Sukenik failed to take this step. A third party that owned a limited interest in PDC convinced a trial court that the partnership must be dissolved, and its assets liquidated. Sukenik tried numerous delaying tactics to block this dissolution, including a breach of contract suit against the third party. Should an appeals court uphold the trial court's order for dissolution of the general partnership? If so, why? [810 Properties VII, L.L.P., et al. v. Sukenik, et al., 153 N.E.3d 990 (Ct. App. OH 8th Dist. 2020)] (See Learning Outcome 2.)

28-2. Partnerships. Leisa Reed and Randell Thurman lived together in Spring City, Tennessee. Randell and his father, Leroy, formed a cattle-raising operation and opened a bank account in the name of L&R Farm. Within a few years, Leroy quit the operation. Leisa and Randell each wrote a personal check for \$5,000 to buy his cattle. Leisa picked up supplies, fed and administered medicine to cattle, collected hay, and participated in the bookkeeping for L&R. Later,

checks drawn on her personal account for \$12,000 to buy equipment and \$35,000 to buy cattle were deposited into the L&R account. After several years, Leisa decided that she no longer wanted to associate with Randell, but they could not agree on a financial settlement. Was Leisa a partner in L&R? Is she entitled to half of the value of L&R's assets? Explain. [Reed v. Thurman, 2015 WL 1119449 (Tenn.App. 2015)] (See Learning Outcome 2.)

28-3. Partnerships. Karyl Paxton asked Christopher Sacco to work with her interior design business, Pierce Paxton Collections, in New Orleans. At the time, they were in a romantic relationship. Sacco was involved in every aspect of the business—bookkeeping, marketing, and design—but was not paid a salary. He was reimbursed, however, for expenses charged to his personal credit card, which Paxton also used. Sacco took no profits from the firm, saying that he wanted to “grow the business” and “build sweat equity.” When Paxton and Sacco's personal relationship soured, she fired him. Sacco objected, claiming that they were partners. Is Sacco entitled to 50 percent of the profits of Pierce Paxton Collections? Explain. [Sacco v. Paxton, 133 So.3d 213 (La.App. 4th Cir. 2014)] (See Learning Outcome 2.)

Ethical Questions

28–4. Partnership Agreement. Why should partnership agreements be in writing? (See Learning Outcome 2.)

28–5. Sole Proprietorships. Tom George was the sole owner of Turbine Component Super Market, LLC (TCSM), when its existence was terminated by the state of Texas. Turbine Resources Unlimited filed and won a suit in a Texas state court against George for breach of contract. The plaintiff sought to collect the judgment amount through a sale of George's property. Instead of turning over his assets, however, George tried

to hide them by reforming TCSM. Without telling the court, he paid a different debt with \$100,000 of TCSM's funds. George claimed that the funds were a loan and that he was merely an employee of TCSM. Is it more likely that the court will recognize TCSM as an LLC or a sole proprietorship? Does the owner of a business have an ethical obligation to represent the organization truthfully? Why? [*Jennifer Mitchell v. Turbine Resources Unlimited, Inc.*, 523 S.W.3d 189 (Tex. App.—Houston [14th Dist.] 2017)] (See Learning Outcome 1.)

Chapter 28—Work Set

True-False Questions

- _____ 1. In a sole proprietorship, the owner and the business are entirely separate.
- _____ 2. A partnership is an association of two or more persons to carry on, as co-owners, a business for profit.
- _____ 3. A general partnership cannot exist unless a certificate of partnership is filed appropriately in a state.
- _____ 4. The sharing of profits from joint ownership of property is usually enough to create a partnership.
- _____ 5. A writing is always necessary to form a partnership.
- _____ 6. Unless a partnership agreement specifies otherwise, each partner has one vote in management matters.
- _____ 7. Unless a partnership agreement specifies otherwise, profits are shared in the same ratio as capital contributions.
- _____ 8. In a limited partnership, the liability of a limited partner is limited to the amount of capital they invest in the partnership.
- _____ 9. A limited liability company offers the limited liability of a corporation and the tax advantages of a partnership.

Multiple-Choice Questions

- _____ 1. Dave and Giorgi agree to go into business together. They do not formally declare that their business has a specific form of organization. Dave and Giorgi's business is
 - a. a proprietorship.
 - b. a partnership.
 - c. a limited liability company.
 - d. none of the above.
- _____ 2. Ulrich is a general partner and Lee and Carol are limited partners in GLC Associates, a limited partnership. Lee and Carol
 - a. have fewer managerial powers than Ulrich.
 - b. cannot sue on behalf of the firm if Ulrich refuses to do so.
 - c. are personally liable for the debts of the firm, unlike Ulrich.
 - d. risk nothing if they participate in the management of the partnership.
- _____ 3. To obtain a contract with Sadat, Cindy misrepresents that she is a partner with Karl. Karl overhears Cindy's misrepresentation but says nothing to Sadat. Cindy breaches the contract. Who is liable to Sadat?
 - a. Cindy only.
 - b. Karl only.
 - c. Cindy and Karl.
 - d. None of the above.
- _____ 4. Mark owns M Carpets, a home-furnishings store. He hires Lois as a salesperson, agreeing to pay her \$18.50 per hour plus 10 percent of her sales. Mark and Lois are
 - a. partners because Lois receives a share of the store's profits.
 - b. partners because Lois is responsible for some of the store's sales.
 - c. not partners because Lois does not have an ownership interest or management right in the store.
 - d. not partners because Lois does not receive an equal share of the store's profits.

- _____ 5. Alphonso, Kim, and Pete are partners in Northern Mines. Alphonso sells the ore extracted from the mines to Yukon Resources, Inc. Alphonso must account for the funds that he receives from Yukon for the ore to
- Yukon.
 - Northern Mines.
 - the state in which Northern Mines is located.
 - none of the above.
- _____ 6. Dr. Jones and Dr. Smith are partners in a medical clinic. Jones manages the clinic, which is organized as a limited liability partnership. A court holds Smith liable in a malpractice suit. Jones is
- not liable.
 - liable only to the extent of her share of that year's profits.
 - liable only to the extent of her investment in the firm.
 - liable beyond her investment in the firm because she manages the clinic.
- _____ 7. Dina is a partner in Eastman Technical Group. Dina's dissociation from the partnership will cause
- the automatic termination of the firm's legal existence.
 - the immediate maturity of all partnership debts.
 - the partnership's buyout of Dina's interest in the firm.
 - the temporary suspension of all partnership business.
- _____ 8. Jay is a limited partner in Kappa Sales, a limited partnership. Jay is liable for the firm's debts
- in no way.
 - in proportion to the total number of partners in the firm.
 - to the extent of his capital contribution.
 - to the full extent of the debts.
- _____ 9. Ava and Bud start CapCo as a limited liability company. They can participate in the firm's management
- only to the extent that they assume personal liability for the firm's debts.
 - only to the extent of the amount that they invest in the firm.
 - to any extent.
 - to no extent.

Answering More Legal Problems

1. Doing business as a sole proprietorship under the name Capital Venture, Dhani offered consulting services to assist new start-ups with business structures, decision making, and customer development. Norberto paid Dhani to provide these services for Norberto's TexMex Café. When the café's customer base did not grow quickly enough, Norberto was forced to close. He filed a suit against Capital Venture and Dhani to recover lost profits.

If the court rules in Norberto's favor, could Dhani be personally liable for the amount of the judgment? Yes. The simplest form of business is a _____ proprietorship. In this form, the owner is the business. A major advantage of the _____ proprietorship is that the proprietor receives all the profits. A major disadvantage of the _____ proprietorship is that, as _____ owner, the proprietor alone bears the burden of all _____ incurred by the business. In this problem, Dhani is Capital Venture. If the court rules in Norberto's favor, Dhani is personally liable.

2. Grant was the general partner in Oil Build, LP, which he formed to construct offshore oil rigs. He asked

Lucinda to invest in the company. A low bridge separated Oil Build's rig construction site from the open sea. Grant admitted that this setup could increase the cost to deliver the rigs out to sea, but he assured Lucinda that the cost increase would not be significant. Lucinda agreed to invest \$10 million and became a limited partner. Oil Build's bids proved too high for the company to obtain work. Without informing Lucinda, Grant sold the limited partnership's assets and pocketed the profits.

Did Grant owe and subsequently breach a duty to Lucinda? Yes. General partners owe the partnership a duty of _____ and a duty of _____, as well as an obligation to act in _____ and in the best _____ of the partnership. General partners owe their co-partners, including any limited partners, the highest fiduciary duty. Here, Grant was the general partner. He owed Lucinda, the firm's limited partner, this duty. He breached the duty by misrepresenting the significance of the low bridge, by selling the firm's assets without notifying her, and by pocketing the profits.

29

Formation and Ownership of a Corporation

Conflict Presented

Edward and Fiona wish to form a corporation to market apps designed to find goods and services for sports fans and participants in unfamiliar locales. They know that all corporations need to have an online presence to compete effectively in today's business climate. The corporate name should therefore be one that can be used as the business's internet domain name. Edward and Fiona would like to do business as Digital Synergy. An existing corporation already uses that name, however.

Q Can Edward and Fiona use the same, or a similar, name for their corporation?

A **corporation** is recognized by law as a “person”—an artificial, legal person—and enjoys many of the same rights under the law that natural persons enjoy. For instance, corporations have the right to be heard in court, and they enjoy the same constitutional guarantees as U.S. citizens.

Corporations are generally formed under state law, which can vary from state to state. When an individual purchases a share of **stock** in a corporation, that person becomes a shareholder and an owner of the corporation. A board of directors, elected by the shareholders, manages the business. Normally, however, day-to-day operations are overseen by corporate officers.

29–1 Formation of a Corporation

A corporation is a legal entity created and recognized by state law. Most often, corporations can be formed online by businesspersons or by attorneys. When businesspersons want to form a new corporation, they must complete all of the appropriate state's incorporation procedures and adopt the new corporation's bylaws.

29–1a Incorporation Procedures

Each state has its own incorporation procedures, which most often can be found on the secretary of state's website. There are four basic steps, however, that all incorporators generally must follow.

Step 1: Select a State of Incorporation For reasons of convenience and cost, businesses often select to incorporate in the state in which the corporation's business will be primarily conducted.

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Summarize incorporation procedures.
- 2 Describe basic corporate powers.
- 3 Explain the methods of corporate financing.
- 4 Define insider trading.
- 5 Explain how a shareholder's derivative suit can help a corporation.

corporation

A business recognized by law as a single entity.

stock

An equity or ownership interest in a corporation.

Learning Outcome 1

Summarize incorporation procedures.

Step 2: Secure the Corporate Name Most state statutes require a search to confirm that the chosen corporate name is available. A new corporation's name cannot be the same as, or deceptively similar to, the name of an existing corporation doing business within the state. All states require the corporation's name to include the word Corporation (Corp.), Incorporated (Inc.), Company (Co.), or Limited (Ltd.).

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Edward and Fiona wish to form a corporation to market apps targeted at sports fans and participants. They would like to do business as Digital Synergy, although an existing corporation already uses that name.

A Can Edward and Fiona use the same, or a similar, name for their corporation? No. A new corporation's name cannot be the same as, or deceptively similar to, the name of an existing corporation doing business within the same state. It could cause confusion. It might also transfer some of the goodwill established by the first user to the second, infringing on the first company's trademark rights. To avoid these problems, a businessperson should check on what names are available for use before seeking approval for a certain name from the state of incorporation. Perhaps more importantly, the name of the corporation should lend itself to a unique name on the internet. You should not only test the name in a web browser, but you should also go to a domain name selling site, such as Whois.com, to see if the name has already been taken.

articles of incorporation

The document filed with the appropriate governmental agency when a business is incorporated.

Step 3: Prepare the Articles of Incorporation The primary document needed to incorporate a business is the **articles of incorporation**. The articles must include the corporation's name, the number of shares it is authorized to issue, its registered agent, and the names of its incorporators. Other information can be included as well, such as the names of the initial members of the board of directors and the corporation's duration and purpose. In essence, the articles serve as a primary source of authority for the corporation's future organization and business operations.

Step 4: File the Articles of Incorporation Once the articles of incorporation have been prepared and signed properly, they are most often filed with the secretary of state's office, along with the required filing fee. Once this occurs, the new corporation officially exists.

29–1b Adoption of the Bylaws

After the incorporation procedures are completed, the first organizational meeting must be held. Usually, the most important function of this meeting is the adoption of the bylaws. **Bylaws** are the corporation's internal rules of management.

If the articles of incorporation named the initial board of directors, then the directors, by majority vote, call the meeting to adopt the bylaws and complete the company's organization. If the articles did not name the directors (as is typical), then the incorporators hold the meeting to elect the directors, adopt the bylaws, and complete the routine business of incorporation.

bylaws

A set of governing rules or regulations adopted by a corporation.

29–1c Defects in Corporate Formation

If the procedures for incorporation are not followed precisely, others may be able to challenge the existence of the corporation. If a corporation seeks to enforce a contract against a third party, for instance, that party may attempt to avoid liability on the ground of a defect in the incorporation procedure.

To prevent injustice, a court may attribute corporate status to an improperly formed corporation by holding it to be a *de facto* corporation or a corporation by estoppel. Sometimes, a court will also “pierce the corporate veil” when a corporation is used to shield persons who commit fraud or other illegal activities.

De Facto Corporations In some states, courts recognize *de facto* (actual) corporate status. In these states, the corporation may be held to legally exist in spite of a defect in formation if the parties have made a good faith attempt to comply with the relevant state statute and have already undertaken to do business as a corporation. A corporation with *de facto* status cannot be challenged by third persons, only by the state.

Corporation by Estoppel Under the doctrine of corporation by estoppel, if a business says it is a corporation and a third party deals with it as a corporation, neither party can question the validity of the business’s corporate status. The estoppel doctrine most commonly applies when a third party contracts with a business that claims to be a corporation but has not filed articles of incorporation. It may also apply when a third party contracts with a person claiming to be an agent of a corporation that does not exist.

Piercing the Corporate Veil Occasionally, the owners of a corporation use the corporate entity to perpetrate a fraud, circumvent the law, or in some other way accomplish an illegitimate objective. In these situations, courts will ignore the corporate formation and structure and **pierce the corporate veil** to expose the shareholders to personal liability.

The following are some of the factors that cause the courts to pierce the corporate veil:

1. A party is tricked or misled into dealing with the corporation rather than the individual.
2. The corporation is set up never to make a profit, or it is too “thinly” capitalized—that is, it has insufficient capital at the time of formation to meet its prospective debts or other liabilities.
3. Statutory corporate formalities, such as holding required corporation meetings, are not followed.
4. Personal and corporate interests are commingled (mixed together) to such an extent that the corporation has no separate identity.

pierce the corporate veil

To disregard the corporate entity and hold the shareholders personally liable for a corporate obligation.

Real Case



Timothy Hunsaker owned the construction company Breawick. Cheryl Deny hired Breawick to build a house. Hunsaker quit working before the house was finished, forcing Deny to hire another company to repair the construction flaws. Deny filed a claim against both Breawick and Hunsaker for breach of contract. She claimed that Hunsaker had altered the building plans without her consent. At trial, Breawick was found to have breached its contract with Deny. Hunsaker’s acts were so egregious that under Ohio’s law the court was willing to “pierce the corporate veil” and hold Hunsaker personally liable for the amount Deny spent to finish the house after he quit.

(Continues)

Should the court be able to pierce the corporate veil? Yes. In *Deny v. Breawick*, the Ohio Court of Appeals affirmed the trial court's decision that Hunsaker had drawn funds from Breawick's bank account to pay for personal expenses and had taken no steps to distinguish himself from the business entity. The court could therefore pierce the company's limited liability structure.

—137 N.E.3d 578 (Ohio Ct. App.)

29–2 Corporate Classifications, Powers, and Liability

When forming a corporation, owners must decide how to classify their new business entity. Once a corporation is created, the express and implied powers necessary to achieve its purpose also come into existence. This section provides an overview of corporate classifications, powers, and liability.

29–2a Corporate Classifications

How corporations are classified may depend on their location, purpose, or ownership characteristics. A list of important corporate classifications follows:

1. Domestic, foreign, and alien corporations—Any corporation incorporated under a state's laws and conducting business there is called a **domestic corporation**. A corporation formed in one state but doing business in another is referred to in that other state as a **foreign corporation**. A corporation formed in another country but doing business within the United States is called an **alien corporation**.
2. Public and private corporations—A public corporation is one formed by the government to meet some political or governmental purpose. Cities and towns that incorporate are common examples. Private corporations, in contrast, are created either wholly or in part for private benefit. Most corporations are private.
3. Nonprofit corporations—Corporations formed without a profit-making purpose are called nonprofit corporations. Examples include private hospitals, charities, and religious organizations.
4. Close corporations—Most U.S. corporate enterprises are classified as close corporations. A **close corporation** is one whose shares are held by a single person, members of a family, or relatively few nonrelated persons. Usually, the members of the small group constituting a close corporation are personally known to one another.
5. S corporations—An S corporation qualifies for special income tax treatment under the Subchapter S Revision Act of the Internal Revenue Code. The S corporation can avoid the imposition of income taxes at the corporate level while retaining many of the advantages of a corporation, particularly limited liability.
6. Benefit corporations—A **benefit corporation** is a for-profit corporation that seeks to have a materially positive impact on society and the environment. A benefit corporation is designed to make a profit, but its purpose is to benefit the public as a whole rather than just to provide long-term shareholder value.

domestic corporation

In a given state, a corporation that does business in and is organized under the laws of that state.

foreign corporation

In a given state, a corporation that does business in the state but is not incorporated there.

alien corporation

A corporation formed in another country but doing business in the United States.

close corporation

A corporation whose shareholders are limited to a small group.

benefit corporation

A corporation that seeks to have a materially positive impact on its surroundings.

29–2b Corporate Powers

Corporations have both express and implied powers. These powers are necessary if the corporations are to conduct business and accomplish the purposes for which they were created. In determining the scope of corporate powers, the *ultra vires* doctrine may come into play.

Express Powers The express powers of a corporation are found in its articles of incorporation, in the law of the state of incorporation, and in the state and federal constitutions. Corporate bylaws and the resolutions of the corporation's board of directors also grant or restrict certain powers.

Implied Powers A corporation has the implied power to perform all acts reasonably appropriate and necessary to accomplish its corporate purposes. For this reason, a corporation has the implied power to borrow funds within certain limits, to lend funds, and to extend credit to those with whom it has a legal or contractual relationship.

Example 29.1 Noble Coffee Company asks Leah, one of its employees, to drive her Ford truck to another city to pick up an overdue shipment of coffee beans. Because Noble has the implied power to reimburse her for her expenses, Leah agrees to this corporate errand. ■

Ultra Vires Doctrine The term *ultra vires* means “beyond the powers.” Acts of a corporation that are beyond the authority given to it under its charter or under the statutes by which it was incorporated are **ultra vires acts**. Such acts may lead to a lawsuit. **Example 29.2** Roberto is the chief executive officer of SOS Plumbing, Inc. The stated purpose of SOS is to install and repair plumbing. If Roberto contracts with Carl in SOS's name to purchase ten cases of brandy, he has likely committed an *ultra vires* act because the contract is not reasonably related to the corporation's purpose. ■

Because of the *ultra vires* doctrine, corporations generally adopt very broad statements of purpose in their articles of incorporation to include almost all conceivable activities. Also, courts have held that any legal action that a corporation undertakes to profit its shareholders is allowable and proper.

Learning Outcome 2

Describe basic corporate powers.

ultra vires acts

Acts of a corporation that are beyond its express and implied powers to undertake.

29–2c Corporate Liabilities

A corporation may be held liable for the criminal acts of its agents and employees. Although corporations cannot be imprisoned, they can be fined. In addition, under sentencing guidelines for crimes committed by corporate employees, corporations can face fines amounting to hundreds of millions of dollars.

A corporation is also liable for the torts (wrongs) committed by its agents, employees, or officers within the course and scope of their employment. The doctrine of *respondeat superior* applies to corporations in the same way as it does to other agency relationships. **Example 29.3** Raja is the financial officer for JB Investments, Inc. While serving as a JB director, Raja starts another investment firm by stealing investment funds from JB's clients. When JB's clients discover this fraud, they sue JB for damages. JB is liable for Raja's wrongful actions. ■

29–3 Corporate Financing

An advantage of the corporate form is its ability to obtain outside funding for formation and expansion. To obtain financing, corporations issue **securities**, which represent ownership interests or promises to repay debt. Securities typically consist of stocks and bonds, both of which are sold to investors.

securities

Items that represent an ownership interest in a corporation or a promise of repayment of debt by a corporation.

Learning Outcome 3

Explain the methods of corporate financing.

common stock

A security that evidences ownership in a corporation.

dividends

A distribution of profits to shareholders.

preferred stock

Classes of stock that have priority over common stock.

bond

A security that evidences a corporate long-term debt.

venture capital

Financing provided by outside investors to new business ventures.

crowdfunding

A cooperative online activity in which people network and pool funds to assist a cause or invest in a business venture.

29–3a Stocks and Bonds

Stocks, or equity securities, represent the purchase of ownership in the business firm. Because they do not represent debt, they need never be repaid. The two major types of stocks issued by corporations are common stock and preferred stock.

Common Stock **Common stock** represents the true ownership of a corporation. It provides a proportionate interest in the corporation with regard to (1) control, (2) earning capacity, and (3) net assets. A shareholder's interest is generally proportionate to the number of shares owned out of the total number of shares issued.

Control is exercised by common shareholders in the form of voting rights. Any person who purchases common stock acquires voting rights—one vote per share held.

Common shareholders may receive **dividends**, or distributions of profit, from the firm. There is, however, no guarantee of a dividend from common stocks. Much of the time, holders of common stock hope to benefit financially when the market value of their shares increases.

When a corporation dissolves or terminates, common shareholders may receive some of the net corporate assets, but they are last in line for repayment of their investments. They are entitled only to what is left after federal and state taxes are paid and after preferred stockholders, bondholders, suppliers, employees, and other groups have been paid.

Preferred Stock Holders of **preferred stock** have priority over holders of common stock as to dividends and to payment on a corporation's termination. Preferred shareholders may or may not have the right to vote.

In addition, preferred shareholders may receive periodic dividend payments, usually established as a fixed percentage of the face amount of each preferred share. For instance, a 5 percent preferred share with a face amount of \$100 would pay its owner a \$5 dividend each year.

Bonds **Bonds** represent the long-term borrowing of funds by a corporation. Bonds, or debt securities, involve no ownership interest in the issuing corporation. When bonds are issued, they almost always have a designated maturity date—the date when the principal, or face amount, of the bond is returned to the investor.

29–3b Alternative Financing

Sometimes, issuing securities is not the best way for a new corporation to raise capital. Some investors do not want to buy stock or bonds in a business that lacks a track record—that is, an established history of financial statements and operations. Therefore, to obtain capital, many new corporations seek alternative financing, such as venture capital and crowdfunding.

Venture Capital Financing provided by professional, outside investors to new business ventures is known as **venture capital**. Venture capitalists are usually groups of wealthy investors or securities firms. To obtain venture capital financing, a business typically gives up a share of its ownership to the venture capitalists.

Crowdfunding **Crowdfunding** is a cooperative activity in which people network and pool funds and other resources via the internet to assist a cause or invest in a venture. Sometimes, crowdfunding is used to finance budding entrepreneurs.

29–4 Sales of Securities

Once corporate securities have been sold to the public, they are traded among investors—often through a securities exchange, such as the New York Stock Exchange. Federal laws seek to protect investors engaging in such transactions. These laws include the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities and Exchange Commission (SEC) is the main federal agency that administers the 1933 and 1934 acts.

29–4a The Securities Act of 1933

The Securities Act of 1933 governs initial sales of stock by businesses. This act requires that investors receive financial and other important information concerning the securities being offered for public sale.

Registration Statement and Prospectus Under the 1933 act, unless exempted, an issuing corporation—one offering a new issue of securities for sale—must first register it with the SEC. Corporate registration statements are posted on the SEC’s online EDGAR (Electronic Data Gathering, Analysis, and Retrieval) database. Additionally, an issuing corporation must provide all investors with a prospectus. A **prospectus** is a disclosure document that describes the securities being offered for sale and the corporation’s financial operations.

prospectus

A disclosure document for investors that is required when selling securities.

The registration statement and the prospectus should provide unsophisticated investors with sufficient information to evaluate the risk of the investment attached to the security. If either document contains misstatements, the SEC will not allow the securities to be offered for sale. A violation of the 1933 act can subject responsible corporate officials to an investor’s suit for damages, as well as criminal prosecution.

Exemptions to the Securities Act of 1933 The SEC exempts certain securities from the 1933 act’s registration requirement, such as those issued by nonprofit or charitable organizations. The SEC also exempts securities that are sold in certain transactions. These include offerings that involve a small dollar amount or are made in a limited manner—for instance, to a small number of knowledgeable investors.

Highlighting the Point



Outfit Corporation needs to raise capital to finance its operations. Outfit makes a non-public offering of \$1 million in newly issued stock to a small group of sophisticated, knowledgeable investors. Outfit notifies the SEC of the offering and provides the investors with material information, including its financial statements.

Is this transaction exempt from the 1933 act’s registration requirement? Most likely, yes. The offering is not open to the public. The number of potential investors is small, and they can intelligently evaluate the risk involved. Outfit provided them with important, relevant, material information, and the SEC was notified.

29–4b An Important Exemption—Regulation A and Reg A+

Periodically, Congress passes modifications to existing exemptions to registration requirements under the 1933 Act. One of the most important is Regulation A. Several years ago, the SEC approved rule changes suggested under a congressional

act called Jumpstart Our Business Startups Act (JOBS Act). The idea was to encourage business growth and to bolster employment. The rule changes affected Regulation A by increasing certain offerings that did not necessitate registration from \$5 million to \$50 million. This new rule change is called Reg A+. Reg A+ expands the number of issuers that qualify for exemption. Anyone can invest in a Reg A+ offering today. Small and mid-sized businesses can now raise up to \$50 million a year selling stock by using a simple, streamlined, and cost-efficient process.

29–4c The Securities Exchange Act of 1934

Most securities can be resold without registration. Registration is required, however, of stockbrokers and other dealers of securities, as well as SEC-regulated publicly held corporations. A publicly held corporation is one whose shares are publicly traded in securities markets, such as the New York Stock Exchange. The Securities Exchange Act of 1934 provides for the regulation and registration of these securities exchanges, stockbrokers, and dealers. The 1934 act requires that a regulated corporation make periodic disclosures about its organization and financial situation.

Scienter and Securities Fraud It is unlawful to commit fraud in connection with any purchase or sale of a security. Private parties can sue for violations. The basis for such an action is a material misrepresentation in connection with the transaction and a reliance on that misrepresentation. The defendant also must have had *scienter* (a wrongful state of mind), and the plaintiff must have suffered an economic loss caused by the misrepresentation. Criminal sanctions are also possible.

Learning Outcome 4

Define insider trading.

insider trading

The purchase or sale of securities based on information not available to the public.

Scienter and Insider Trading One of the major goals of the 1934 act is to prevent insider trading. **Insider trading** occurs when persons buy or sell securities on the basis of information that is not available to the public. Insiders include corporate directors, officers, majority shareholders, and others who possess nonpublic information that affects the value of securities. Examples of such information include new discoveries, processes, or products, as well as changes in a firm's financial condition. *Scienter* is required to prove insider trading.

Insider trading also occurs when a corporate director, officer, or majority shareholder buys and then sells, or sells and then buys the corporation's securities within any six-month period. In these situations, it is irrelevant whether the insider uses inside information. All profits from the deal realized by the insider must be returned to the corporation.

29–5 Corporate Ownership—Shareholders

The acquisition of a share of stock makes a person an owner and shareholder of a corporation. Shareholders thus own the corporation. One of the key advantages of the corporate organization is that shareholders are not personally liable for the corporation's debts. Their liability is limited to the amount of their investments.

As a general rule, shareholders have no responsibility for the corporation's daily management. They have other powers and rights, however. Here, we look at the powers and voting rights of shareholders, which are generally established in the articles of incorporation and the state's incorporation law.

29–5a Shareholders' Powers

Shareholders must approve fundamental changes affecting the corporation before the changes can be implemented. Hence, shareholders must approve amendments to the articles of incorporation and bylaws, a merger or termination of the corporation, or the sale of all or substantially all of the corporation's assets.

Shareholders also elect and remove the directors of the corporation. For instance, they can remove a director from office for cause by a majority vote. Some state statutes permit removal of directors without cause by the vote of a majority of the holders of outstanding shares entitled to vote. Some corporate charters expressly provide that shareholders, by majority vote, can remove a director at any time without cause.

29–5b Shareholders' Meetings

Shareholders' meetings must occur at least annually. Additionally, special meetings can be called to take care of urgent matters. Because it is not practical for owners of only a few shares of stock to attend shareholders' meetings, such stockholders normally give third parties a written authorization to vote their shares at the meeting. This authorization is called a **proxy**.

Quorum Requirements For shareholders to act during a meeting, a **quorum** must be present. Generally, a quorum exists when shareholders holding more than 50 percent of the outstanding shares are present, but state laws often permit the articles of incorporation to set higher or lower quorum requirements.

Once a quorum is present, voting can proceed. Corporate business matters are presented in the form of resolutions, which shareholders vote to approve or disapprove. A straight majority vote of the shares represented at the meeting is usually required to pass resolutions.

Cumulative Voting At the shareholders' meeting, shareholders can elect persons to serve on the corporation's board of directors. Sometimes, each director is elected by a simple majority vote of the shareholders present at the meeting. Most states permit, however, and some states require, shareholders to elect directors by cumulative voting. This voting method allows minority shareholders to obtain representation on the board of directors.

When cumulative voting is used, the number of members of the board to be elected is multiplied by the total number of voting shares held. The result equals the number of votes a shareholder has. The shareholder can cast this total number of votes for one or more nominees for director.

proxy

A written agreement authorizing one shareholder to vote for another's shares in a certain manner.

quorum

The number of decision-makers that must be present before business can be conducted.

Highlighting the Point



Tam Corporation has 10,000 outstanding shares. Three members of the board are to be elected. A majority of the shareholders (holding 7,000 shares) favor Acevedo, Barkley, and Craycik. The other shareholders (3,000 shares) favor Drake.

If cumulative voting is allowed, can Drake be elected by the minority shareholders? Yes. The minority shareholders have 9,000 votes among them (the number of directors to be elected times the number of shares is 3 times 3,000, which equals 9,000 votes). All of these votes can be cast to elect Drake. The majority shareholders have 21,000 votes (3 times 7,000 equals 21,000 votes), but these votes have to be distributed among their three choices. No matter how the majority shareholders cast their votes, they cannot elect all three directors if the minority shareholders cast all of their votes for Drake. (See Exhibit 29.1.)

Exhibit 29.1 Results of Cumulative Voting

Ballot	Majority Shareholders' Votes			Minority Shareholders' Votes	Directors Elected
	Acevedo	Barkley	Craycik	Drake	
1	10,000	10,000	1,000	9,000	Acevedo/Barkley/Drake
2	9,001	9,000	2,999	9,000	Acevedo/Barkley/Drake
3	6,000	7,000	8,000	9,000	Barkley/Craycik/Drake

29–5c Rights of Shareholders

Shareholders possess many rights. We discuss several important shareholder rights in this section.

Voting Rights Shareholders exercise ownership control through the power of their votes. Each shareholder is entitled to one vote per share. The articles of incorporation can exclude or limit voting rights.

stock certificate

A certificate evidencing the ownership of corporate shares.

Stock Certificates A **stock certificate** is issued by a corporation to demonstrate ownership of a specified number of shares in the corporation. In jurisdictions that require the issuance of stock certificates, shareholders have the right to demand that the corporation issue a certificate and record their names and addresses in the corporate stock record books.

Physical stock certificates are becoming a relic of the past. Most trading of shares of stocks is done online and often rapidly. Consequently, there is rarely time (nor a need or desire) to print out new stock certificates and mail them to new purchasers of shares of stock in a publicly traded company. There are, of course, notations on electronic records for each publicly traded corporation that indicate who owns how many shares at a given point in time.

preemptive right

A shareholder's right to purchase a prorated share of a new stock issue before the stock is offered to others.

Preemptive Rights A shareholder who has a **preemptive right** obtains a preference over all other purchasers to subscribe to, or purchase, a prorated share of a new issue of stock. This allows the shareholder to maintain their portion of control, voting power, and financial interest in the corporation.

Example 29.4 Margaret, a shareholder who owns 10 percent of a company and who has preemptive rights, can buy 10 percent of any new issue (to maintain her 10 percent position). Thus, if Margaret owns 100 shares of 1,000 outstanding shares, and the corporation issues 1,000 more shares, she can buy 100 of the new shares. ■

Dividends A dividend is a distribution of corporate profits. Dividends are ordered by the directors and paid to the shareholders in proportion to their respective shares in the corporation. Dividends can be paid in cash, property, stock of the corporation that is paying the dividends, or stock of other corporations.

State laws vary, but every state determines the circumstances and legal requirements under which dividends are paid. State laws also control the sources of revenue to be used. All states allow dividends to be paid from the undistributed net profits earned by the corporation, for instance. A number of states allow dividends to be paid out of any surplus.

Inspection Rights Shareholders have a right to inspect and copy corporate books and records for a proper purpose, provided they request access to the books and records in advance. Either the shareholder can inspect in person or an attorney, agent, accountant, or other type of assistant can do so.

Highlighting the Point



Laila, the majority shareholder of Market Mogul, Inc., sells the firm's assets to herself and sets up another corporation, Nano Research. Laila then tells Market Mogul's minority shareholders that she is dissolving Market Mogul because it is failing financially. Kurt, a minority shareholder, asks to inspect the corporate records so that he can determine Market Mogul's financial condition, the value of its stock, and whether any misconduct has occurred.

Is Kurt entitled to inspect Market Mogul's books and records? Yes. Kurt has expressed a proper purpose for the inspection and should be allowed access to Market Mogul's records. A shareholder can be denied access to corporate records to prevent harassment or to protect trade secrets or other confidential corporate information, but that is not the situation here—Kurt is not abusing his right to inspect.

Transfer of Shares Generally shareholders have the right to transfer their shares to another party. Sometimes, corporations or their shareholders restrict transferability by reserving the option to purchase any shares offered for resale by a shareholder.

The Shareholder's Derivative Suit When the corporation is harmed by the actions of a third party, the directors can bring a lawsuit in the name of the corporation against that party. If the corporate directors fail to bring a lawsuit, shareholders can do so “derivatively” in what is known as a **shareholder's derivative suit**.

The right of shareholders to bring a derivative action is especially important when the wrong suffered by the corporation results from the actions of corporate directors or officers. This is because the directors and officers would most likely not be willing to sue themselves.

When shareholders bring a derivative suit, they are not pursuing rights or benefits for themselves personally but are acting as guardians of the corporate entity. Therefore, if the suit is successful, any damages recovered normally go into the corporation's treasury, not to the shareholders personally.

Learning Outcome 5

Explain how a shareholder's derivative suit can help a corporation.

shareholder's derivative suit

A suit brought by a shareholder to enforce a corporate cause of action against a third person.

29–5d Duties of Majority Shareholders

In some instances, a majority shareholder is regarded as having a fiduciary duty to the corporation and to the minority shareholders. This occurs when a single shareholder (or a few shareholders acting together) owns a sufficient number of shares to exercise actual control over the corporation. In these situations, majority shareholders owe a fiduciary duty to the minority shareholders.

When a majority shareholder breaches their fiduciary duty to a minority shareholder, the minority shareholder can sue for damages. A breach of fiduciary duties by those who control a close corporation normally constitutes what is known as oppressive conduct. A common example of a breach of fiduciary duty occurs when the majority shareholders “freeze out” the minority shareholders and exclude them from the benefits of participating in the firm.

Chapter Summary—Formation and Ownership of a Corporation

Learning Outcome 1: Summarize incorporation procedures.

Exact procedures for incorporation differ among states, but the basic steps are to select a state of incorporation, secure the corporate name, and prepare and file the articles of incorporation.

Learning Outcome 2: Describe basic corporate powers.

The powers of the corporation include the following:

- (1) Express powers are granted by the U.S. Constitution, state constitutions, state statutes, articles of incorporation, bylaws, and resolutions of the board of directors.
- (2) Implied powers exist to perform all acts reasonably appropriate and necessary to accomplish corporate purposes.
- (3) Any act of a corporation that is beyond its express or implied powers is an *ultra vires* act and may lead to a lawsuit.

Learning Outcome 3: Explain the methods of corporate financing.

Corporations obtain financing by selling stocks and bonds to investors. Stocks are equity securities issued by a corporation that represent the purchase of ownership in the business firm. The main types are common stock and preferred stock. Bonds are securities representing corporate debt—that is, money borrowed by a corporation. Other sources of financing include venture capital and crowdfunding.

Learning Outcome 4: Define insider trading.

Insider trading is the purchase or sale of securities on the basis of information that has not been made available to the public. This activity is prohibited to prevent corporate insiders from taking advantage of their positions at the expense of other shareholders.

Learning Outcome 5: Explain how a shareholder's derivative suit can help a corporation.

If the directors refuse to act in order to redress a wrong suffered by the corporation, the shareholders can act on its behalf by filing a shareholder's derivative suit. Any monetary damages recovered by such a lawsuit goes to the corporation.

Straight to the Point

1. What is a close corporation? (See Learning Outcome 2.)
2. What are some consequences if the procedures for incorporation are not followed precisely? (See Learning Outcome 1.)
3. What are securities? (See Learning Outcome 3.)
4. What does a business usually exchange for venture capital? (See Learning Outcome 3.)
5. How does federal law protect investors in securities? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Wonder Corporation has an opportunity to buy stock in Xience, Inc. The Wonder directors decide to buy the stock for themselves instead. On learning of the deal, Yves, a Wonder shareholder, wants to sue the directors on the corporation's behalf. Can he do it? Explain. (See Learning Outcome 5.)
2. The incorporators of Consumer Investments, Inc., want their new corporation to have the authority to transact nearly any conceivable type of business. Can they grant this authority to their firm? If so, how? If not, why? (See Learning Outcome 2.)

Real Law

29-1. Duties Among Majority Shareholders. Perma-Jack is a franchisor of a foundation repair and stabilization system in St. Louis, Missouri. Three siblings—John Langenbach, Judy Lanfri, and Joan Robinson—were three equal shareholders. Robinson served as the company’s president for twenty-five years. When the number of franchisees declined, Langenbach and Lanfri had a special board meeting to vote to remove her. She was not provided with salary, severance pay, benefits, or dividends as a shareholder. Robinson filed a suit in Missouri state court alleging breach of fiduciary duty to Robinson as a shareholder. At trial, the court ordered Langenbach and Lanfri to pay her almost \$400,000 in damages and to buy her Perma-Jack shares for fair value. They appealed. Should an appellate court uphold the trial court’s decision? [*Robinson v. Langenbach*, 599 S.W.3d 167 (S.Ct. MO, 2020)] (See Learning Outcome 5.)

29-2. Criminal Liability. Jennifer Hoffman took her smartphone to a store owned by R&K Trading, Inc., for repairs. Later, Hoffman filed a suit in a New York state court against R&K and Verizon Wireless, Inc., seeking to recover damages for a variety of torts. She alleged that an R&K employee, Keith Press, had examined her phone in a store’s backroom, accessed private

photos of her, and then circulated the photos to the public. Hoffman testified that “after the incident, she learned from another R&K employee that personal information and pictures had been removed from the phones of other customers.” Can R&K be held liable for Press’s torts? Explain. [*Hoffman v. Verizon Wireless, Inc.*, 5 N.Y.S.3d 123, 125 A.D.3d 806 (2015)] (See Learning Outcome 2.)

29-3. Piercing the Corporate Veil. Scott Snapp contracted with Castlebrook Builders, Inc., which was owned by Stephen Kappeler, to remodel a house. Kappeler estimated the cost at \$500,000. Eventually, however, Snapp paid Kappeler more than \$1.3 million. Snapp sought to be reimbursed, but Kappeler could not provide an accounting for the project. Specifically, he could not explain double and triple charges, nor whether the amount that Snapp paid had actually been spent on the house. Meanwhile, Kappeler had commingled personal and corporate funds. As for Castlebrook, it had issued no shares of stock, and the minutes of the corporate meetings “all looked exactly the same.” Are these sufficient grounds to pierce the corporate veil? Explain. [*Snapp v. Castlebrook Builders, Inc.*, 54 Ohio App.3d 361, 7 N.E.2d 574 (2014)] (See Learning Outcome 1.)

Ethical Questions

29-4. Corporate Liability. Why do companies need to be careful about whom they hire and how much they supervise or monitor their employees? (See Learning Outcome 2.)

29-5. Piercing the Corporate Veil. Lester Fulmer sold H2O Lifts and Ramps, LLC (H2O), to Hurt-Hoover Investments, LLC (HHI). HHI agreed to pay \$550,000 of the price by a note in thirty-six installments. From the installments, HHI deducted offsets, including charges for expenses incurred before the sale. Meanwhile, HHI incurred annual losses. Its owners, William Hurt and Michael Hoover, contributed

funds to keep the firm in business. They followed the statutory business formalities. To collect on the note, Fulmer obtained a judgment in an Arkansas state court against HHI for the unpaid amount. Hurt and Hoover did not dissolve HHI or form another entity to avoid the judgment but offered to pay it when the profits from H2O became sufficient. Should HHI’s corporate veil be pierced to hold Hurt and Hoover liable? Did they conduct their business according to ethical standards? Explain. [*Fulmer v. Hurt*, 2017 Ark.App. 117 (2017)] (See Learning Outcome 1.)

Chapter 29—Work Set

True-False Questions

- _____ 1. A corporation is an artificial being.
- _____ 2. A corporation that is formed in a country other than the United States, but which does business in the United States, is a foreign corporation.
- _____ 3. Stocks represent the purchase of corporate ownership.
- _____ 4. The rights of shareholders are established only in the articles of incorporation.
- _____ 5. Damages recovered in a shareholder's derivative suit are normally paid to the shareholder who brought the suit.
- _____ 6. As a general rule, shareholders are not personally responsible for the debts of the corporation.
- _____ 7. Cumulative voting allows minority shareholders to obtain representation on the board of directors.

Multiple-Choice Questions

- _____ 1. Arley, Terry, and Victor want to form ATV Corporation. Which of the following is not a step in forming the corporation?
 - a. Selecting a state of incorporation.
 - b. Preparing articles of incorporation.
 - c. Adopting bylaws at a shareholders' meeting.
 - d. Filing articles of incorporation.
- _____ 2. Mike, Nora, and Cleona are shareholders in National Business, Inc. All of the shareholders are National's
 - a. owners.
 - b. directors.
 - c. incorporators.
 - d. officers.
- _____ 3. Jill is a shareholder of United Manufacturing Company. As a shareholder, Jill's rights include all of the following except a right to
 - a. have one vote per share.
 - b. access corporate books and records.
 - c. transfer shares.
 - d. sell corporate property when directors are mishandling corporate assets.
- _____ 4. The board of directors of U.S. Goods Corporation announces that the corporation will pay a cash dividend to its shareholders. Once declared, a cash dividend is
 - a. a corporate debt.
 - b. a personal debt of the directors.
 - c. a personal debt of the shareholders.
 - d. an illusory promise.
- _____ 5. U.S. Digital Corporation incorporated in Ohio, its only place of business. Its stock is owned by ten shareholders. Two are resident aliens. Three of the others are the directors and officers. The stock has never been sold to the public. If a shareholder wants to sell their shares, the other shareholders must be given the opportunity to buy them first. U.S. Digital is
 - a. a close corporation.
 - b. a foreign corporation.
 - c. an alien corporation.
 - d. none of the above.

- _____ 6. General Manufacturing, Inc. (GMI), issues bonds to finance the purchase of a factory. Regarding those bonds, which of the following is true?
- The bonds must be repaid.
 - The bondholders will receive interest payments only when voted by GMI directors.
 - The bonds are identical to preferred stock from an investment standpoint.
 - The bondholders will be the last investors paid on GMI's dissolution.
- _____ 7. The management of National Brands, Inc., is at odds with the shareholders over some recent decisions. To redress a wrong suffered by National from the actions of management, the shareholders may
- exercise their preemptive rights.
 - exercise their inspection rights.
 - file a shareholder's derivative suit.
 - issue a proxy.
- _____ 8. Federated Products Corporation uses cumulative voting in its elections of directors. Mary owns 3,000 Federated shares. At an annual shareholders' meeting at which three directors are to be elected, how many votes may Mary cast for any one candidate?
- 1,000.
 - 3,000.
 - 9,000.
 - 2,700.

Answering More Legal Problems

1. Jeremy incorporated FormFit Concrete, Inc., but did not file its first annual report, so the state involuntarily dissolved the firm. Unaware of this, Jeremy contracted with Market Square to lay the foundations for a commercial building project. After the work was complete, Market Square refused to pay. To recover, Jeremy filed a claim as "FormFit Concrete, Inc." Market Square asked the court to dismiss the claim on the ground that the state had dissolved that firm. Jeremy immediately filed new articles of incorporation for "FormFit Concrete, Inc."
2. Brent, Jon, and Kenzie owned Kenzie's Lemonade Corp., which made and sold fruit drinks. Each owned one-third of the shares of the corporate stock, and each was a director. A disagreement arose over the direction of the business. Kenzie asked Brent and Jon to buy her shares, but they refused. They also denied her access to the company's books and records, did not declare a dividend, and did not reelect her as a director.

Can Jeremy recover from Market Square? Yes. Under the doctrine of corporation by _____, if a business holds itself out as a corporation, and a third-party deals with it as a corporation, neither party can question the validity of the business's _____ status. In this problem, Jeremy fulfilled the contract in good faith, as indicated by his lack of awareness of the dissolution, his continuing to act as a corporation, and his filing of new articles under the same corporate name immediately on learning of the involuntary dissolution. Market Square dealt with FormFit as a _____ and accepted the benefit of its performance.

Did Brent and Jon, as majority shareholders, breach their fiduciary duty to Kenzie? Yes. When a few shareholders acting together own a sufficient number of shares to exercise _____ control over a corporation, they owe a _____ duty to the minority shareholders. A breach of this duty occurs when the majority shareholders of a close corporation "freeze out" the minority shareholder or shareholders, whom they exclude from the benefits of the firm. A minority shareholder's remedy for this oppressive conduct is to sue for _____.



30 | Management of a Corporation

Conflict Presented

Antonio, one of the directors of the First National Bank, attends no board of directors' meetings in five and a half years, never inspects any of the bank's books or records, and generally fails to supervise the efforts of the bank president and the loan committee. Meanwhile, the bank president makes various improper loans and permits large overdrafts.

Q Can Antonio be held liable to the bank for losses resulting from the unsupervised actions of the bank president and the loan committee?

A corporation joins together the efforts and resources of a large number of individuals for the purpose of producing greater returns than those persons could have produced individually. When it comes to managing a corporation, the corporation relies on its board of directors and officers.

30-1 Corporate Management—Directors

Every corporation is governed by a board of directors, which is its ultimate authority. Directors have responsibility for all policymaking decisions necessary to the management of corporate affairs.

30-1a Election of Directors

How many directors serve on a corporation's board is determined by its articles of incorporation. Traditionally, the minimum number of directors is three, although several states now allow fewer than three. The initial board of directors is normally appointed by the incorporators when the corporation is created. This initial board serves until the first annual shareholders' meeting.

Subsequent directors are elected by a majority vote of the shareholders at the annual meeting. A director usually serves for one year—from annual meeting to annual meeting. Longer and staggered terms are permissible under most state statutes. A common practice is to elect one-third of the board members each year for a three-year term. In this way, there is greater management continuity.

Removal of Directors A director can be removed for cause (breach of duty or other misconduct), either as specified in the articles or bylaws or by shareholder action. The board of directors itself may be given power to remove a director for cause, subject to shareholder review. In most states, unless the corporation has previously authorized such an action, a director cannot be removed without cause.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Discuss corporate directors' management responsibilities.
- 2 State the primary function of corporate officers.
- 3 Define the business judgment rule.
- 4 Explain director and officer liabilities.

Vacancies Sometimes, vacancies occur on the board of directors due to death or resignation. In addition, new positions may be created through amendment of the articles or bylaws. When a vacancy exists, either the shareholders or the board itself can fill the position, depending on state law or on the provisions of the bylaws.

30–1b Board of Directors' Meetings

The board of directors conducts business by holding formal meetings with recorded minutes. Most often, the date at which regular meetings are held is established in the articles and bylaws or by board resolution. Special meetings can be called with notice sent to all directors. Most states allow directors to participate in board meetings from remote locations via telephone or web conferencing.

Quorum Requirements A quorum is the minimum number of members of a decision-making body that must be present before business may be transacted. Quorum requirements vary among jurisdictions. Many states leave the decision to the corporate articles or bylaws. If the articles or bylaws do not state quorum requirements, most states provide that a quorum is a majority of the number of directors authorized in the articles or bylaws.

Voting Once a quorum is present, the directors transact business and vote on issues affecting the corporation. Each director has one vote. Ordinary matters generally require a majority vote. Certain extraordinary issues may require a greater-than-majority vote.

30–1c Directors' Responsibilities

The directors act as a body in carrying out routine corporate business. Each director has one vote, and customarily the majority rules. The general areas of responsibility of the board of directors include those listed below. Examples of these responsibilities are presented in Exhibit 30.1.

1. Authorization of major corporate policy decisions. **Example 30.1** The board of directors of Catalina Swimwear approves the company's new product lines every season. It also oversees the contract negotiations with the companies that will manufacture the new swimsuits and other swim apparel. ■
2. Appointment, supervision, and removal of corporate officers and other managerial employees, and determination of their compensation.
3. Financial decisions, such as the declaration and payment of dividends to shareholders and the issuance of authorized shares (stocks) or bonds.

Exhibit 30.1 Examples of Directors' Management Responsibilities

Authorize Major Corporate Policy Decisions Examples: • Oversee major contract negotiations and management–labor negotiations. • Initiate negotiations on the sale or lease of corporate assets outside the regular course of business.	Make Executive Personnel Decisions Examples: • Engage in selection of corporate officers and executives, and determine their compensation. • Supervise managerial employees and make decisions regarding their termination.	Make and Announce Financial Decisions Examples: • Make decisions regarding the issuance of authorized stocks and bonds. • Decide when dividends are to be paid to shareholders.

Learning Outcome 1

Discuss corporate directors' management responsibilities.

The board of directors can delegate some of its functions to an executive committee or to corporate officers. Corporate officers and managerial personnel are then empowered to make decisions relating to ordinary, daily corporate affairs within well-defined guidelines. The board retains its overall responsibility for directing the corporation's affairs, however.

Highlighting the Point



The board of directors for Shire Pharmaceuticals has a dozen members. To manage the many complex issues facing the company, the board creates an executive committee and an audit committee. The board appoints directors to serve on these committees. The executive committee is authorized to make management decisions between board meetings. The audit committee is charged with the selection, compensation, and oversight of the independent public accountants who audit the firm's financial records.

Can a board of directors delegate these responsibilities to committees? Yes. When a board has a large number of members who must deal with complex issues, meetings can become unwieldy. The boards of large corporations typically create committees of directors to focus on specific subjects and increase company efficiency. Thus, it is quite common for a board to form executive and audit committees.

30–1d Directors' Rights

Directors must have certain rights in order to perform their duties and responsibilities. These rights include the right to participation, the right of inspection, and the right to indemnification.

Right to Participation Directors are entitled to participate in all board of directors' meetings and have a right to be notified of these meetings. Because the dates of regular board meetings are usually specified in the bylaws, no notice of these meetings is required. When special meetings are called, however, notice must be given to the directors.

Right of Inspection Each director has the right to access the corporation's books and records, facilities, and other property. This right is essential for directors to make informed decisions and to supervise officers and other employees. It cannot be restricted by the corporate articles, the bylaws, or any act of the board.

Highlighting the Point



SmartLink, Inc., provides data management and other services. Taylor is a member of SmartLink's board of directors. Taylor believes that the other directors are holding secret "pre-board meetings" and making decisions without her. Her requests to review the minutes of the board meetings held during the past six months are ignored. She files a suit against SmartLink to obtain the meeting minutes.

Is Taylor entitled to inspect the minutes from all board meetings? Yes. Directors are entitled to inspect all corporate documents. These documents include the minutes of board meetings, as well as communications among the corporate staff regarding those minutes.

Right to Indemnification Directors who become involved in litigation because of their positions may have a right to be reimbursed, or indemnified, for the costs, fees, and damages involved. A corporation may be able to buy liability insurance to cover these amounts.

30–2 Corporate Management—Officers

Learning Outcome 2

State the primary function of corporate officers.

As noted, the board of directors manages the corporate business and formalities, which includes hiring the corporation's officers and other executive employees. The primary function of a corporation's officers and executives is to manage corporate policies and the day-to-day operations.

At a minimum, most corporations have a president, one or more vice presidents, a secretary, and a treasurer. In most states, an individual can hold more than one office. For instance, a person can be both president and secretary. A person can also be both an officer and a director. In addition to carrying out the duties outlined in the bylaws, corporate and managerial officers act as agents of the corporation. Hence, the ordinary rules of agency usually apply to their employment.

Because officers and high-level managers are employees, their rights are defined by their employment contracts. Regardless of these contracts, the board of directors normally can remove corporate officers at any time with or without cause. If the board removes an officer in violation of an employment contract, the corporation may be liable for breach of contract.

30–3 Duties of Directors and Officers

Directors and officers are fiduciaries of the corporation. A fiduciary is a person with a duty to act primarily for another's benefit. Thus, the relationship of directors and officers with the corporation and its shareholders is one of trust and confidence. The fiduciary duties of the directors and officers include the duty of care and the duty of loyalty.

30–3a Duty of Care

Directors are obligated to be honest and to use prudent business judgment in the conduct of corporate affairs. They must exercise the same degree of care that reasonably prudent people use in conducting their own personal affairs. In addition, they must carry out their responsibilities in an informed, business-like manner and act in accordance with their own knowledge and training.

Directors can be held answerable to the corporation and to the shareholders for breaching their duty of care. When directors delegate work to corporate officers and employees, they are expected to use a reasonable amount of supervision. Otherwise, they will normally be held liable for negligence or mismanagement of corporate personnel.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Antonio, one of the directors of the First National Bank, attends no board meetings in five and a half years, never inspects any of the bank's books or records, and fails to supervise the bank president and the loan committee. Meanwhile, the bank president makes improper loans and permits large overdrafts.

A Can Antonio be held liable to the bank for losses resulting from the actions of the president and the loan committee? Yes. The director has breached his duty of care and may be held liable to the bank for the losses.

30-3b Duty of Loyalty

Loyalty can be defined as faithfulness to one's obligations and duties. In the corporate context, the duty of loyalty requires directors and officers to subordinate their personal interests to the corporation's welfare. Directors cannot use corporate funds or confidential information for personal advantage and must refrain from self-dealing.

Example 30.2 Reyna is a member of the board of directors for Coal Creek Creamery, Inc. When Seattle Cheese Company makes an offer to merge with Coal Creek, Reyna cannot oppose it simply because she will lose her board position. If, however, the offer is not in Coal Creek's best interest, then her duty of loyalty justifies her opposition. In short, Reyna's loyalty is to Coal Creek, not herself. ■

Real Case



In 1930, Charles Guth became the president of Loft, Inc., a Candyland restaurant chain. Guth and his family owned Grace Company, which made syrups for soft drinks. Coca-Cola Company supplied Loft with cola syrup. Unhappy with what he felt was Coca-Cola's high price, Guth entered into an agreement with Roy Megargel to acquire the trademark and formula for Pepsi-Cola and to form Pepsi-Cola Corporation. Without the knowledge of Loft's board of directors, Guth used Loft's capital, credit, facilities, and employees to further the Pepsi enterprise. Loft filed suit against Guth, Grace, and Pepsi, seeking their Pepsi stock and an accounting. The trial court entered a judgment in the plaintiff's favor. The defendants appealed to the Delaware Supreme Court.

Did Guth violate the duty of loyalty to Loft, Inc., by acquiring the Pepsi-Cola trademark and formula for himself, without the knowledge of Loft's board of directors? Yes. In *Guth v. Loft, Inc.*, the Delaware Supreme Court upheld the judgment of the lower court. The reviewing court pointed out that the officers and directors of the corporation stand in a fiduciary relationship to that corporation. Corporate officers and directors must provide undivided and unselfish loyalty to the corporation. Guth clearly created a conflict between his self interests and his duty to Loft.

—5 A.2d 503 (S.Ct. Del.)

30-3c Disclosure of Conflicts of Interest

Corporate officers often have many business affiliations. A director may sit on the board of more than one corporation. Directors are precluded from entering into or supporting businesses that operate in direct competition with the corporation on whose boards they serve. This fiduciary duty requires them to make a full disclosure of any potential conflict of interest that might arise in any corporate transaction. **Example 30.3** Central Corporation needs more office space. Cecilia Lozello, one of its five directors, owns the building adjoining the corporation's main office building. She negotiates a lease with Central for the space, making a

full disclosure to Central and the other four directors. The lease arrangement is fair and reasonable, and it is unanimously approved by the other four directors. Lozello has not breached her duty of loyalty to the corporation, and thus the lease contract is valid. ■

30–3d The Business Judgment Rule

Learning Outcome 3

Define the business judgment rule.

business judgment rule

A rule that immunizes management from liability for actions undertaken in good faith.

Directors and officers are expected to exercise due care and to use their best judgment in guiding corporate management, but they are not insurers of business success. Under the **business judgment rule**, a corporate director or officer will not be liable to the corporation or to its shareholders for honest mistakes of judgment and bad business decisions. For the rule to apply, the directors or officers must act within their managerial authority and within the powers of the corporation. They must also exercise due care.

Generally, if there is a reasonable basis for a business decision, a court will not likely interfere with that decision, even if it causes the corporation to suffer. In fact, unless there is evidence of bad faith, fraud, or a clear breach of fiduciary duties, most courts will apply the business judgment rule to protect directors and officers from liability for their bad business decisions.

30–4 Liability of Directors and Officers

Learning Outcome 4

Explain director and officer liabilities.

Directors and officers can be subject to liability in many circumstances. In particular, directors and officers may be held liable for negligence in the performance of their duties. Additionally, they may be liable for the torts and crimes of employees under their supervision.

Directors and officers may also be liable for violations of a variety of statutes, including those enacted to protect consumers or the environment. **Example 30.4** Clark Pharmaceuticals, Inc., produces a sleep-aid that, in certain instances, may cause migraine headaches. Clark corporate officers approve a new marketing plan that does not include any mention of the potential negative side effect. Clark's management may be held liable for its intentional disregard of federal consumer protection laws. ■

Corporations must file certain financial and stock-transaction reports with the Securities and Exchange Commission (SEC). Chief corporate executive officers are personally responsible for the accuracy of financial statements and reports filed with the SEC. High-level managers must maintain an effective system of control within the corporation to ensure that the reports are accurate. These are requirements of the federal Sarbanes-Oxley Act of 2002. This act was passed to protect investors from fraudulent corporate accounting practices.

Note that when directors and officers do not act in the best interests of their corporation, the shareholders may sue them on the company's behalf. These lawsuits are called shareholders derivative suits.

Chapter Summary—Management of a Corporation

Learning Outcome 1: Discuss corporate directors' management responsibilities.

Directors' management responsibilities include (1) authorization of major corporate policy decisions, (2) appointment, supervision, compensation, and removal of corporate officers and other management employees, and (3) declaration and payment of corporate dividends to shareholders and issuance of authorized shares or bonds. Directors may delegate some of their responsibilities to executive committees or officers and executives.

Learning Outcome 2: State the primary function of corporate officers.

The primary function of a corporation's officers and executives is to manage corporate policies and to make daily business decisions.

Learning Outcome 3: Define the business judgment rule.

Under the business judgment rule, a corporate director or officer will not be liable to the corporation or to its shareholders for honest mistakes of judgment or bad business decisions. For the rule to apply, the directors or officers must act within their managerial authority and within the powers of the corporation. They must also exercise due care.

Learning Outcome 4: Explain director and officer liabilities.

Directors and officers may be held liable for negligence in the performance of their duties. Additionally, they may be liable for the torts and crimes of employees under their supervision. Directors and officers may also be liable for violations of a variety of statutes. Chief corporate executive officers are personally responsible for the accuracy of financial statements and reports filed with the SEC. When directors and officers do not act in the best interests of their corporation, the shareholders may sue them on the company's behalf.

Straight to the Point

1. How can directors be removed from their positions? (See Learning Outcome 1.)
2. How many directors constitute a quorum? (See Learning Outcome 1.)
3. Can a board delegate its responsibilities? (See Learning Outcome 1.)
4. Why does a director have a right of inspection? (See Learning Outcome 1.)
5. What is the role of corporate officers? (See Learning Outcome 3.)
6. What are some fiduciary duties of directors and officers? (See Learning Outcome 3.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Glen is a director and shareholder of Diamond Corporation and of Emerald, Inc. If a resolution comes before the Emerald board to compete with Diamond, what is Glen's responsibility? (See Learning Outcome 1.)
2. Tandin is a director and officer of United Products, Inc. Tandin makes a decision about the marketing of United's products that results in a dramatic decrease in profits for United and its shareholders. The shareholders accuse Tandin of breaching his fiduciary duty to the corporation. What is Tandin's best defense? (See Learning Outcome 3.)

Real Law

30-1. Business Judgment Rule. Expansion Capital Group (ECG), a Delaware company, worked out of Sioux Falls, South Dakota. Matt Patterson invested \$100,000 in ECG. ECG provides small business financing through business loans and merchant cash advances. ECG was a financial success, going from two employees to seventy in fewer than three years and from no revenue to \$15 million in the same time period. ECG claimed that Patterson, as chief

executive officer, breached fiduciary duties owed to ECG by overpaying an investor and failing to collect management fees owed to ECG. ECG further claimed that Patterson formed a participation fund to compete against ECG and used his position of trust and confidence with ECG to further his own private interests. Patterson used the business judgment rule defense to counter some of the claims against him. The trial court pointed out that this rule creates

a “powerful presumption” in favor of actions taken by a loyal, informed, and authorized corporate decisionmaker. Should a court accept Patterson’s argument that all of his actions were covered by the business judgment rule? Why or why not? [*Expansion Capital Group, LLC v. Patterson*, 2021 WL229352 (U.S. Dist. Ct. South Dakota, 2021)] (See Learning Outcome 3.)

30–2. Business Judgment Rule. Country Contractors, Inc., contracted to provide excavation services for A Westside Storage of Indianapolis, Inc. Country did not complete the job and later filed for bankruptcy. Stephen Songer and Jahn Songer were Country’s sole shareholders and officers. The Songers had not misused the corporate form to engage in fraud, the firm had not been undercapitalized, personal and corporate funds had not been commingled, and Country had kept accounting records and minutes of its

annual board meetings. Are the Songers personally liable for Country’s failure to complete its contract? Explain. [*Country Contractors, Inc. v. A Westside Storage of Indianapolis, Inc.*, 4 N.E.3d 677 (Ind.App. 2014)] (See Learning Outcome 3.)

30–3. Duty of Loyalty. Kids International Corp. produced children’s wear for Walmart and other retailers. Gila Dweck was a Kids director and its chief executive officer. Because she felt that she was not paid enough for the company’s success, she started Success Apparel to compete with the firm. Success operated out of Kids’ premises, used its employees, borrowed on its credit, took advantage of its business opportunities, and capitalized on its customer relationships. As an “administrative fee,” Dweck paid Kids 1 percent of Success’s total sales. Did Dweck breach any fiduciary duties? Explain. [*Dweck v. Nasser*, 2012 WL 161590 (Del. Ch. 2012)] (See Learning Outcome 3.)

Ethical Questions

30–4. Duty of Loyalty. Under what circumstances might a director’s sale of corporate property to himself be justified? (See Learning Outcome 3.)

30–5. Duties of Directors and Officers. Hewlett-Packard Company (HP) monitored the phones of its directors to find the sources of leaks of company information to the media. When the government learned of the monitoring, criminal charges were brought against HP’s officers. Mark Hurd, HP’s chief executive officer, was found free of wrongdoing and kept his position. In congressional testimony, press

releases, and investor briefings, Hurd proclaimed HP’s integrity and its intent to enforce violations of its corporate code of ethics, the Standards of Business Conduct (SBC). Meanwhile, an investigation by HP’s board revealed that Hurd had lied about his personal relationship with an HP contractor and falsified related expense reports. Hurd resigned, causing the price of HP stock to drop. Did Hurd commit an ethical violation against HP and its shareholders? Discuss. [*Retail Wholesale and Department Store Union Local 338 Retirement Fund v. Hewlett-Packard Co.*, 845 F.3d 1268 (9th Cir. 2017)] (See Learning Outcome 3.)

Chapter 30—Work Set

True-False Questions

- _____ 1. Both directors and officers may be immunized from liability for poor business decisions under the business judgment rule.
- _____ 2. Officers have the same fiduciary duties as directors.
- _____ 3. Directors have a right to inspect corporate books and records.
- _____ 4. When directors do not act in the best interests of their corporation, the shareholders may sue them on the company's behalf.
- _____ 5. In the conduct of corporate affairs, directors must exercise a different degree of care than in conducting their own personal affairs.
- _____ 6. For breaching their duty of care, directors may be liable to the corporation.
- _____ 7. Officers, but not directors, owe a duty of loyalty to the corporation.
- _____ 8. The business judgment rule makes a director liable for losses to the firm that result from the director's authorized, good faith business decisions.
- _____ 9. Unlike managers, officers are not corporate employees.

Multiple-Choice Questions

- _____ 1. Godfrey is a director of Hospitality Hotel Corporation. Like most directors, Godfrey was most likely
 - a. appointed by the secretary of state in the state of incorporation.
 - b. chosen by a vote of the corporate managers.
 - c. elected by the corporation's shareholders.
 - d. selected by the corporation's chief executive officer.
- _____ 2. Like the boards of most corporations, the board of directors of Paolo's Pizzas, Inc. conducts business through
 - a. annual shareholders' meetings.
 - b. consultations with corporate officers and employees.
 - c. formal board meetings with recorded minutes.
 - d. informal conferences with corporate power brokers.
- _____ 3. Julio and Gloria are officers of World Export Corporation. As corporate officers, their rights are set out in
 - a. state corporation statutes.
 - b. World Export's certificate of authority.
 - c. their employment contracts with World Export.
 - d. international agreements with nonresident shareholders.
- _____ 4. The board of Consumer Sales Corporation delegates work to corporate officers and employees. If the directors do not use a reasonable amount of supervision, they could be held liable for
 - a. negligence only.
 - b. mismanagement of corporate personnel only.
 - c. negligence or mismanagement of corporate personnel.
 - d. none of the above.

- _____ 5. The board of directors of Tiger's Pipes & Fittings approves a new line of products for the company to sell and oversees contract negotiations for obtaining the products from the supplier. This is
- a corporate conflict of interest.
 - a usurpation of the corporate officers' duties.
 - a violation of state corporate law.
 - within the general area of the board's responsibilities.
- _____ 6. Bree is an officer of Chic Petites Corporation. Like most corporate officers, Bree
- can act as Chic's agent.
 - can participate in managing Chic's day-to-day operations.
 - must carry out the duties spelled out in Chic's bylaws.
 - has all of these options.
- _____ 7. Local Corporation invests in intrastate businesses. In Local's state, as in most states, the minimum number of directors that must be present before a board can transact business is
- all of the directors authorized in the articles.
 - a majority of the number authorized in the articles or bylaws.
 - any odd number.
 - one.
- _____ 8. Nationwide Company's chief financial officer resigns. After a personnel search, an investigation, and an interview, the board of directors hires Anton. Anton turns out to be dishonest. Nationwide's shareholders sue the board. The board's best defense is
- the business judgment rule.
 - the directors' duty of care.
 - the directors' duty of loyalty.
 - a shareholder's derivative suit.
- _____ 9. Ron is a director of Standard Company. Ron has a right to
- compensation for his efforts on Standard's behalf.
 - transfer shares of Standard stock.
 - participate in Standard board meetings.
 - preemptive rights to buy Standard shares on any new issue.

Answering More Legal Problems

1. The directors of Urban Credit Corp.—a consumer, corporate, and investment bank—voted to invest in subprime lending. Soon after, the housing market declined, foreclosures increased, and other subprime lenders collapsed. Subsequently, Urban Credit suffered significant losses.
- Were Urban Credit's directors liable for their decision to engage in this course of business?** No. Directors are not insurers of business success. Honest mistakes of judgment and poor business decisions on their part do not make them liable to the corporation or its shareholders for damages. This is the _____ rule. For the rule to apply, directors and officers must act within their _____ authority and within the _____ of the corporation. They must also exercise _____. Here, the directors of Urban Credit did not disregard their duties or act in bad faith.
2. Pedigree Millwork Company negotiates with Quality Builders, Inc., for the construction of a new facility to manufacture pattern moldings, stair parts, cabinet parts, panels, and other specialty wood products. The terms of the contract are standard for this kind of deal. Rikki—one of the five directors on Pedigree's board—owns Quality Builders. Pedigree's board plans to vote on the contract at its next meeting.
- What is Rikki's duty in this situation?** Directors are _____ of their corporation. The _____ duty of the directors includes the duty of loyalty. This duty requires directors to _____ their personal interests to the corporation's welfare. When a corporation engages in a transaction, such as entering into a contract, in which a director has a personal interest, the director must make a _____ of any conflict of interest and _____ on the proposed deal. That is what Rikki should do here.

31

Combining and Dissolving Corporations

Conflict Presented

Algorithm Corporation owns an application to manage financial documents and data. Bright Ideas, Inc., wants to incorporate features of the application in its own products, but Algorithm will not agree to this use. Bright offers to buy Algorithm's assets, including the application, but Algorithm's board refuses to approve the sale.

Q What might Bright do to gain control and use of the application?

A corporation may grow simply by reinvesting retained earnings in more equipment or by hiring more employees. A corporation may also extend its operations by combining with another corporation through a merger, a consolidation, or a share exchange. In addition, a corporation may gain control of another corporation by purchasing its assets or a substantial number of its voting shares. Dissolution and winding up (liquidation) are the combined processes by which a corporation terminates its existence.

31-1 Mergers, Consolidations, and Share Exchanges

The terms "merger" and "consolidation" are often used interchangeably, but they refer to two legally distinct proceedings. Whether a combination is a merger, a consolidation, or a share exchange, however, the effect on the rights and liabilities of the corporation, its shareholders, and its creditors is the same.

31-1a Mergers

A **merger** involves the legal combination of two or more corporations in such a way that only one of the corporations continues to exist. **Example 31.1** Corporation A and Corporation B decide to merge. It is agreed that A will absorb B. On merger, B ceases to exist as a separate entity, and A continues as the surviving corporation. ■ This process is illustrated in Exhibit 31.1.

In a merger, the surviving corporation assumes all of the assets and liabilities of the disappearing corporation. The articles of merger (the agreement between the merging corporations, which sets out the surviving corporation's name, capital structure, and so forth) amend the articles of the surviving corporation. The surviving corporation issues shares or pays some fair consideration to the shareholders of the disappearing corporation.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Identify the basic steps in a merger and a consolidation.
- 2 Explain successor liability following a purchase of assets.
- 3 Identify actions to resist takeovers.
- 4 Discuss the phases for corporate termination.

merger

When one corporation acquires the assets and liabilities of another corporation, which then ceases to exist.

Exhibit 31.1 Merger

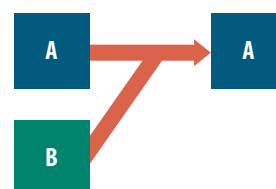
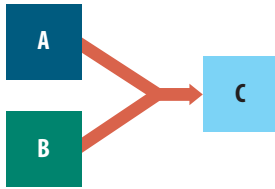


Exhibit 31.2 Consolidation**consolidation**

When two or more corporations join to become a new corporation.

31–1b Consolidations

In a **consolidation**, two or more corporations combine in such a way that each corporation ceases to exist, and a new one emerges. **Example 31.2** Corporation A and Corporation B consolidate to form an entirely new organization, Corporation C. In the process, A and B both terminate, and C comes into existence as a new entity. ■ This process is illustrated in Exhibit 31.2.

After a consolidation, the new corporation acquires all of the assets and liabilities of the corporations that were consolidated. The articles of consolidation (the agreement between the consolidating corporations, which sets out the new corporation's name, capital structure, and so forth) take the place of the disappearing corporations' original corporate articles and are thereafter regarded as the new corporation's corporate articles. As with a merger, the newly formed corporation issues shares or pays some fair consideration to the shareholders of the disappearing corporations.

**Highlighting the Point**

McCarty Music Corporation and Rosen Instruments, Inc., decide to consolidate to form MCR, Inc., an entirely new corporation. After the consolidation, McCartney and Rosen will cease to exist.

What happens to McCartney's assets? Who pays Rosen's creditors? After the consolidation, MCR is recognized as a new corporation and a single entity. MCR assumes all the rights, privileges, and powers previously held by McCartney and Rosen. Title to any assets owned by McCartney and Rosen passes to MCR without formal transfer. MCR also assumes liability for all debts owed by McCartney and Rosen.

share exchange

An exchange of one corporation's shares for those of another.

31–1c Share Exchange

In a **share exchange**, some or all of the shares of one corporation are exchanged for some or all of the shares of another corporation. Both companies continue to exist. A share exchange can be used to create a holding company—a company whose business activity is holding shares in another company. For instance, Alphabet is the holding company that owns Google. One corporation that owns all of the shares of another corporation is a parent corporation, and the wholly owned company is a subsidiary corporation.

31–1d Procedure for a Corporate Combination

All states have statutes authorizing mergers, consolidations, and share exchanges for domestic (in-state) corporations. Most states also allow the combination of domestic and foreign (out-of-state) corporations. In each situation, the basic steps are as follows:

1. The board of directors of each corporation involved must approve the plan.
2. The shareholders of each corporation must vote approval of the plan at a shareholders' meeting. Before a vote is taken on a proposed combination, the shareholders must be given sufficient information to evaluate the deal. This includes the information that the directors relied on when deciding on the merger.
3. Once approved by the directors and the shareholders, the plan is filed, usually with the secretary of state.
4. When state formalities are satisfied, the state issues a certificate of merger, consolidation, or a share exchange.

Learning Outcome 1

Identify the basic steps in a merger and a consolidation.

31-1e Short-Form Mergers

Some states provide a simplified procedure for the merger of a subsidiary corporation into its parent corporation. Under these provisions, if the parent owns substantially all of the stock of the subsidiary, a **short-form merger** can be accomplished without the approval of the shareholders of either corporation.

The short-form merger can be used only when the parent corporation owns at least 90 percent of the outstanding shares of stock of the subsidiary corporation. The simplified procedure requires that a plan for the merger be approved by the board of directors of the parent corporation before it is filed with the state. A copy of the merger plan must be sent to each shareholder of the subsidiary corporation.

short-form merger

A merger that can be accomplished without shareholder approval.

31-1f Shareholder Approval

Except in a short form merger, the shareholders of both corporations must approve a merger or other plan of consolidation. Shareholders invest in a corporation with the expectation that the board of directors will make decisions about ordinary business matters. For extraordinary matters, normally both the board of directors and the shareholders must approve the transaction.

Mergers and other combinations are extraordinary business matters, meaning that the board of directors must normally obtain the shareholders' approval and provide appraisal rights (discussed next). Amendments to the articles of incorporation and the dissolution of the corporation also generally require shareholder approval.

31-1g Appraisal Rights

What if a shareholder disapproves of a merger or consolidation but is outvoted by the other shareholders? The law recognizes that dissenting shareholders should not be forced to become unwilling shareholders in a corporation that is new or different from the one in which they originally invested. The shareholders dissenting have the right to dissent and may be entitled to be paid the fair value for the shares held on the date of the merger or consolidation. This right is referred to as the shareholder's **appraisal right**.

appraisal right

Shareholder's right to be paid fair value for shares at the time of a merger or consolidation.

Real Case



Papa Murphy's was a successful pizza chain that was acquired by MTY Food Group. Evan Brown was a former Papa Murphy's shareholder. She alleged that Papa Murphy's merger and consolidation agreement was based on materially false and misleading information with respect to Papa Murphy's financial projections. Basically, the projections were unreasonably lower than Papa Murphy's management had made earlier. These unreasonably low projections caused shareholders to tender their shares into an undervalued tender offer.

Were shareholders "harmed to the tune of millions of dollars," and were shareholders conned into forfeiting their appraisal rights? Perhaps yes. In *Brown v. Papa Murphy's Holding Incorporated, et al.*, a U.S. District Court of the Western District of Washington did not accept the defendant's attempt to dismiss the entire case. The court ruled that the plaintiff could continue her lawsuit against the company for a variety of reasons, not the least being that the shareholders were not able to exercise their appraisal rights.

—2021 WL 235865 (W.D. Wash.)

An appraisal right is available only when a state statute specifically provides for it. It normally applies to regular mergers, consolidations, short-form mergers, and sales of substantially all of the corporate assets. The appraisal right may be lost if the statutory procedures are not followed precisely. Whenever the right is lost, the dissenting shareholder must go along with the transaction despite their objections.

31–2 Purchase of Assets

Recall that actions taken on extraordinary matters must be authorized by the board of directors and the shareholders. When a corporation acquires all or substantially all of the assets of another corporation by direct purchase, however, the purchasing, or acquiring, corporation simply extends its ownership and control over more assets. Because no change in the legal entity occurs, the acquiring corporation is not generally required to obtain shareholder approval for the purchase.

31–2a Sales of Corporate Assets

In contrast to an acquiring corporation, a corporation that is selling all its assets is substantially changing its business position and perhaps its ability to carry out its corporate purposes. For that reason, the corporation whose assets are being acquired must obtain the approval of both the board of directors and the shareholders. In most states, a dissenting shareholder of the selling corporation can demand appraisal rights.

31–2b Successor Liability

Generally, a corporation that purchases the assets of another corporation is not responsible for the liabilities of the selling corporation. Exceptions to this rule are made in the following circumstances:

1. When the purchasing corporation assumes the seller's liabilities, or a court imposes the seller's liabilities on the purchasing corporation.
2. When the sale amounts to what in fact is a merger or a consolidation.
3. When the purchaser continues the seller's business and retains the same personnel (same shareholders, directors, and officers).
4. When the sale is fraudulently executed to escape liability.

Example 31.3 OakFabco, Inc., sold its Omni-Cast division to Precision Templates. Under the sales contract, Precision agreed to buy the assets “subject to all the liabilities connected with Omni-Cast.” Weeks later, claims alleging injuries from Omni-Cast products began to arise. These claims had also been made before the sale of the Omni-Cast division to Precision. Because the deal between OakFabco and Precision was a purchase and sale of substantially all the assets of Omni-Cast subject to “all the liabilities connected with Omni-Cast,” Precision, as the successor, was liable for the obligations resulting from the claims. ■

31–3 Purchase of Stock

An alternative to the purchase of another corporation's assets is the purchase of a substantial number of the voting shares of its stock. This enables the acquiring corporation to control the target corporation—the corporation being acquired. The process of acquiring control over a corporation in this way is commonly referred to as a corporate **takeover**.

Learning Outcome 2

Explain successor liability following a purchase of assets.

takeover

The acquisition of control over a corporation through a purchase of stock.

31–3a Tender Offer

In a takeover attempt, the acquiring corporation deals directly with the target company's shareholders in seeking to purchase their shares. It does this by making a **tender offer** to all of the target corporation's shareholders. The tender offer can be conditioned on receipt of a specified number of shares by a certain date. To induce shareholders to accept the tender offer, the acquiring corporation generally offers them a price higher than the market price of the target corporation's shares.

tender offer

An offer to buy shareholders' voting shares.

Example 31.4 Dugan Airtel, a telecom corporation, wants to merge with Blue Ridge Communications, a television company. Dugan offers to pay \$40 million to acquire Blue Ridge. This means that Blue Ridge shareholders will receive \$25 per share—\$5 in cash and \$20 in Dugan stock. This \$25 per share is 12 percent higher than the current market price of Blue Ridge's shares. ■

Conflict Resolved

In the Conflict Presented feature at the beginning of the chapter, Algorithm Corporation owns an application that Bright Ideas, Inc., wants to use. Algorithm will not consent to the use. Bright offers to buy Algorithm's assets, including the application. The firm's board refuses to sell.

A **What might Bright do to gain control and use of the application?** Bright's best chance to obtain the application is to buy enough shares of Algorithm's stock to control the corporation. To acquire the shares, Bright could make a tender offer to all of Algorithm's shareholders. An offer of more than the stock's market price could induce the shareholders to sell. Once Bright owns a sufficient number of shares, it can elect its own directors to Algorithm's board and gain the right to use the application.

31–3b Responses to Takeover Attempts

A firm may respond to a takeover attempt in many ways. Sometimes, a target firm's board of directors will see a tender offer as favorable and will recommend to the shareholders that they accept it. Frequently, though, the target corporation's management opposes the proposed takeover.

Learning Outcome 3

Identify actions to resist takeovers.

Takeover Defenses To resist a takeover, a target company can make a self-tender, which is an offer to acquire stock from its own shareholders and thereby retain corporate control. Alternatively, the target corporation might resort to one of several other defensive tactics. Several of these tactics are described in Exhibit 31.3.

Directors' Fiduciary Duties In a hostile takeover attempt, sometimes directors' duties of care and loyalty collide with their self-interest. Then the shareholders, who would have received a premium for their shares as a result of the takeover, sometimes file lawsuits. Such lawsuits frequently allege that the directors breached their fiduciary duties in defending against the tender offer.

Courts apply the business judgment rule when analyzing whether the directors acted reasonably in resisting the takeover attempt. The directors must show that they had reasonable grounds to believe that the tender offer posed a danger to the corporation's policies and effectiveness.

Exhibit 31.3 The Terminology of Takeover Defenses

Term	Definition
Crown Jewel	When threatened with a takeover, management makes the company less attractive to the raider by selling the company's most valuable asset (the "crown jewel") to a third party.
Pac-Man	Named after a video game, this is an aggressive defense in which the target corporation attempts its own takeover of the acquiring corporation.
Poison Pill	The target corporation issues to its stockholders rights to purchase additional shares at low prices when there is a takeover attempt. This makes the takeover undesirably or even prohibitively expensive for the acquiring corporation.
White Knight	The target corporation solicits a merger with a third party, which then makes a better (often simply a higher) tender offer to the target's shareholders. The third party that "rescues" the target is the "white knight."

In addition, the board's response must have been rational in relation to the threat posed. Basically, the defensive tactics used must have been reasonable, and the board of directors must have been trying to protect the corporation and its shareholders from a perceived danger. If the directors' actions were reasonable, then they are not liable for breaching their fiduciary duties.

31-4 Termination of a Corporation

Termination of a corporate life has two phases—dissolution and liquidation.

31-4a Dissolution

dissolution
The formal disbanding of a corporation.

Dissolution is the legal death of the artificial person of the corporation. Dissolution of a corporation can be brought about in any of the following ways:

1. An act of the state.
2. An agreement of the shareholders and the board of directors.
3. The expiration of a time period stated in the certificate of incorporation.
4. A court order.



Highlighting the Point

Fabiola and Jim form Home Remodeling, Inc. They are Home Remodeling's only shareholders and directors. After three years, they decide to cease business, dissolve the corporation, and go their separate ways.

Can they simply dissolve Home at will? Yes. Shareholders acting unanimously can dissolve a corporation. Also, close corporations can be dissolved by a single shareholder if the articles of incorporation provide for it.

Voluntary Dissolution Dissolution can be voluntary or involuntary. State corporation statutes establish the procedures required to dissolve voluntarily a corporation. Basically, there are two possible methods: (1) by the shareholders' unanimous vote to initiate dissolution proceedings or (2) by a proposal of the board of directors that is submitted to the shareholders at a shareholders' meeting. When a corporation is dissolved voluntarily, the corporation must file articles of dissolution with the state. It must also notify its creditors of the dissolution.

Involuntary Dissolution Because corporations are creatures of statute, the state can dissolve a corporation in certain circumstances, such as the following:

1. Failure to comply with administrative requirements (for instance, failure to pay annual corporate taxes, to submit an annual report, or to have a designated registered agent).
2. Procurement of a corporate charter through fraud or misrepresentation.
3. Abuse of corporate powers (*ultra vires* acts).
4. Violation of the state criminal code after a demand to discontinue has been made by the secretary of state.
5. Failure to commence business operations.
6. Abandonment of operations before startup.

Sometimes, a shareholder petitions a court for corporate dissolution because of misconduct or a deadlock among its board of directors or controlling shareholders. **Example 31.5** The Miller family—Rick, Otilia, and Breanna—operates Seven Oaks Farm in rural Virginia as a close corporation. When Rick and Otilia are arrested for stealing from the farm’s bank accounts, Breanna petitions the court for dissolution so that she can wind up Seven Oaks’s business. ■

Learning Outcome 4

Discuss the phases for corporate termination.

31–4b Liquidation

Liquidation is the process by which corporate assets are converted into cash and distributed among creditors and shareholders according to specific rules. When dissolution takes place by voluntary action, the members of the board of directors act as trustees of the corporate assets. As trustees, they are responsible for winding up the affairs of the corporation for the benefit of corporate creditors and shareholders. This makes the board members personally liable for any breach of their fiduciary trustee duties.

In certain situations, a court will appoint a receiver to wind up corporate affairs and liquidate corporate assets. A receiver is always appointed when the dissolution is involuntary. A receiver may also be appointed when the board members do not wish to act as trustees or when shareholders or creditors can show that the board members should not be permitted to act as trustees.

liquidation

The sale and distribution of the assets of a business.

Chapter Summary—Combining and Dissolving Corporations

Learning Outcome 1: Identify the basic steps in a merger and a consolidation.

Whether a merger or consolidation, the basic steps are:

- (1) The board of directors of each corporation approves the merger or consolidation plan.
- (2) A majority of the shareholders of each corporation approve the plan.
- (3) Articles of merger or consolidation (the plan) are filed, usually with the secretary of state.
- (4) The state issues a certificate of merger or consolidation to the surviving or new corporation.

Learning Outcome 2: Explain successor liability following a purchase of assets.

A corporation that purchases the assets of another corporation is not normally responsible for the liabilities of the seller. Exceptions occur when:

- (1) The purchasing corporation assumes the seller’s liabilities, or a court imposes the liabilities on the purchasing corporation.
- (2) The sale is in fact a merger or consolidation.
- (3) The purchaser continues the seller’s business with the same personnel.
- (4) The sale is fraudulently executed to escape liability.

Learning Outcome 3: Identify actions to resist takeovers.

To resist a takeover, a target company may make a self-tender, which is an offer to acquire stock from its own shareholders. Alternatively, the target company may sell a crown jewel, use a Pac-Man defense, take a poison pill, or solicit a merger with a white knight. These actions involve selling company assets, attempting a takeover of the acquiring firm, giving its shareholders the right to buy additional shares at low prices, and merging with a firm that offers a better price for stock.

Learning Outcome 4: Discuss the phases for corporate termination.

The termination of a corporation involves two phases: (1) dissolution, the legal death of the artificial person of the corporation, which can be brought about voluntarily by the directors and shareholders or involuntarily by the state or through a court order; and (2) liquidation, the process by which corporate assets are converted into cash and distributed to creditors and shareholders according to specified rules. Liquidation may be supervised by members of the board of directors or by a receiver appointed by the court to wind up corporate affairs.

Straight to the Point

1. What is the difference between a merger and a consolidation? (See Learning Outcome 1.)
2. What is a share exchange? (See Learning Outcome 1.)
3. When is a shareholder's appraisal right available? (See Learning Outcome 1.)
4. Who must authorize corporate actions on extraordinary matters? (See Learning Outcome 1.)
5. What is a corporate takeover? (See Learning Outcome 3.)
6. When a corporation is dissolved, what are its creditors entitled to? (See Learning Outcome 4.)
7. What does a receiver do? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. ABC Corporation combines with DEF, Inc. ABC ceases to exist. DEF is the surviving firm. Global Corporation and Hometown Company combine. Afterwards, Global and Hometown cease to exist. GH, Inc., a new firm, functions in their place. Which of these combinations is a merger and which is a consolidation? (See Learning Outcome 1.)
2. Interstate Corporation asks its shareholders to vote on a proposed merger with Regional, Inc. Jill, an Interstate shareholder, votes against it but is outvoted by the other shareholders. Is there anything Jill can do to avoid being forced to go along with the transaction? Explain. (See Learning Outcome 1.)

Real Law

31-1. Successor Liability and Purchases of Assets. USA DeBusk entered into an asset purchase agreement ("APA") with Wrap It Up Construction (WIU). Pursuant to the APA, DeBusk purchased substantially all of WIU's assets, including WIU's name and the goodwill associated with it, and then stepped into WIU's shoes employing its employees and performing work for its customers, in what amounted to a de facto merger. At that time, DeBusk had noticed that

WIU was not making its required contributions to an Allied Workers Local No. 46 Annuity Fund. DeBusk claimed that it was not subject to "successor liability." When DeBusk determined the price it would pay under the asset purchase agreement, it did not take account of any prior liabilities of WIU. DeBusk claimed that it was never told that WIU owed unpaid amounts to the Annuity Fund and that it never received actual notice of any debt owed by WIU to the fund.

The Annuity Fund countered that, although there was no evidence of direct knowledge, constructive knowledge was sufficient to establish successor liability. After all, DeBusk “knew that they were acquiring a unionized company” and therefore had to be aware of the obligations they were taking on when they acquired WIU. Was constructive notice enough? [*Workers Local No. 46 Annuity Fund v. USA DeBusk, LLC*, 2020 WL 7425863 (U.S. Dist. Ct. Middle Dist. Tennessee, 2020)] (See Learning Outcome 2.)

31-2. Purchase of Assets. Lockheed Martin Corp. owned an aluminum refinery in St. Croix, Virgin Islands. Lockheed sold the refinery to Glencore, Ltd. Their contract provided that the buyer would assume the seller’s liability for preexisting environmental conditions. Alcoa World Alumina, LLC, bought the refinery from Glencore. Alcoa did not agree to assume Glencore’s liabilities. Later, the Virgin Islands brought actions against the refinery’s current and former owners to recover for environmental damage.

Lockheed agreed to pay certain cleanup costs and filed a suit against Glencore to recover the amount. Does Alcoa have to reimburse Glencore for costs related to Lockheed’s suit? Why or why not? [*Alcoa World Alumina, LLC v. Glencore, Ltd.*, 2016 WL 521193 (Del.Super. 2016)] (See Learning Outcome 2.)

31-3. Purchase of Assets. Grand Adventures Tour & Travel Publishing Corp. (GATT) provided travel services. Duane Boyd, a former GATT director, incorporated Interline Travel & Tour, Inc. At a public sale, Interline bought GATT’s assets. Interline moved into GATT’s office building, hired former GATT employees, and began to serve GATT’s customers. A GATT creditor, Call Center Technologies, Inc., sought to collect the unpaid amount on a contract with GATT from Interline. Is Interline liable? Why or why not? [*Call Center Technologies, Inc. v. Grand Adventures Tour & Travel Publishing Corp.*, 635 F.3d 48 (2d Cir. 2011)] (See Learning Outcome 2.)

Ethical Questions

31-4. Shareholder Approval. Why should shareholders be required to approve certain types of corporate actions? (See Learning Outcome 1.)

31-5. Successor Liability. Ian Bell loaned \$250,000 to Bio Defense Corporation, a waste management company in Massachusetts. Before Bell’s loan came due, Boston Local Development Corp. (BLDC) foreclosed on its own loan to Bio Defense, forcing Bio Defense to cease operations and be sold. At the foreclosure sale, BLDC bought Bio Defense’s property, including three very valuable patents

(assets). BLDC then sold these patents to Oneighty C Technologies Corporation (OCTC). Bell, who had not been paid back for his loan to Bio Defense, learned of these events and filed a lawsuit against OCTC claiming that OCTC was the corporate successor to Bio Defense. Could OCTC be held legally liable on the unpaid loan to Bell? Could OCTC owe an ethical duty to assume liability for the debt? Why or why not? [*Bell v. Oneighty C Technologies Corp.*, 91 Mass.App.Ct. 1112, 81 N.E.3d 825 (2017)] (See Learning Outcome 2.)

Chapter 31—Work Set

True-False Questions

- _____ 1. In a merger, two or more corporations join to become a completely new corporation.
- _____ 2. In a consolidation, one corporation acquires all the assets and liabilities of another corporation, which then ceases to exist.
- _____ 3. Some states provide a simplified procedure for the merger of a subsidiary corporation into its parent corporation.
- _____ 4. A shareholder's appraisal right is available in all states under all circumstances.
- _____ 5. During the liquidation of a corporation, corporate assets are converted to cash and distributed to creditors and shareholders.
- _____ 6. Shareholders who disapprove of a merger or a consolidation may be entitled to be paid the fair value of their shares.
- _____ 7. A corporation that purchases the assets of another corporation always assumes the selling corporation's liabilities.
- _____ 8. The dissolution of a corporation can be brought about by an agreement of the shareholders and the board of directors.

Multiple-Choice Questions

- _____ 1. Analytics Corporation acquires substantially all of the assets of Big Data Company by direct purchase. There is no change in either legal entity. This is
 - a. a consolidation.
 - b. a purchase of assets.
 - c. a merger.
 - d. an appraisal right.
- _____ 2. Midwest Movers, Inc., and Northwest Transport Corporation consolidate. When this combination is completed,
 - a. Midwest and Northwest will cease to exist.
 - b. Midwest will continue as the sole surviving firm.
 - c. Northwest will continue as the sole surviving firm.
 - d. Midwest and Northwest will continue to exist as separate entities.
- _____ 3. Eaters' Feast Company is a subsidiary of Food Prep, Inc. A merger of Eaters' Feast into Food Prep is
 - a. a corporate liquidation.
 - b. a short-form consolidation.
 - c. a short-form merger.
 - d. a violation of the relevant state law.
- _____ 4. Good Healthcare, Inc., initiates an attempt to purchase enough shares in Home Health Aides Corporation to control it. This process is a corporate
 - a. consolidation.
 - b. merger.
 - c. liquidation.
 - d. takeover.

- _____ 5. Redwood, Inc., is unprofitable. In a suit against Redwood, Inc., a court might order dissolution if the firm does not
- buy its stock from its shareholders.
 - declare a dividend.
 - make a profit this year.
 - pay its taxes.
- _____ 6. Macro Corporation and Micro Company combine, and a new organization, MM, Inc., takes their place. This is
- a consolidation.
 - a merger.
 - a purchase of assets.
 - a purchase of stock.
- _____ 7. Tabina and Adam are the directors and majority shareholders of U.S. Imports, Inc., and Overseas Corporation. U.S. Imports owes \$5,000 to International Transport, Inc. To avoid the debt, Tabina and Adam vote to sell all of U.S. Imports' assets to Overseas. If International sues Overseas on the debt, International will
- win because an acquiring firm always assumes a selling corporation's liabilities.
 - win because the sale was fraudulently executed to avoid liability.
 - lose because Overseas refused to assume U.S. Imports' debt.
 - lose because U.S. Imports has ceased to exist.

Answering More Legal Problems

- Mountainview Resort made annual contributions to its employees' pension fund. During the latest recession, business began to decline. Mountainview's owners obtained a loan from Investco Bank. Two years later, the resort closed due to poor business. Investco—which was still owed \$14 million by Mountainview—instituted foreclosure proceedings. At the foreclosure sale, Investco bought the resort and reopened it under new management with new employees.
- Split Bean Corporation is formed to own and operate Split Bean Coffee Stands. The articles of incorporation prohibit Split Bean from selling or leasing any of its property without the approval of a majority of the directors. Following three years of increasing competition, decreasing business, and a mounting pile of debt, Split Bean officers enter into contracts to sell corporate property without notifying the directors.

As the resort's new owner, was Investco obligated to pay into the pension fund? No. An acquiring corporation will be held to have assumed the _____ of the selling corporation when (1) the purchasing corporation expressly or impliedly assumes the seller's _____, (2) the sale is in effect a merger or consolidation of the two companies, (3) the purchaser continues the seller's business and retains the same _____, or (4) the sale is entered into fraudulently to avoid liability. Here, Mountainview ceased operations before Investco bought it. Under the new owner, there was a new _____. The company was not a continuation of the previous operation.

Can Split Bean's shareholders seek to dissolve the corporation in this situation? Dissolution can occur voluntarily by the directors and the _____ of a corporation. State statutes establish the procedures. Dissolution proceedings can be initiated by a _____ of the _____ submitted at a shareholders' meeting. Proceedings may also be initiated by a _____ of the _____. Sometimes, due to misconduct, corporate dissolution can be sought through a court petition by _____.



Unit 7

Credit and Risk

Unit Contents

Chapter 32

Security Interests and Creditors' Remedies

Chapter 33

Mortgages

Chapter 34

Bankruptcy

Chapter 35

Insurance

32

Security Interests and Creditors' Remedies

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Explain how an enforceable security interest is created and perfected.
- 2 Identify general priority rules governing security interests.
- 3 State a secured party's options on a debtor's default.
- 4 Distinguish different types of liens.
- 5 Define suretyship and guaranty contracts.

secured transaction

Any transaction in which debt payment is guaranteed by personal property.

Conflict Presented

Ethan and Raney own a summer cabin in the Pocono Mountains. They contract with Adrian, a local painter, to paint the cabin before the summer season. They agree on a price of \$5,000, including labor and materials. Adrian completes the job on time, but the Ethan and Raney claim financial hardship and pay him only \$2,000 of the charges.

Q Can Adrian obtain the rest of what he is owed from Ethan and Raney?

Whenever the payment of a debt is guaranteed, or secured, by the debtor's personal property—such as a building or a vehicle—the transaction is known as a **secured transaction**. The concept of a secured transaction is as basic to modern business practice as the concept of credit. Logically, sellers and lenders want to get paid for their goods and services, so they usually will not sell goods or lend funds unless payment is somehow guaranteed.

Normally, creditors have no problem getting paid. When disputes arise, however, or when the debtor simply cannot or will not pay, what happens? What remedies are available to creditors when debtors default? The latter part of this chapter focuses on some basic laws that assist creditors in resolving their disputes with debtors.

32–1 Secured Transactions

The Uniform Commercial Code (UCC) provides the law covering secured transactions. A brief summary of the UCC's definitions of terms relating to secured transactions follows:

1. A security interest is every interest in personal property that secures (guarantees) the payment or performance of an obligation.
2. A secured party is a lender, a seller, or any person in whose favor there is a security interest. The terms secured party and secured creditor are used interchangeably.
3. A debtor is the party who owes payment or performance of the secured obligation.
4. A security agreement is the agreement that creates or provides for a security interest between the debtor and a secured party.

5. Collateral is the property subject to a security interest (the property that secures the payment or performance of the obligation).
6. A financing statement gives notice to the public that the creditor has a secured interest in collateral belonging to the debtor named in the statement. The secured creditor prepares the financing statement and files it with the appropriate state official.

32–1a Creating a Security Interest

To become a secured party, the creditor must have a security interest in the debtor's collateral. Three requirements must be met for a creditor to have an enforceable security interest:

1. Either the collateral must be in the possession of the secured party or there must be a written security agreement. In most situations, a written security agreement is used. The agreement must be signed by the debtor and must contain a description that reasonably identifies the collateral.
2. The secured party must give value to the debtor. Normally, the value takes the form of a direct loan or a commitment to sell goods on credit.
3. The debtor must have rights in the collateral.

Once these requirements are met, the creditor's rights attach to the collateral. This means that the creditor has a security interest against the debtor that is enforceable. **Attachment** ensures that the security interest between the debtor and the secured party is effective.

Example 32.1 Roma applies for a credit card at Macy's. The application contains a clause giving Macy's a security interest in any goods that Roma buys with the card until she pays for them in full. This signed application meets the first requirement for a security interest. Macy's commitment to sell goods to Roma on credit constitutes value, which is the second requirement. The goods that Roma buys with the card are the collateral, and her right in them is her ownership interest, which is the third requirement. Thus, all the requirements for an enforceable security interest are met. When Roma buys something with the credit card, the store's rights attach to it. ■

The concept under which a debtor-creditor relationship becomes a secured transaction and the terminology involved are illustrated in Exhibit 32.1.

Learning Outcome 1

Explain how an enforceable security interest is created and perfected.

attachment

In a secured transaction, the process to an enforceable security interest.

32–1b Perfecting a Security Interest

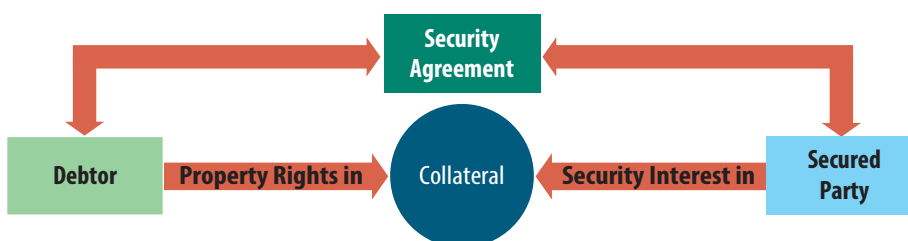
Even though a security interest has attached, the secured party must take steps to protect its claim to the collateral in the event that the debtor defaults—that is, fails to pay the debt as promised. **Perfection** is the legal process by which secured parties protect themselves against the claims of third parties who may wish to have their debts satisfied out of the same collateral.

perfection

The method by which a secured party obtains a priority interest in the debtor's collateral.

Exhibit 32.1 Secured Transactions—Concept and Terminology

In a security agreement, a debtor and a creditor (secured party) agree that the creditor will have a security interest in collateral in which the debtor has rights. In essence, the collateral secures the loan and ensures the creditor of payment should the debtor default.



In most situations, a secured party perfects a claim by filing a financing statement with the appropriate state or local official. (Note that here, the verb “perfects” means to take all the required steps to achieve a result.) The financing statement must contain the following:

- The signature of the debtor.
- The names and addresses of the debtor and the creditor.
- A description of the collateral by type or item.

Improper filing of the financing statement can render the security interest unperfected and reduce the secured party’s claim to that of an unsecured creditor. For instance, if the debtor’s name on a financing statement is seriously misleading or if the collateral is not sufficiently described, the filing may not be effective.



Highlighting the Point

Nick and Bianca operate a ranch in Texas. They buy twenty cows from Malena on credit. To perfect a security interest in the cows (the collateral), Malena files a financing statement that identifies the cows by their names and ear-tag designations. She also gives Nick and Bianca a certificate of registration for each cow, which includes the same information. Nick and Bianca remove the ear tags, sell the cows, and then file for bankruptcy. Malena makes a claim with the bankruptcy court for the debt Nick and Bianca owe her. The bankruptcy court’s trustee, however, maintains that Malena’s security interest in the cows is not perfected, because the financing statement does not describe the cows in sufficient detail.

Are the cows’ descriptions in the financing statement sufficient to perfect Malena’s security interest in them? Yes. Both the statement and the certificates of registration contain the cows’ names and ear-tag numbers. This is sufficient information to permit any party to easily identify which cows are covered by the security interest.

proceeds

Whatever is received when collateral is sold, exchanged, collected, or disposed of.

after-acquired property

Debtor property that is acquired after a secured creditor’s interest in the debtor’s property has been created.

32–1c The Scope of a Security Interest

A security interest can cover property in which the debtor has either present or future rights. Therefore, security agreements can cover the proceeds of the sale of collateral, after-acquired property, and future advances.

Proceeds include whatever cash or property is received when collateral is sold, exchanged, collected, or disposed of. A secured party has an interest in the proceeds of the sale of collateral. A security interest in proceeds perfects automatically on the perfection of the secured party’s security interest in the original collateral. It remains perfected for twenty days after the debtor receives the proceeds.

After-acquired property is property that the debtor acquires after the execution of the security agreement. To cover after-acquired property, the security agreement must provide for the coverage.

Often, a debtor arranges with a bank to have a continuing line of credit under which the debtor can borrow funds intermittently. These future advances against lines of credit can be subject to a perfected security interest in identified collateral. The security agreement may provide that any future advances made against that line of credit are also subject to the security interest in the same collateral.

When a security agreement provides for the creation of a security interest in proceeds of the sale of after-acquired property or future advances, or both, the security interest is referred to as a floating lien. A floating lien is a security interest retained in collateral even when the collateral changes in character, classification, or location.

Floating liens commonly arise in the financing of inventories. A creditor is not interested in specific pieces of inventory, because they are constantly changing. Thus, the lien “floats” from one item to another as the inventory changes.

Highlighting the Point



Cascade Sports, Inc., a cross-country ski dealer, has a line of credit with Portland First Bank to finance an inventory of cross-country skis. Cascade and Portland First enter into a security agreement that provides for coverage of proceeds, after-acquired inventory, present inventory, and future advances. Portland First perfects the security interest by filing centrally (with the secretary of state). One day, Cascade sells a new pair of cross-country skis and receives a used pair in trade. The same day, it buys two new pairs of skis from a local manufacturer with a new advance of funds from Portland First.

Does Portland First have a perfected security interest in the used skis, the new skis, and the advance? Yes. All of this is accomplished under the original perfected security interest. The bank has a perfected security interest in the used skis under the proceeds clause, in the new skis under the after-acquired property clause, and in the advance under the future-advance clause. Hence, Portland First has a floating lien.

32–1d Priorities Among Security Interests

When more than one party claims an interest in the same collateral, which one has priority? The UCC sets out detailed rules to answer this question.

General Priority Rules In most situations, the following general priority rules apply when more than one creditor claims rights in the same collateral:

1. Conflicting unperfected security interests—When two conflicting security interests are unperfected, the first to attach (be created) has priority. This is sometimes called the “first-in-time” rule.
2. Perfected security interests versus unperfected interests—When a security interest is perfected, it has priority over any unperfected interests.
3. Conflicting perfected security interests—When two or more creditors have perfected security interests in the same collateral, the first to perfect (by filing or taking possession of the collateral) generally has priority.

Learning Outcome 2

Identify general priority rules governing security interests.

An Exception to the General Priority Rules An exception to these general priority rules concerns a buyer in the ordinary course of business. Under the UCC, a buyer in the ordinary course of business is a person who, in good faith, buys goods from a party in the business of selling such goods.

A buyer in the ordinary course of business takes the goods free from any security interest created by the seller even if the security interest is perfected and the buyer knows of its existence. In other words, a buyer in the ordinary course of business will have priority even if a previously perfected security interest exists in the goods.

The rationale for this exception to the general priority rules is clear. If buyers could not obtain goods free of any security interest the seller had created, the unconstrained flow of goods in the marketplace would be hindered.

Example 32.2 Destiny buys clothes regularly at Urban Fashions. She takes those items free of any security interest that a creditor (such as a bank or the store’s suppliers) has in them. This is true even if Destiny knows that Urban borrows funds to buy its inventory and uses that inventory—including the clothes that she buys—to guarantee repayment of the loan. ■

Learning Outcome 3

State a secured party's options on a debtor's default.

32–1e Default

Any breach of the terms of a security agreement can constitute default. Most commonly, default occurs when the debtor fails to meet the scheduled payments that the parties have agreed on or when the debtor becomes bankrupt.

Basic Remedies When a debtor defaults, a secured party has two basic remedies available. One is to relinquish the security interest and pursue a judicial remedy, such as seeking a judgment on the underlying debt. The other remedy is to repossess the collateral. Here, the secured party takes peaceful possession of the collateral without going to court. (Peaceful possession means a secured party takes possession of the collateral without committing trespassing or assault.)

Once the secured party has obtained possession of the collateral, the secured party can retain the collateral or can sell, lease, or otherwise dispose of it in any commercially reasonable manner.

Retention of the Collateral by the Secured Party A secured party's right to retain the collateral is subject to several conditions. Written notice must be sent to the debtor. In the case of consumer goods, no other notice need be given. In many other situations, notice must be sent to any other secured creditor from whom the secured party has received written notice of a claim to the collateral.

Disposition of the Collateral by the Secured Party A secured party who does not choose to retain the collateral must dispose of it in a commercially reasonable manner. Selling the collateral by the same method normally used for selling similar property fulfills the commercially reasonable requirement. The secured party must notify the debtor and other specified parties in writing ahead of time about the sale or disposition of the collateral.

When the collateral is consumer goods—such as a car or a boat—and the debtor has paid 60 percent or more of the purchase price, the secured party must sell or dispose of the repossessed collateral within ninety days. If a debtor has paid less than 60 percent of the purchase price, the secured party has the option of disposing of the collateral in a commercially reasonable manner.

Deficiency Judgment Often, after proper disposition of the collateral, the secured party has not collected all that the debtor still owes. Unless otherwise agreed, the debtor is liable for any deficiency, and the creditor normally can obtain a **deficiency judgment** from a court to collect the remaining unpaid amount.

Example 32.3 Randy buys a new Honda ATV for \$6,000 from PowerPlay Motors on credit. Randy begins making payments but defaults six months into the sales contract. PowerPlay then repossesses the ATV, and to recover Randy's remaining \$5,500 debt, the store sells it at auction for \$4,000. PowerPlay can then obtain a deficiency judgment against Randy for \$1,500, because he is still liable for what he owes the store. ■

Redemption Rights of the Debtor Before the creditor retains or sells the collateral, the debtor can exercise the right of redemption. This is done by tendering performance of all obligations secured by the collateral, by paying the expenses reasonably incurred by the secured party, and by retaking the collateral and maintaining its care and custody.

32–2 Laws Assisting Creditors

When a debtor defaults on a debt or cannot repay a debt, the law provides many rights and remedies for creditors. These remedies include liens, garnishment, and suretyship and guaranty agreements.

deficiency judgment

A judgment against a debtor for the amount of a debt remaining unpaid after the collateral has been repossessed and sold.

32–2a Liens

A **lien** is an encumbrance on (claim against) property to satisfy a debt or protect a claim for the payment of a debt. Liens are a very important tool for creditors because they generally take priority over other claims against the same property. In fact, mechanic's liens and artisan's liens normally take priority even over perfected security interests in the property.

Mechanic's Lien When a person contracts for labor, services, or materials to be furnished for the purpose of making improvements on real property but does not immediately pay for the improvements, a creditor can place a **mechanic's lien** on the property. The real estate itself becomes security for the debt. Basically, the property can be taken and held to guarantee payment of the debt, or it can be sold to provide actual payment. The lienholder must give notice to the property owner before the sale.

Example 32.4 Kim owns the Lake Valley Ranch. She hires Mountain View Excavation to remove tree stumps on her lower ten acres. When she refuses to pay for the completed work, Mountain View places a mechanic's lien on the ranch. If Kim does not pay the lien, the property can be sold to satisfy the debt. ■

In addition, the lien typically must be filed within a certain time period, or it will not be enforced.

Learning Outcome 4

Distinguish different types of liens.

lien

A claim against specific property to satisfy a debt.

mechanic's lien

A lien on real property to ensure priority of payment for work performed.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Adrian agreed to paint Ethan and Raney's summer cabin for \$5,000 to cover labor and materials. Ethan and Raney could only pay \$2,000 of the charges.

A Can Adrian get the rest of what he is owed from them? Yes. A mechanic's lien against the property could be created. Adrian would be the lienholder. The property would be subject to the mechanic's lien for the amount owed (\$3,000). If Ethan and Raney did not pay the lien, their cabin could be sold to satisfy the debt.

Artisan's Lien An **artisan's lien** is a security device through which a creditor can recover payment from a debtor for labor and materials furnished in the repair of personal property. The lienholder ordinarily must have retained possession of the property and have agreed to provide the services on a cash, not a credit, basis. The artisan's lien exists as long as the lienholder maintains possession. The lien ends when possession is voluntarily surrendered.

If the debtor does not pay, the holder of an artisan's lien can sell the personal property subject to the lien to satisfy the debt. As with the mechanic's lien, the lienholder must give notice to the owner of the property before selling it.

Example 32.5 Selena leaves her diamond ring at the jeweler's to be repaired and to have her initials engraved on the band. In the absence of an agreement, the jeweler can keep the ring until Selena pays for the services. Should she fail to pay, the jeweler has a lien on Selena's ring for the amount of the bill and normally can sell the ring in satisfaction of the lien. ■

artisan's lien

As security for payment for services performed, a lien given to a person who has added value to another's personal property.

Judicial Liens When a debt is past due, a creditor can bring a legal action against the debtor to collect the debt. If the creditor succeeds in the action, the court awards the creditor a judgment against the debtor. The amount of the judgment is usually the amount of the debt, plus interest and legal costs. Frequently, however, the creditor is unable to collect the awarded amount.

To ensure that a judgment in the creditor's favor will be collectible, the creditor can request that certain property of the debtor be seized to satisfy the debt. A court's order to seize the debtor's property is known as a writ of attachment if it is issued before a judgment. If it is issued after a judgment, it is referred to as a writ of execution.

32-2b Garnishment

garnishment

A legal process whereby a creditor appropriates a debtor's property or wages that are in the hands of a third party.

Garnishment occurs when a creditor collects a debt by seizing a debtor's property (such as wages) that is being held by a third party (such as an employer). As a result of a garnishment proceeding, the debtor's employer may be ordered by the court to turn over a portion of the debtor's wages to pay the debt. (Note that garnishments also can be seized from a debtor's funds in a banking or savings account.)

Procedures After a creditor obtains a judgment on a debt, the creditor can commence a garnishment proceeding by filing written notice with the appropriate court. The debtor is then given an opportunity for a hearing at which the right to garnish can be disputed. If the debtor does not respond, does not offer supporting evidence to its defense, or does not appear, the right to garnish can be upheld. The garnishee (the third party, such as an employer or a bank) is then notified, and the garnishment process can proceed.

Limitations Both federal laws and state laws limit the amount that can be garnished from a debtor's weekly take-home pay. Federal law provides a minimal framework to protect debtors from losing all their income in order to pay judgment debts. State laws also provide dollar exemptions. State and federal statutes can be applied together. Also, under federal law, an employer cannot dismiss an employee because the employee's wages are being garnished.



Highlighting the Point

Farzana is an independent contractor working for Dash Delivery Service as a driver. She receives medical treatment for a knee injury from Eastside Orthopedic Specialists. When she does not pay for the treatment, Eastside asks a court to issue a garnishment order to Dash Delivery to withhold an appropriate amount from Farzana's earnings until the debt is paid.

Can Farzana's earnings be garnished to pay this debt? Yes. Farzana is working as an independent contractor for Dash Delivery, but its payments for her services fall within the definition of earnings. Dash Delivery can be ordered to turn over Farzana's earnings to pay her debt to Eastside, subject to the federal and state limits on the amount that can be garnished.

Learning Outcome 5

Define suretyship and guaranty contracts.

suretyship

A third party's contractual promise to be primarily responsible for a debtor's obligation.

surety

A third party who agrees to be primarily responsible for the debt of another.

32-2c Suretyship and Guaranty

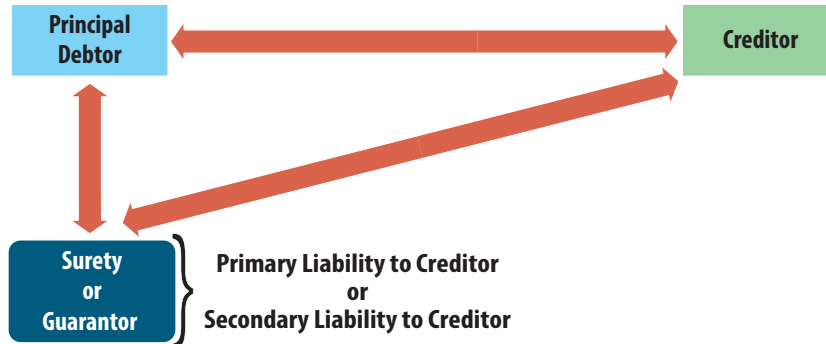
When a third party promises to pay a debt owed by another in the event the debtor does not pay, either a suretyship or a guaranty relationship is created.

Exhibit 32.2 illustrates the relationship between a suretyship or guaranty party and the creditor.

Surety A contract of strict **suretyship** is a promise made by a third party to be responsible for a debtor's obligation. It is an express contract between the **surety** (a third party, other than the debtor, who agrees to assume the debt) and the

Exhibit 32.2 Suretyship and Guaranty Relationships

In a suretyship or guaranty arrangement, a third party promises to be responsible for a principal debtor's obligations. A third party who agrees to be primarily responsible for the debt is known as a surety. A third party who agrees to be secondarily responsible for the debt is known as a guarantor.



creditor. The surety is primarily liable for the debt of the principal debtor—that is, the creditor can demand payment from the surety from the moment that the debt is due. Surety agreements are usually in writing, although not all states require a writing.

Highlighting the Point

Robert Delmar wants to borrow funds from the bank to buy a used car. Because Robert is still in college, the bank will not lend him the funds unless his father, Joseph Delmar, who has dealt with the bank before, will cosign the note. By adding his signature to the note, Joseph becomes jointly liable for payment of the debt.

When Joseph cosigns the note, is he primarily liable to the bank? Yes. Once he signs the note, Joseph is a surety. On the note's due date, the bank can seek payment from Robert, his father, or both jointly.

Guaranty With a suretyship arrangement, the surety is primarily liable for the debtor's obligations. With a guaranty arrangement, the **guarantor**—the third party making the guaranty—is secondarily liable. The guarantor can be required to pay the obligation only after the debtor defaults, and default usually takes place only after the creditor has made an attempt to collect from the debtor.

guarantor

A third party who agrees to be secondarily liable for the debt of another.

Real Case

Staff members at Altercare, a nursing home, told resident Connie Turner that her insurance company was covering all costs related to her stay. After Turner left Altercare, however, the nursing home sued to recover an unpaid bill of about \$8,000. The trial court found that, because the assurances on which she relied were untrue, Turner did not owe Altercare any repayment. Altercare then tried to recover the costs from Victoria Cox, Turner's granddaughter, who had signed several forms as guarantor of Turner's financial obligation to Altercare.

(Continues)

Should Turner's granddaughter, as guarantor, be responsible for the \$8,000 unpaid bill? No. In *Altercare of Canal Winchester Post-Acute Rehabilitation Center, Inc., v. Turner*, the Court of Appeals of Ohio blocked this maneuver by Altercare, holding that a guarantor could not be held responsible for debts that the debtor is not legally required to pay.

—2019-Ohio-1011 (Ct. App. Ohio 10th Dist.)

A guaranty contract between the guarantor and creditor must be in writing to be enforceable unless the main purpose rule applies. This exception provides that if the main purpose of the guaranty agreement is to benefit the guarantor, then the contract need not be in writing to be enforceable.

Defenses of the Surety and the Guarantor Basically, the same actions will release either a surety or a guarantor from obligation. These defenses include the following:

1. **Material modification of the contract**—Any material change made in the terms of the original contract between the principal debtor and the creditor will discharge the surety or guarantor either completely or to the extent that the surety or guarantor suffers a loss. Such a material change, for instance, would be extending the time for making payment without first obtaining the consent of the surety or guarantor.
Example 32.6 Roxanne agrees to act without compensation as a surety for Stewart's loan from Scott Valley Bank. Later, without Roxanne's knowledge, Stewart and Scott Valley Bank agree to postpone one year of payments and add their accrued interest to the balance due. This modification extends the time for payment of the loan and thereby discharges Roxanne's obligation as a surety completely. If she had accepted compensation to act as a surety, her obligation would have been discharged only to the extent that she suffered a loss under the contract as modified. ■
2. **Surrender or impairment of the collateral**—If a creditor surrenders the collateral to the debtor or impairs the collateral without the surety or guarantor's consent, these acts can reduce the obligation of the surety or guarantor.
3. **Payment of the obligation**—Naturally, any payment of the principal obligation by the debtor (or by someone on their behalf) will discharge the surety or the guarantor from the obligation.

Defenses of the Principal Debtor Generally, any defenses available to a principal debtor can be used by the surety or guarantor to avoid liability on the obligation to the creditor. The ability of the surety or guarantor to assert any defenses the debtor may have against the creditor is the most important concept in suretyship because most of the defenses available to the surety or guarantor are also those of the debtor.

Rights of the Surety and Guarantor When the surety or guarantor pays the debt owed to the creditor, either of these third parties has the following rights:

right of subrogation

The right to stand in the place of another.

1. **The right of subrogation**—The surety or guarantor has the legal **right of subrogation**. This means that any right the creditor had against the debtor becomes the right of the surety or guarantor. In short, the surety or guarantor stands in the shoes of the creditor and may pursue any remedies that were available to the creditor against the debtor.

2. The right of reimbursement—The surety or guarantor has a **right of reimbursement** from the debtor. Basically, the surety or guarantor is entitled to receive from the debtor all outlays made on behalf of the suretyship or guaranty arrangement. Such outlays can include expenses incurred as well as the actual amount of the debt paid to the creditor.
3. The right of contribution—Two or more sureties on the same obligation are called **co-sureties**. When one co-surety pays more than their proportionate share on a debtor's default, they are entitled to recover from the other co-sureties the excess amount paid. This is the **right of contribution**. Generally, a co-surety's liability either is determined by agreement or, in the absence of agreement, is set at the maximum liability under the suretyship contract. A co-guarantor has the same right.

right of reimbursement

The right to be repaid for expenses incurred on another's behalf.

co-surety

One who assumes liability jointly with another surety for the payment of an obligation.

right of contribution

The right to recover from co-sureties the excess paid on a debt.

Highlighting the Point



Two co-sureties—Jeremiah and Veda—are obligated under a suretyship contract to guarantee the debt of Jules. Veda's maximum liability is \$15,000, and Jeremiah's is \$10,000. Jules owes \$10,000 and is in default. Veda pays the creditor the entire \$10,000.

Can Veda recover anything from Jeremiah? Yes. How much? In the absence of an agreement to the contrary, Veda can recover \$4,000 from Jeremiah. The amount of the debt that Jeremiah agreed to cover is divided by the total amount that Veda and Jeremiah together agreed to cover. The result is multiplied by the amount of the default, yielding the amount that Jeremiah owes— $(\$10,000 \div \$25,000) \times \$10,000 = \$4,000$.

Chapter Summary—Security Interests and Creditors' Remedies

Learning Outcome 1: Explain how an enforceable security interest is created and perfected.

Creating an enforceable security interest involves three requirements: (1) The secured party must possess the collateral, or there must be a written security agreement signed by the debtor and reasonably identifying the collateral; (2) the secured party must give value to the debtor; and (3) the debtor must have rights in the collateral. The most common method of perfecting a security interest is by filing a financing statement that contains the names and addresses of the secured party and the debtor, describes the collateral by type or item, and is signed by the debtor.

Learning Outcome 2: Identify general priority rules governing security interests.

When two conflicting security interests are unperfected, the first to attach has priority. A perfected security interest takes priority over an unperfected security interest. When both security interests are perfected, the interest that was first to perfect generally has priority.

Learning Outcome 3: State a secured party's options on a debtor's default.

When a debtor defaults, a secured party has two basic remedies available. One is to relinquish the security interest and pursue a judicial remedy, such as seeking a judgment on the underlying debt. The other remedy is to repossess the collateral. A secured party can take peaceful possession of the collateral without going to court. Once the secured party obtains possession of the collateral, it can then retain or sell it to satisfy the debtor's debt.

Learning Outcome 4: Distinguish different types of liens.

A mechanic's lien is a lien on real estate for labor, services, or materials furnished to make improvements on the property. An artisan's lien is a lien on personal property for labor performed or value added. Judicial liens are imposed by a court. A court's order to seize a debtor's property can include attachments and writs of execution.

Learning Outcome 5: Define suretyship and guaranty contracts.

Under a suretyship contract, a third party agrees to be primarily liable for the debt owed by the principal debtor. Under a guaranty contract, a third party agrees to be secondarily liable. A creditor can turn to this third party for payment of the principal debtor's debt.

Straight to the Point

1. Discuss the scope of a security interest. (See Learning Outcome 1.)
2. What is the floating lien concept? (See Learning Outcome 1.)
3. In terms of a security agreement, what constitutes default? (See Learning Outcome 1.)
4. What is garnishment? (See Learning Outcome 4.)
5. What is a co-surety? (See Learning Outcome 5.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Joe contracts with Larry of Midwest Roofing to fix Joe's roof. Joe pays half of the contract price in advance. Larry and Midwest complete the job, but Joe refuses to pay the rest of the price. What can Larry and Midwest do to get the remainder of what Joe owes? (See Learning Outcome 4.)
2. First National Bank loans \$5,000 to Gail to buy a car, which is used as collateral to secure the loan. Gail has paid less than 50 percent of the loan when she defaults. First National could repossess and keep the car, but the bank does not want it. What are some alternatives? (See Learning Outcome 1.)

Real Law

32-1. Garnishment. Gwendolyn Berry pled guilty to stealing funds from her employer. At sentencing, she was ordered to pay restitution of more than \$2 million. To enforce this judgment, the government garnished 50 percent of two investment retirement accounts (IRAs) belonging to Gwendolyn's husband, Michael. A federal appeals court upheld this garnishment, holding that in Texas, where the Berrys were residents, a spouse has one-half interest in the other spouse's solely managed community property, including IRAs. Therefore, half of Michael's IRA was part of Gwendolyn's garnishable property. Attempting to reduce the amount of the court order, the Berrys looked to a federal law that limits restitution-related garnishments to 25 percent of "weekly earnings." If Michael liquidated

his IRA, they argued, that would be the same as getting "earnings" and thus the 25-percent law applied to this case. Should an appellate court accept this argument? [*United States v. Berry*, 951 F.3d 632 (U.S. Ct. App. 5th Cir. 2020)] (See Learning Outcome 5.)

32-2. Garnishment Proceedings. Grand Harbour Condominium Owners Association, Inc., obtained a judgment in an Ohio state court against Gene and Nancy Grogg for \$45,458.86. To satisfy the judgment, Grand Harbour filed a notice of garnishment with the court, seeking funds held by the Groggs in various banks. The Groggs disputed Grand Harbour's right to garnish the funds, claiming that they were exempt, but the Groggs offered no proof of this exemption. The banks delivered the funds to the court. The

Groggs filed a “motion to return funds to debtors.” What is Grand Harbour’s best argument in response to the Groggs’ motion? [*Grand Harbour Condominium Owners Association, Inc. v. Grogg*, 2016-Ohio-1386 (2016)] (See Learning Outcome 1.)

32-3. Default. With a loan of 1.4 million euros from Barclays Bank, Thomas Poynter bought a yacht. The loan agreement gave Barclays multiple stand-alone options on default. One option required that it give ten days’ advance

notice of a sale. A different option permitted the bank to avoid this requirement. When Poynter did not repay the loan, Barclays repossessed the yacht, notified Poynter that it would be sold—but did not specify a date, time, or place—and sold it two months later. Barclays got less than what Poynter owed. Is Barclays entitled to collect the deficiency even though it did not give Poynter ten days’ advance notice of the sale? Explain. [*Barclays Bank PLC v. Poynter*, 710 F.3d 16 (1st Cir. 2013)] (See Learning Outcome 1.)

Ethical Questions

32-4. Taking Possession of the Collateral. Does the potential harm of allowing a creditor to repossess collateral on a debtor’s default, without going to court, outweigh the benefit? Discuss. (See Learning Outcome 1.)

32-5. Defenses of the Guarantor. Woodsmill Park Limited Partnership borrowed \$6.2 million secured by real property in Chicago, Illinois. Bill and Brian Bruce, and Matthew O’Malley, signed guaranties to meet Woodsmill’s obligation on the loan. Woodsmill defaulted on the payments. Northbrook Bank & Trust Company filed an action in an Illinois state court against Woodsmill and the Bruces to foreclose on

the property. The defendants agreed to modify the contract to resolve the claim. In exchange for Northbrook not pursuing foreclosure proceedings, the defendants promised to pay the difference between the value of the property and the unpaid amount of the loan. As part of the contract modification, the parties also stipulated, “Nothing in this Agreement shall release or reduce O’Malley’s obligations under O’Malley’s Guaranty.” Was it ethical of Northbrook and the Bruces to agree to these terms? Explain. [*Northbrook Bank & Trust Co. v. Matthew O’Malley*, 2017 IL App (1st) 160438-U (2017)] (See Learning Outcome 1.)

Chapter 32—Work Set

True-False Questions

- _____ 1. To be valid, a financing statement does not need to contain a description of the collateral.
- _____ 2. The security agreement determines most of the parties' rights and duties concerning the security interest.
- _____ 3. Default occurs most commonly when a debtor fails to repay the loan for which their property served as collateral.
- _____ 4. When two secured parties have perfected security interests in the same collateral, generally the last to perfect has priority.
- _____ 5. A mechanic's lien always involves real property, and an artisan's lien always involves personal property.
- _____ 6. A surety or guarantor is discharged from their obligation when the principal debtor pays the debt.
- _____ 7. A writ of execution is issued before the entry of a final judgment.
- _____ 8. An employer can dismiss an employee due to garnishment.

Multiple-Choice Questions

- _____ 1. Aksel owns Parkside Café, which he uses as collateral to borrow \$10,000 from First State Bank. To be effective, the security agreement must include
 - a. a description that reasonably identifies the collateral only.
 - b. Aksel's signature only.
 - c. a description that reasonably identifies the collateral and Aksel's signature.
 - d. none of the above.
- _____ 2. Koffi borrows \$5,000 from Modern Financial Corporation (MFC). MFC files a financing statement on May 1, but Koffi does not sign a security agreement until he receives the funds on May 5. He also borrows \$5,000 from Omega Bank, which advances funds, files a financing statement, and signs a security agreement on May 2. He uses the same property as collateral for both loans. On Koffi's default, in a dispute over the collateral, MFC will
 - a. lose because Omega perfected first.
 - b. lose because Omega's interest attached first.
 - c. win because it filed first.
 - d. win because its interest attached first.
- _____ 3. Safe Loans, Inc., wants to perfect its security interest in Tech Corporation's inventory for sale or lease. Most likely, Safe should file a financing statement with
 - a. a city manager.
 - b. a county clerk.
 - c. a federal loan officer.
 - d. the appropriate state or local official, usually the secretary of state.
- _____ 4. John is a cabinetmaker. Tammy contracts with John to make and install a custom bookcase in her house for \$4,000. John completes the bookcase, but Tammy does not pay. To obtain the amount that is owed, John can use
 - a. an artisan's lien.
 - b. a financing statement.
 - c. a mechanic's lien.
 - d. a writ of execution.

- _____ 5. Diane's \$6,000 debt to Ace Credit Company is past due, and Ace files suit. Before the judge hears the case, Ace learns that Diane has hidden some of her property from Ace. Ace believes that Diane is about to hide the rest of her property. To ensure there will be some assets to satisfy the debt if Ace wins the suit, Ace can use
- a. garnishment.
 - b. a mechanic's lien.
 - c. an artisan's lien.
 - d. attachment.
- _____ 6. Darius' \$2,500 debt to Oscar is past due. Darius does not own a house and has very little personal property, but he has a checking account, a savings account, and a job. To reach these assets to satisfy the debt, Oscar can use
- a. garnishment.
 - b. a mechanic's lien.
 - c. an artisan's lien.
 - d. attachment.
- _____ 7. L&R Computers, Inc., wants to obtain a loan from First National Bank. The bank refuses to lend L&R the funds unless Lee, L&R's sole stockholder, agrees to assume liability if L&R does not pay off the loan. Lee agrees. When the first payment is due, the bank can seek payment from L&R
- a. but not Lee because Lee is a guarantor.
 - b. but not Lee because Lee is a surety.
 - c. or Lee because Lee is a surety.
 - d. or Lee because Lee is a guarantor.

Answering More Legal Problems

1. Good Buy Co. sold consumer electronics. To operate its business, Good Buy borrowed funds from Capital Bank and Business Credit, Inc. Good Buy granted Capital Bank a security interest in "all Apple products," which attached on May 1. Business Credit's interest in "all Good Buy's inventory" attached on May 10. Business Credit perfected the interest by filing a financing statement on May 15. Capital filed a financing statement on May 20. One week later, Alexis bought an iPad from Good Buy. EZ Lending, LLC, loaned Good Buy funds on May 31 for an interest in "all Good Buy's equipment, whenever acquired." Before EZ Lending filed a financing statement, Good Buy filed for bankruptcy.
2. North Star Motors, Inc., sold used cars. To finance the purchase of the used cars, North Star borrowed funds from ReFinance Co. When North Star defaulted on its loans, ReFinance took possession of the dealer's inventory and notified it that the cars would be sold. In the auto industry, there are many ways to resell cars, including individual retail sales and wholesale sales of sets of vehicles. Most of North Star's repossessed vehicles were sold individually, but those that had high mileage or were in poor condition were sold to wholesalers in batches. The total sales did not amount to the full debt, so ReFinance held North Star liable for the difference.

What is the priority to Good Buy's assets among these security interests? _____ has first priority. _____ is second, _____ is third, and _____ is last. When a security interest is perfected, it has priority over any _____ interests. When two or more creditors have perfected security interests in the same collateral, the interest that was the _____ to attach has priority. A buyer in the ordinary course of business—any person who in good faith, and without knowledge that a sale is in violation of a security interest, buys in ordinary course from a person in the business of selling goods of that kind—has priority over a _____ security interest.

Were these sales commercially reasonable? Yes. Once default occurs, the secured party can obtain possession of the collateral. A secured party who does not choose to retain the collateral must dispose of it in a commercially reasonable manner. Selling the collateral using the same _____ that is typical for selling similar property fulfills this requirement. Generally, _____ of the sale must be sent to the debtor. Often, after proper disposition of the collateral, the secured party has not collected all that the debtor still owes. Unless otherwise agreed, the debtor is liable for any _____.

33 | Mortgages

Conflict Presented

Dakota owns a home on which she has two mortgage loans held by Homeland Bank. Malosi tells her that he can refinance her mortgages to reduce her monthly payments. He says that he represents Homeland. In fact, though, he represents Principal Loans, Inc. At the closing of the new loan, Malosi gives Dakota all of the relevant documents. The documents accurately state the new monthly payment, which is higher than Dakota's original payments. She signs the documents without reading them.

Q Can Dakota cancel the new loan on the basis of fraud?

When individuals purchase real property, they typically borrow funds from a financial institution by taking out a mortgage loan. A **mortgage** is a written instrument that gives the creditor (the mortgagee) an interest in, or lien on, the property being acquired by the debtor (the mortgagor) as security for the debt's payment.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Distinguish between fixed- and adjustable-rate mortgage loans.
- 2 Identify ways lenders can protect their interests.
- 3 State the debtor protection provisions of the Truth-in-Lending Act.
- 4 Identify ways to avoid foreclosure proceedings.

mortgage

A security interest in a debtor's real property.

33-1 Types of Mortgages

Mortgage loans are contracts, and as such, they come in a variety of forms, including fixed-rate and adjustable-rate mortgages.

A **fixed-rate mortgage**, the simplest mortgage loan, is a standard mortgage with a fixed rate of interest. Payments on the loan remain the same for the duration of the mortgage, which ranges from fifteen to fifty years.

The rate of interest paid by the borrower changes periodically with an **adjustable-rate mortgage (ARM)**. Typically, the initial interest rate is set relatively low and is fixed for a specified period, such as a year or three years. After that, the interest rate adjusts periodically, often annually. ARMs generally are described in terms of the initial fixed period and the adjustment period. For instance, if the interest rate is fixed for three years and then adjusts annually, the mortgage is called a 3/1 ARM. If the rate adjusts annually after five years, the mortgage is a 5/1 ARM.

Most ARMs have interest rate caps that limit how much the rate can rise over the duration of the loan. In addition, some ARMs have caps that stipulate the maximum increase that can occur in any particular adjustment period.

In addition, most adjustable-rate mortgage contracts include what is known as an **ARM margin**. The ARM margin is a fixed percentage rate that is added to an index (variable) rate to determine the fully indexed interest rate of an adjustable-rate mortgage.

Learning Outcome 1

Distinguish between fixed- and adjustable-rate mortgage loans.

fixed-rate mortgage

A mortgage with a fixed, or unchanging, rate of interest.

adjustable-rate mortgage (ARM)

A mortgage in which the rate of interest changes periodically.

ARM margin

The amount of interest a borrower pays on an adjustable-rate mortgage above the so-called index rate.



Highlighting the Point

Greta and Marcus obtain a 3/1 ARM from Neighbors Bank to purchase a home. The mortgage's initial interest rate is 4 percent. The loan documents stipulate that the rate can rise no more than 3 percentage points in one adjustment period. The ARM margin is fixed at 2 percentage points. After three years, when the first adjustment is to be made, the relevant index rate is 6 percent. This means that the adjusted interest rate would rise to 8 percent (the index rate of 6 percent plus the margin of 2 percent).

Can Neighbors Bank increase the mortgage's interest rate to 8 percent? No. The loan document specifies that the interest rate can rise no more than 3 percentage points in any one period. Because the initial rate was 4 percent, the new adjusted rate cannot be higher than 7 percent.

Learning Outcome 2

Identify ways lenders can protect their interests.

mortgage insurance

Insurance that compensates a lender for losses due to a borrower's default on a mortgage loan.

33-2 Lender Protections

When lenders (creditors) grant mortgages, they are lending large amounts for long periods. Consequently, they take steps to protect their interests.

33-2a Mortgage Insurance

One precaution that lenders can take to protect their interest in a mortgage is to require borrowers to obtain **mortgage insurance**. Most creditors require a borrower to purchase mortgage insurance if the borrower does not make a down payment of at least 20 percent of the purchase price. (The down payment is the part of the purchase price paid up front, typically in cash.)

Example 33.1 Tian and Joy apply for a mortgage loan with Sterling Silver Bank to purchase a house for \$200,000. They make a down payment of only \$20,000 (10 percent of the purchase price). Sterling Silver Bank requires them to purchase insurance to cover the remaining 10 percent of the 20 percent down payment. If Frank and Joy stop making payments on the loan, the bank can repossess the house and also receive reimbursement from the insurer for the covered portion of the loan. ■

33-2b Recording the Mortgage Loan

Another form of protection for a creditor is to record the mortgage with the appropriate office in the county where the property is located. Recording ensures that the creditor is officially on record as holding an interest in the property. A lender that fails to record a mortgage could find itself in the position of an unsecured creditor.

33-2c Contract Provisions

To further protect their interests, lenders ensure that mortgage documents comply with applicable statutes. Because a mortgage involves a transfer of real property, for instance, it must be in writing.

Lenders also make sure that mortgage documents contain the following important provisions:

1. The terms of the underlying loan. These include the loan amount, the interest rate, the period of repayment, and other important financial terms, such as the margin and index rate for an ARM. Many lenders include a **prepayment penalty clause**, which requires the borrower to pay a penalty if

prepayment penalty clause

A clause assessing a penalty if a loan is repaid early.

the mortgage is repaid in full within a certain period. A prepayment penalty helps to protect the lender should the borrower refinance within a short time after obtaining a mortgage.

2. Provisions relating to the maintenance of the property. Because the mortgage conveys an interest in the property to the lender, the lender will require the borrower to maintain the property in such a way that the lender's investment is protected.
3. A statement obligating the borrower to maintain homeowners' insurance on the property. This type of insurance protects the lender's interest in the event of a loss due to certain hazards, such as fire or storm damage.
4. A list of the nonloan financial obligations to be paid by the borrower. For example, the borrower typically is required to pay all property taxes, assessments, and other claims against the property.

33–3 Borrower Protections

To better protect borrowers from improper lending practices, Congress and the Federal Reserve Board have instituted a number of requirements for lenders.

33–3a Predatory Lending

The general term “predatory lending” describes a number of improper lending practices. **Predatory lending** occurs when borrowers are the victims of loan terms or lending procedures that are excessive, deceptive, or not properly disclosed. Predatory lending typically occurs during the loan origination process. It includes a number of practices, ranging from failure to disclose terms to providing misleading information to outright dishonesty.

Two specific types of improper practices are often at the core of a violation.

1. **Steering and targeting**—Occurs when the lender manipulates a borrower into accepting a loan product that benefits the lender but is not the best loan for the borrower. For instance, a lender may steer a borrower toward an ARM, even though the buyer qualifies for a low-cost fixed-rate mortgage.
2. **Loan flipping**—Occurs when a lender convinces a homeowner to refinance soon after obtaining a mortgage. Such early refinancing rarely benefits the homeowner and may, in fact, result in prepayment penalties.

predatory lending

Lending procedures that are excessive, deceptive, or not properly disclosed.

33–3b The Truth-in-Lending Act

One important law protecting borrowers is the Truth-in-Lending Act (TILA). The TILA requires lenders to disclose the terms of a loan in clear, readily understandable language so that borrowers can make rational choices. With respect to real estate transactions, the TILA applies only to residential loans.

Learning Outcome 3

State the debtor protection provisions of the Truth-in-Lending Act.

Disclosures The major terms that must be disclosed under the TILA include:

1. The loan principal
2. The interest rate at which the loan is made
3. The **annual percentage rate**, or **APR** (the actual cost of the loan on a yearly basis)
4. All fees and costs associated with the loan.

annual percentage rate (APR)

The cost of credit on a yearly basis, typically expressed as an annual percentage.

The TILA requires that these disclosures be made on standardized forms and based on uniform formulas of calculation. A mortgage cannot be finalized until at least seven days after a borrower has received the TILA paperwork.

The TILA disclosure requirements apply to the written materials, not to any oral representations. If a lender provides the required TILA disclosures, a borrower who fails to read the documents cannot claim fraud, even if the lender orally misrepresented the terms of the loan or some other aspect of the transaction.

Prohibitions and Requirements The TILA prohibits a number of lender abuses. Lenders may not, for instance, pressure an appraiser to misstate the value of a property on which a loan is to be issued. (An appraiser specializes in estimating property values.) In addition, lenders cannot advertise a loan as a fixed-rate loan if, in fact, its rate or payment amounts will change.

The TILA also creates certain rights for borrowers. Once a borrower has received the required disclosures, for instance, the borrower has the right to cancel the mortgage within three business days. If the lender fails to provide the required disclosures, the cancellation period can last up to three years.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Malosi tells Dakota that he can refinance her mortgages to reduce her monthly payments. He says that he represents Homeland Bank. In fact, he represents Principal Loans, Inc. At the closing of the new loan, Dakota has an opportunity to read all of the relevant documents, which reveal that her new monthly payment will be higher than her original payments. Dakota does not read the documents.

A Can Dakota cancel the new loan on the basis of fraud? No. The disclosure requirements under the Truth-in-Lending Act (TILA) apply to the written materials that a lender provides, not to oral representations. If a lender provides the required TILA disclosures, a borrower who fails to read the documents cannot claim fraud, even if the lender orally misrepresents a material fact. Dakota had the opportunity to read all of the relevant documents, but she did not do so.

foreclosure

A proceeding in which a lender either takes title to or forces the sale of the borrower's property in satisfaction of a debt.

Learning Outcome 4

Identify ways to avoid foreclosure proceedings.

forbearance

An agreement between a lender and a borrower to postpone, for a limited time, payments on the loan.

33-4 Foreclosures

If a homeowner defaults, or fails to make mortgage payments, the lender has the right to foreclose on the mortgaged property. **Foreclosure** is a process that allows a lender to legally repossess and auction off the property that is securing a loan.

Foreclosure is expensive and time consuming. In addition, it generally benefits neither borrowers, who lose their homes, nor lenders, which face the prospect of losses on their loans. Consequently, both parties often try to avoid foreclosure.

Various methods to avoid foreclosure have been developed. We look first at some of these methods and then turn to the foreclosure process itself.

33-4a How to Avoid Foreclosure

A number of alternatives to foreclosure may be available to borrowers who are unable to make payments on their mortgage loans, including the following options.

Forbearance and Workout Agreements A **forbearance** is an agreement between the lender and the borrower to postpone, for a limited time, part or all of the payments on a loan in jeopardy of foreclosure. This option may work well when the debtor

has short-term financial problems that can likely be solved—such as when the debtor has lost a job but is likely to find a new job soon.

Another similar option to foreclosure is a workout agreement, which is a formal contract between the lender and borrower to negotiate a payment plan for the amount due on the loan instead of going into foreclosure. In such agreements, the lender will likely agree to delay seeking foreclosure.

Short Sales The lender may agree to a short sale—that is, a sale of the property for less than the balance due on the mortgage loan. The borrower must obtain the lender’s permission for the short sale and typically must show some hardship. The borrower may have lost a job, for instance, or may owe more than the home’s value. The lender receives the proceeds of the sale. The borrower still owes the balance of the debt to the lender unless the lender specifically agrees to forgive the remaining debt.

A Deed in Lieu of Foreclosure Under a deed in lieu of foreclosure, the property can be conveyed (transferred) to the lender in satisfaction of the mortgage. A property that is worth close to the outstanding loan principal and on which no other loans have been taken might be the subject of such a conveyance.

Friendly Foreclosure The parties can avoid a contested foreclosure by engaging in a friendly foreclosure. In such a transaction, the borrower in default agrees to submit to the court’s jurisdiction, to waive any defenses as well as the right to appeal, and to cooperate with the lender.

33–4b The Foreclosure Procedure

If all efforts to find another solution fail, the lender will proceed to foreclosure. Generally, two types of foreclosure are used in the United States: judicial foreclosure and power of sale foreclosure.

In a **judicial foreclosure**, which is available in all states, a court supervises the process. In a **power of sale foreclosure**, the lender is allowed to foreclose on and sell the property without judicial supervision. Only a few states permit power of sale foreclosures because borrowers have less protection when a court does not supervise the process.

judicial foreclosure

A court-supervised foreclosure.

power of sale foreclosure

A foreclosure procedure that is not court supervised.

Real Case



Ritu Madhok borrowed \$213,069 from Banc of California, N.A., to buy a house. She executed a note for that amount and a mortgage to secure payment. Ten months later she stopped making payments. She was given three additional months to provide a loss mitigation package, but it was partial and incomplete the day before the bank effectuated a foreclosure sale. The sale went ahead as scheduled. After the sale, Madhok asked the court to set aside the sale, but the court refused.

Did the court abuse its discretion? No. In *Banc of California v. Madhok*, a state intermediate appellate court affirmed the lower court’s order denying Madhok’s motion to vacate the foreclosure sale. The court did not abuse its discretion by refusing Madhok’s request. She delayed until the day before the sale to apply for a loan modification and then only provided a partial loss-mitigation application.

—2019 WL 149660 (N.J. App.)

acceleration clause

A clause allowing a lender to call an entire loan due.

notice of default

A formal notice to borrowers that they are in default on mortgage payments and may face foreclosure.

notice of sale

A formal notice to a borrower who is in default that the mortgaged property will be sold in a foreclosure proceeding.

Acceleration Clauses Lenders often include an acceleration clause in their loan documents. An **acceleration clause** allows the lender to call the entire loan due under certain conditions—even if only one payment is late or missed. With an acceleration clause, the lender can foreclose on the entire amount of the loan rather than on only the amount of the missed payments.

Notice of Default and Notice of Sale To initiate a foreclosure, a lender must record a **notice of default** with the appropriate county office. The borrower is then on notice of a possible foreclosure and can take steps to pay off the loan and cure the default.

If the loan is not paid within a reasonable time (usually three months), the borrower will receive a **notice of sale**. In addition, the notice of sale usually is posted on the property, recorded with the county, and published in a newspaper.

The property is then sold in an auction on the courthouse steps. The buyer generally has to pay cash within twenty-four hours for the property. If the procedures are not followed precisely, the parties may have to resort to litigation to establish clear ownership of the property.

Deficiency Judgments If the final sales price at the foreclosure sale is not enough to cover the loan amount, the lender can generally ask a court for a deficiency judgment. A deficiency judgment requires the borrower to make up the difference between the final sales price and their remaining debt on the mortgage loan.



Highlighting the Point

Layan obtains a loan from Springwater Finance Company to buy a home. The loan is secured by a mortgage on the house. Layan defaults on the loan, and Springwater forecloses on the property. At the time, Layan owes \$175,000 on the loan. At the foreclosure sale, Springwater successfully bids \$150,000 for the property.

Can Springwater recover the difference between its successful bid at the foreclosure sale and the remaining unpaid debt in a deficiency action against Layan? Yes. A lender who successfully bids on property at a foreclosure sale is considered to have received repayment of the loan in the amount of the bid. The lender can recover the difference between that amount and the remaining unpaid debt in a deficiency action against the debtor. Springwater can recover \$25,000 from Layan.

Ordinarily, a deficiency judgment will amount to the difference between the borrower's outstanding debt and the final sales price at the foreclosure sale. Courts will not apply the sales price, however, if the property sells for far less than its fair market value. When this situation occurs, the lender is entitled to the difference between the borrower's outstanding debt and the property's fair market value at the time of the foreclosure sale.

33–4c Redemption Rights

Every state allows a defaulting borrower to redeem the property before the foreclosure sale by paying the full amount of the debt, plus any interest and costs that have accrued. This is referred to as the buyer's **equitable right of redemption**.

Equitable redemption allows a defaulting borrower to gain title and regain possession of a property. The idea is that it is only fair, or equitable, for the borrower to have a chance to regain possession after default. Some states allow borrowers to repurchase property even after a judicial foreclosure sale.

equitable right of redemption

The right of borrowers to redeem or purchase their property before foreclosure proceedings.

Chapter Summary—Mortgages

Learning Outcome 1: Distinguish between fixed- and adjustable-rate mortgage loans.

A fixed-rate mortgage is a standard mortgage with a fixed rate of interest. An adjustable-rate mortgage is a mortgage in which the interest rate changes periodically, usually starting low and increasing over time.

Learning Outcome 2: Identify ways lenders can protect their interests.

A lender can protect its interests in a mortgage loan in the following ways:

- (1) By requiring borrowers to obtain mortgage insurance—which compensates a lender for losses due to a borrower's default on a mortgage loan.
- (2) By recording the mortgage loan with the proper county office—which ensures that the creditor is officially on record as holding an interest in the property.
- (3) By ensuring that mortgage documents comply with applicable statutes and contain important terms.

Learning Outcome 3: State the debtor protection provisions of the Truth-in-Lending Act.

The Truth-in-Lending Act (TILA) requires lenders to disclose the terms of a loan in clear, readily understandable language so that borrowers can make rational choices. Terms that must be disclosed include the loan principal, the interest rate, the annual percentage rate (APR), and all fees and costs. The TILA prohibits certain lender practices, such as pressuring an appraiser into misstating the value of property. A borrower has the right to rescind a mortgage within three business days, which may extend to three years if the required disclosures are not made.

Learning Outcome 4: Identify ways to avoid foreclosure proceedings.

Ways to avoid foreclosure proceedings include a forbearance, a workout agreement, a short sale, a deed in lieu of foreclosure, and a friendly foreclosure.

Straight to the Point

1. How does mortgage insurance protect a lender? (See Learning Outcome 2.)
2. What is the possible consequence to a lender of failing to record a mortgage? (See Learning Outcome 2.)
3. What important provisions should mortgage documents contain? (See Learning Outcome 2.)
4. When does a lender have the right to foreclose on mortgaged property? (See Learning Outcome 4.)
5. Why do lenders and borrowers often try to avoid foreclosure? (See Learning Outcome 4.)
6. What is the difference between a judicial foreclosure and a power of sale foreclosure? (See Learning Outcome 4.)
7. What is the idea behind equitable redemption? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Ruth Ann borrows \$175,000 from Sunny Valley Bank to buy a home. Federal law regulates the terms of the mortgage that must be disclosed in writing in clear, readily understandable language. What are the major terms that must be disclosed under the Truth-in-Lending Act? (See Learning Outcome 3.)
2. Tanner borrows \$150,000 from Southeast Credit Union to buy a home, which secures the loan. Two years into the term, Tanner stops making payments on the loan. After six months without payments, Southeast informs Tanner that he is in default and that it will proceed to foreclosure. What is foreclosure, and what is the usual procedure? (See Learning Outcome 4.)

Real Law

33–1. Borrower Protections. Tony and Julie Odigie took out an adjustable-rate mortgage from Nationstar Mortgage, LLC, to purchase their new home. They were late with the first payment and delinquent several times a year for every year for over a decade. Nationstar modified the interest rate, payment schedule, and principal amount numerous times in an attempt to find a solution, but nothing worked. The Odigies sued Nationstar, alleging violations of the Truth in Lending Act. When a district court entered summary judgment for Nationstar, the Odigies appealed. They claimed that, among other things, Nationstar had violated the Truth in Lending Act by failing to provide certain disclosures along with the loan application form. During the appeal, the Odigies conceded that Nationstar fulfilled this obligation. In one final try, they argued that Nationstar did not make necessary disclosures under a different regulatory provision that they never cited when they were in front of the district court. On appeal, can the Odigies use this as an opportunity to try out new legal claims? [*Odigie v. Nationstar Mortgage, LLC*, 831 Fed.Appx. 788 (U.S. Ct. App. 6th Cir., 2020)] (See Learning Outcome 3.)

33–2. Foreclosure. Douglas and Archondoula Edmonds borrowed funds from Chase Bank USA, National Association (N.A.), secured by a mortgage on real property in Cape Coral, Florida. The mortgage required the lender to give the borrowers notice of default and an opportunity to cure it.

Later, JP Morgan Chase Bank, N.A. filed a suit in a Florida state court against the Edmondses to foreclose on the mortgage. The Edmondses responded that they had not received the required notice of default. At the trial, the bank showed the court several default letters addressed to the couple. But the bank could not provide any return receipts, a mailing log, or other evidence to show that the letters had actually been mailed or delivered. Should the court enter a judgment of foreclosure or dismiss the suit? Explain. [*Edmonds v. U.S. Bank National Association*, 215 So.3d 628 (Fla.App. 2 Dist. 2017)] (See Learning Outcome 4.)

33–3. Deficiency Judgments. First Brownsville Company borrowed funds from Beach Community Bank to build and operate a mini-warehouse storage business. The loan was secured by a mortgage. First Brownsville defaulted on the payments. Beach filed an action in a Florida state court to foreclose on the mortgage. The court determined that First Brownsville owed \$1,224,475, entered a judgment for the bank, and ordered a foreclosure sale. The property was appraised to be worth \$770,000, but Beach bought it for a mere \$1,300 at the sale and sought a deficiency judgment. What should be the amount of the deficiency judgment? Why? [*Beach Community Bank v. First Brownsville Co.*, 37 Fla.L.Weekly D618, 85 So.3d 1119 (Fla.App. 1 Dist. 2012)] (See Learning Outcome 4.)

Ethical Questions

33–4. Foreclosure. What purpose is served by the seizure and sale of property on the mortgagor's default? Why notify the mortgagor of the foreclosure? (See Learning Outcome 4.)

33–5. Foreclosure. Carmen Johnson operated CJ Lending as a so-called credit-repair business. Real estate agent Edgar Tibakweitira paid Johnson to fabricate credit histories for certain individuals who had no such histories. Johnson submitted the data to credit-reporting agencies. Lenders relied on the false information to approve mortgage loans.

Johnson and Tibakweitira used the identities of the individuals to purchase real property. They then shared in the proceeds of the loans disbursed at the closings. When the “buyers” did not pay the loans, the properties went into foreclosure. The U.S. Secret Service uncovered the scheme. Johnson was indicted for making false statements on loan applications. In addition, what made Johnson's actions unethical? Why? [*United States v. Johnson*, 2017 WL 1226100 (4th Cir. 2017)] (See Learning Outcome 4.)

Chapter 33—Work Set

True-False Questions

- _____ 1. Steering and targeting occur when a lender convinces a homeowner to refinance soon after obtaining a mortgage.
- _____ 2. A borrower has up to seven business days to rescind a mortgage.
- _____ 3. Federal disclosure requirements apply only to the written materials provided by a mortgage lender.
- _____ 4. Foreclosure allows a lender to legally repossess and auction off the property securing a loan.
- _____ 5. An appraiser specializes in estimating property values.
- _____ 6. In a power of sale foreclosure, a court supervises the process.
- _____ 7. On foreclosure, if a mortgage is not paid within a reasonable time after a notice of default, the property securing the loan can be sold without notice.

Multiple-Choice Questions

- _____ 1. Pacific Bank provides Ogden with a standard mortgage with an unchanging rate of interest to buy a home. Payments on the loan remain the same for the duration of the mortgage. This is
 - a. a fixed-rate mortgage.
 - b. an adjustable-rate mortgage.
 - c. an acceleration clause.
 - d. a violation of the law.
- _____ 2. Selma borrows \$125,000 from Riverview Credit Union to buy a home. Among the terms that must be disclosed under federal law is the annual percentage rate. This rate is
 - a. the actual cost of the loan on a yearly basis.
 - b. the average prime offer rate.
 - c. the interest rate at which the loan is made.
 - d. the loan principal.
- _____ 3. Ian applies to Hometown Mortgage Company for \$180,000 to buy a home. Hometown steers Ian toward an adjustable-rate mortgage even though he qualifies for a low-cost fixed-rate mortgage. This is
 - a. a short sale.
 - b. a forbearance.
 - c. loan flipping.
 - d. steering and targeting.
- _____ 4. Lizette borrows \$150,000 from Main Street Bank to buy a home. The Truth-in-Lending Act (TILA) regulates primarily
 - a. the mortgage terms that must be disclosed in writing.
 - b. the lender's oral representations concerning the terms of a loan.
 - c. the lowest prices for which real property can be sold.
 - d. who can buy real property, where they can buy it, and why.
- _____ 5. Heneli borrows \$150,000 from Countywide Credit Union to buy a home. By recording the mortgage, Countywide protects its
 - a. priority against a previously filed lien on the property.
 - b. priority against any party with an earlier claim to the property.
 - c. rights against Heneli.
 - d. rights against the claims of later buyers of the property.

- _____ 6. Infinity Credit LLC makes loans to consumers secured by their homes. An Infinity Credit loan is an adjustable-rate mortgage if its interest rate
- adjusts periodically.
 - changes with the consumer's debt-to-income ratio.
 - increases with the market value of the consumer's home.
 - remains the same for the duration of the mortgage.
- _____ 7. Miray borrows \$150,000 from Community Bank to buy a home. If she fails to make payments on the mortgage, the bank has the right to repossess and auction off the property securing the loan. This is
- a short sale.
 - forbearance.
 - foreclosure.
 - the equitable right of redemption.
- _____ 8. Shirley borrows \$200,000 from Ridgetop Credit Union to buy a home, which secures the loan. Three years into the term, she stops making payments on it. Ridgetop repossesses and auctions off the property to Toby. The sale proceeds are not enough to cover the unpaid amount of the loan. In most states, Ridgetop can ask a court for
- a deficiency judgment.
 - an equitable right of redemption.
 - a short sale.
 - nothing.

Answering More Legal Problems

1. Lake County Credit Union (LCCU) approved a mortgage loan to Giselle for \$175,000 at a fixed rate of 3.75 percent with a thirty-year term secured by the home. After paying \$10,500 of the mortgage, Giselle lost her job and asked LCCU to defer the payments on the mortgage for six months, when she was to start a new job. In the current market, the value of Giselle's home had decreased to \$125,000.

What is the best option for LCCU to recover the outstanding amount of the loan? The lender's options include a forbearance, a workout agreement, a short sale, a deed in lieu of foreclosure, and a friendly foreclosure. Because the market value of Giselle's home has fallen below the amount owed on the mortgage, a _____ sale would not likely recover the debt. Most of the other options would cost the parties time, expense, and other negative consequences. These consequences could be avoided by a _____ or a _____ agreement.

2. Dante borrowed \$150,000 from Eden Valley Bank to buy a home. The loan was a fixed-rate mortgage at 4.25 percent with a thirty-year term subject to an acceleration

clause and secured by the home. After paying \$8,500 of the mortgage, Dante lost his job and stopped making payments. For six months, Eden tried unsuccessfully to contact Dante. The current market value of the home was \$115,000.

What is Eden's best option to recover the unpaid amount of the mortgage? Because Dante did not contact or even respond to Eden, the best option to recover the unpaid amount of the loan is a _____. The acceleration clause allows Eden to call the entire loan due. A court supervises a judicial _____. Eden's first step is to file a notice of _____ with the appropriate state office. This puts Dante on notice to pay the loan and cure the _____. If this does not occur, Eden can give a notice of sale to Dante, post it on the property, file it with the county, and announce it in a newspaper. The property will be sold at _____ on the courthouse steps. Because the market value of the home has fallen, the sale is unlikely to recover the unpaid amount of the loan, plus Eden's fees and costs. Eden can then ask the court for a _____ judgment against Dante.

34 | Bankruptcy

Conflict Presented

William is having trouble paying his monthly bills. To get a fresh start, William decides to file for relief under a Chapter 7 liquidation plan. As part of the bankruptcy proceeding, he submits a list of debts that he would like discharged. These debts include his mortgage loan, credit card debt, car loan, and student loan.

Q Are all of William's debts dischargeable under Chapter 7?

Although in the old days, debtors were punished and sometimes even sent to prison for failing to pay what they owed, debtors today rarely go to jail. Instead, when people have trouble paying their debts, they have many other options, including bankruptcy—the last resort in resolving debtor–creditor problems.

Bankruptcy relief is provided under federal law. The federal bankruptcy law is called the Bankruptcy Code, or the Code. It has two main goals:

1. To protect a debtor by giving them a new start without creditors' claims.
2. To ensure equitable treatment of creditors who are competing for a debtor's assets.

This chapter introduces three common types of bankruptcy relief and their basic procedures.

34–1 Types of Bankruptcy Relief

Anyone who owes a creditor can declare bankruptcy. Individuals and businesses need not be technically **insolvent**—that is, need not have more liabilities than assets—to file for bankruptcy relief. Debtors whose cash-flow problems become severe may petition for bankruptcy voluntarily or be forced into involuntary bankruptcy by creditors even though their assets exceed their liabilities.

Three chapters of the Code—Chapters 7, 11, and 13—set forth important types of relief that debtors can seek:

1. Chapter 7 provides for liquidation proceedings. Simply put, liquidation means the sale of the assets of a business or an individual for cash and the distribution of this cash to pay creditors. If any debts remain after liquidation, they are **discharged**, and debtors are relieved of their obligation to pay the debts. This gives debtors an opportunity for a fresh start.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Describe three common types of bankruptcy relief.
- 2 List the duties of a bankruptcy trustee.
- 3 Identify the debtor and procedures in a Chapter 11 reorganization.
- 4 Explain how a Chapter 13 plan differs from Chapter 7 and 11 plans.

Learning Outcome 1

Describe three common types of bankruptcy relief.

insolvent

Having liabilities that exceed assets or being unable to pay debts.

discharged

The termination of a debtor's obligation to a creditor.

- Chapter 11 governs reorganization of the obligations of the debtor (which is usually a corporation). In Chapter 11 proceedings, the parties create a plan under which the debtor pays a portion of the debts and is discharged of the remainder. Then the debtor is allowed to continue in business.
- Chapter 13 provides for the adjustment of debts of individuals (not businesses). Debtors in a Chapter 13 bankruptcy create an individual's repayment plan that outlines how debt payments will be made. Under Chapter 13 bankruptcy, debtors retain possession of most of their assets. The majority of debts are discharged within three years.

All bankruptcy proceedings are conducted in federal bankruptcy courts. The first step for each type of bankruptcy plan is the filing of a petition. A debtor makes a voluntary filing. Alternatively, a creditor can file a petition to force the debtor into involuntary bankruptcy. In a Chapter 7 or a Chapter 11 case, either the debtor or a creditor may file. A Chapter 13 case, however, can be established only by the filing of a voluntary petition by the debtor or by the conversion of a Chapter 7 petition.

34–1a Voluntary Bankruptcy

Voluntary petitions may be filed to initiate Chapter 7, Chapter 11, or Chapter 13 bankruptcies. A voluntary petition is brought by the debtor, who files official forms designated for that purpose in the bankruptcy court. Spouses can file jointly for bankruptcy under a single petition.

secured creditor

A lender or seller who has a security interest in collateral that secures a debt.

unsecured creditor

A creditor whose debt is not backed by any collateral.

The Voluntary Petition The voluntary petition must include a list of the debtor's **secured creditors** and **unsecured creditors**, their addresses, and the amount of debt owed to each. It must also include a list of all of the debtor's property, income, and expenses, as well as other information. The official forms must be completed accurately, sworn to under oath, and signed by the debtor. To conceal assets or knowingly supply false information is a crime.

In addition to the financial statements, each voluntary petition must include a certificate that proves the debtor has received credit counseling from an approved agency within the previous six months. Also, all individual debtors (but not businesses) must include a statement indicating that they understand the relief available under the Code.

Grounds for Dismissal Failing to provide the necessary filing documents can result in the court's dismissal of a debtor's petition for relief under any chapter. In addition, concealing assets or knowingly supplying false information on the documents is grounds for dismissal. A court might also dismiss a voluntary petition if the debtor has been convicted of a violent crime or if the debtor has not paid a domestic-support obligation, such as child support.

order for relief

A court's grant of assistance to a debtor.

Order for Relief If a voluntary petition for bankruptcy is found to be proper, the court will enter an **order for relief**. This order relieves the debtor of having to pay the debts listed in the petition.

34–1b Involuntary Bankruptcy

An involuntary bankruptcy occurs when the debtor's creditors force the debtor into bankruptcy proceedings. Such a case cannot be commenced against a farmer or a charitable institution. Nor can it be filed unless one of the following two requirements is met:

- If the debtor has twelve or more creditors, three or more of those having unsecured claims adding up to at least \$16,750 must join in the petition.

2. If the debtor has fewer than twelve creditors, one or more creditors having an unsecured claim of \$16,750 may file.

Sometimes, a debtor challenges the involuntary petition. The court will listen to the debtor's arguments and decide whether or not to go ahead with the bankruptcy proceeding.

34–1c Automatic Stay

The filing of a petition, either voluntary or involuntary, operates as an **automatic stay** on (suspension of) almost all litigation and other action by creditors against the debtor or the debtor's property. Once a petition is properly filed, creditors cannot commence or continue most legal actions against the debtor to recover claims. Nor can they take any action to repossess property in the hands of the debtor.

automatic stay

A suspension of all judicial proceedings on the occurrence of an independent event.

Highlighting the Point



Soon after graduating from Applied Science University (ASU), Britta files a Chapter 7 bankruptcy petition. Before the court finds that Britta's petition is proper and enters an order for relief, she requests a transcript from the university. ASU refuses her request, claiming that she owes more than \$6,000 in unpaid tuition.

Can Britta obtain her transcript despite the unpaid ASU tuition? Yes. ASU is violating the automatic stay when it refuses to provide the transcript because the school is attempting to collect an unpaid tuition debt. An automatic stay prohibits a creditor from taking any action to collect, assess, or recover a claim against the debtor that arose before the filing of their bankruptcy petition.

34–2 Chapter 7—Liquidation

Liquidation under Chapter 7 is the most familiar type of bankruptcy proceeding. Any person—which is defined as including individuals, partnerships, and corporations—may be a debtor under Chapter 7. Railroads, insurance companies, banks, savings and loan associations, credit unions, and investment companies licensed by the U.S. Small Business Administration cannot be Chapter 7 debtors.

To determine whether debtors qualify under Chapter 7, they must complete a means test. In short, if the debtors' average monthly income is below the median income in the geographic area in which they live, the debtors' petition will most likely be allowed. If the debtors' average monthly income is above the median, their disposable income is calculated by subtracting living expenses and secured debt payments from monthly income. The purpose is to determine whether the debtor can repay some of the unsecured debts.

Next, we discuss the procedure for Chapter 7's bankruptcy proceedings once the petition has been found to be proper and the order for relief has been issued.

34–2a Creditors' Meeting

Within a reasonable time after the order for relief is granted, the court must call a meeting of creditors. At this meeting, a bankruptcy trustee is elected to take over the debtor's assets.

The Debtor's Role at the Meeting The debtor must attend the creditors' meeting and must submit to an examination under oath by the creditors and the trustee.

Debtors who fail to appear when required or who make false statements under oath may be denied a discharge of their debts in the bankruptcy proceeding. At the meeting, the trustee ensures that debtors are aware of the potential consequences of bankruptcy and of their ability to file for bankruptcy under a different chapter.

Learning Outcome 2

List the duties of a bankruptcy trustee.

bankruptcy trustee

A person appointed by the court to sell the debtor's assets and distribute the proceeds to creditors.

The Bankruptcy Trustee The basic duty of the **bankruptcy trustee** is to collect the debtor's property and reduce it to money for distribution, preserving the interests of both the debtor and the unsecured creditors. In other words, the trustee is accountable for administering the debtor's estate.

Initially, the trustee in a Chapter 7 proceeding determines whether the debtor's financial situation warrants relief based on a comparison of the debtor's income with the income of other families in the same state. The trustee must notify the creditors of this determination. The trustee must then either (1) file a motion to dismiss the petition or convert it to a Chapter 13 bankruptcy proceeding or (2) explain to the court why such a motion would not be appropriate.

34–2b Estate in Property

On the commencement of a Chapter 7 proceeding, an **estate in property** is created. The estate consists of all the debtor's property, together with certain jointly owned property, property transferred in a transaction voidable by the trustee, and proceeds and profits from the property. Interests in certain property—such as gifts, inheritances, and life insurance proceeds—to which the debtor becomes entitled within 180 days after filing may also become part of the estate.

The trustee takes control over the debtor's property, but an individual debtor is entitled to exempt certain property from the bankruptcy. An important property exemption under Chapter 7 is the debtor's equity in their residence (up to a certain amount). Other exemptions include limited interests in the debtor's motor vehicle, household goods, and trade tools.

Example 34.1 Clifford is a skilled handyperson and the sole proprietor of Mobile Mister Fix-It. After five years in business, Clifford files for Chapter 7 bankruptcy relief. Under the plan, he is entitled to exempt a portion of the tools that he uses in his business. The bankruptcy trustee cannot take all of his trade tools to pay off his debts. ■

34–2c Property Distribution

In the next step of a Chapter 7 bankruptcy, the trustee distributes the bankruptcy estate to creditors with proofs of claim. The right of a creditor to be paid from the property of the estate depends on whether the creditor is secured or unsecured.

Creditors' Claims To be entitled to receive a portion of the debtor's estate, each creditor normally files a proof of claim with the bankruptcy court within ninety days of the creditors' meeting. A proof of claim is necessary if there is any dispute concerning the claim. The proof of claim lists the creditor's name and address, as well as the amount that the creditor asserts is owed to the creditor by the debtor.

Secured Creditors A secured creditor has a security interest in collateral that secures the debt. If the collateral is surrendered to the secured creditor, the creditor can enforce the security interest either by accepting the property in full satisfaction of the debt or by selling the collateral and using the proceeds to pay off the debt. Should the collateral be insufficient to cover the secured debt owed, the secured creditor becomes an unsecured creditor for the difference.

Unsecured Creditors Unsecured creditors, of course, do not have security interests in collateral. Their claims are subordinate (lower ranking) to the claims of secured creditors.

Priority Secured creditors are paid in a certain order of priority. They are divided into classes, and each class must be fully paid before the next class is entitled to any of the proceeds. The highest-priority class comprises claims for domestic support, such as child support. These claims must be paid first. If there are not enough funds to pay an entire class, the proceeds are distributed proportionately to creditors in the class. Classes lower in priority on the list receive nothing.

In most Chapter 7 bankruptcies, there is not enough money to pay all the creditors. If any amount remains after the creditors have been paid, however, the trustee gives it back to the debtor.

34–2d Discharge Under Chapter 7

Once the proceeds have been distributed, the debtor's remaining debts are discharged. Certain debts, however, are not dischargeable in bankruptcy. Also, certain debtors may not qualify to have all their debts discharged.

Exceptions to Discharge Discharge of a debt may be denied because of the nature of the claim or the conduct of the debtor. Claims that are not dischargeable in bankruptcy include the following:

- Claims that are based on a debtor's willful or malicious conduct or fraud.
- Claims for amounts due to the government for taxes accruing within three years, fines, or penalties, as well as any amounts borrowed to pay these debts.
- Domestic-support obligations and property settlements arising from a divorce or separation.
- Certain student loans (unless payment of the loans imposes an undue hardship on the debtor).

Conflict Resolved

In the Conflict Presented feature at the beginning of the chapter, William is having trouble paying his monthly bills. To get a fresh start, William decides to file for relief under a Chapter 7 liquidation plan. As part of the bankruptcy proceeding, he submits a list of debts that he would like discharged. They include his mortgage loan, credit card debt, car loan, and student loan.

A Are all of William's debts dischargeable under Chapter 7? No. While most debts can be discharged under Chapter 7, certain debts cannot be—including certain student loans. If William wants his student loans to be discharged, he must show that making the student loan payments will cause him "undue hardship." A bankruptcy court decides whether a certain debt can be discharged.

Objections to Discharge Sometimes, the debtor's conduct can cause a discharge to be denied. Examples of these circumstances include the following:

- The debtor's concealment or destruction of property with the intent to hinder, delay, or defraud a creditor.

- The debtor's fraudulent concealment or destruction of records, or failure to keep adequate records, of their financial condition.
- The debtor's failure to attend a required consumer education course.

Effect of a Discharge The primary effect of a discharge is to void, or set aside, any judgment on a discharged debt and prohibit any action to collect it. A discharge may be revoked (taken back) within one year, however, if it is discovered that the debtor acted fraudulently or dishonestly during the bankruptcy proceeding.

34-3 Chapter 11—Reorganization

reorganization

A bankruptcy plan for the readjustment of a corporation's debts.

A Chapter 11 bankruptcy proceeding is commonly a corporate **reorganization**, in which a debtor corporation and its creditors agree on a plan under which the corporation pays a portion of its debt and is discharged of the rest. Normally, any debtor who is eligible under Chapter 7 is eligible under Chapter 11. (Railroads are eligible under Chapter 11.) As with Chapter 7, Chapter 11 reorganizations can be filed either voluntarily or involuntarily. Additionally, the same principles govern the entry of the order for relief, and the automatic stay provision applies.

There are, however, some differences. For instance, qualifying for relief under Chapter 11 is related to the amount of debt involved (and not to the debtor's income, as under Chapter 7). Procedurally, Chapter 11 differs in its creditors' committees and the fact that it requires a reorganization plan.

34-3a Creditors' Committees

Soon after the entry of the order for relief, a creditors' committee of unsecured creditors is appointed. Generally, no orders affecting the estate will be entered without the consent of the committee or after a hearing in which the judge is informed of the committee's position. Businesses with debts of less than \$2.49 million that do not own or manage real estate can avoid creditors' committees.

34-3b The Reorganization Plan

The next step is to establish a reorganization plan. The plan is intended to conserve and administer the debtor's assets in the hope of an eventual return to successful operation and solvency.

Filing the Plan Only the debtor may file a plan within the first 120 days after the date of the order for relief. (This period may be extended up to 18 months.) If a small-business debtor chooses to avoid creditors' committees, the time for the debtor's filing is shortened to 100 days.

The Plan's Criteria The plan must be fair and equitable, and do the following:

1. Designate classes of creditors under the plan.
2. Specify the treatment to be afforded the classes of creditors.
3. Provide an adequate means for the plan's execution.
4. Provide for payment of tax claims over a five-year period.

Acceptance of the Plan Once the plan has been developed, it is submitted to each class of creditors for acceptance. Even if all classes of creditors accept the plan, the court may refuse to confirm it if it is not "in the best interests of the creditors." Conversely, under the Code's so-called cram-down provision, the court may confirm the plan over the objections of creditors.

Learning Outcome 3

Identify the debtor and procedures in a Chapter 11 reorganization.

Discharge of the Plan The plan is binding on confirmation. For individual debtors, the plan must be completed before discharge will be granted, unless the court orders otherwise. For all other debtors, the court may order discharge at any time after the plan is confirmed. This discharge does not apply to any claims that would be denied discharge under Chapter 7 liquidation.

34-4 Chapter 13—Adjustment

Under Chapter 13 of the Code, debtors with a regular income can have their debts adjusted. Individuals (not partnerships or corporations) with regular income who owe fixed, unsecured debts of less than \$394,725 or fixed, secured debts of less than \$1,184,200 can take advantage of Chapter 13. Sole proprietors and individuals on welfare, Social Security, fixed pensions, or investment income are included.

Learning Outcome 4

Explain how a Chapter 13 plan differs from Chapter 7 and 11 plans.

Real Case



Laverne Leonard purchased a house using funds from a mortgage provided by HSBC Bank USA. She signed a note for \$1,237,500 plus interest. The note was secured by a mortgage on the home that she bought. She failed to make payments on the principal and interest. HSBC brought an action for judgment for foreclosure and sale. Four days prior to the foreclosure sale, Leonard filed a petition under Chapter 13 of the Bankruptcy Code. The Chapter 13 trustee filed and obtained a motion to dismiss for a variety of reasons. One of those reasons concerned the fact that Leonard's secured debts were over \$2.5 million, an amount that far exceeded the jurisdictional limit of \$1,257,850 that allows for relief under Chapter 13.

Should a reviewing court agree to dismiss Leonard's attempt to utilize Chapter 13 of the Bankruptcy Code? Yes. In *Leonard v. HSBC Bank USA, N.A.*, a district court judge agreed with the Chapter 13 trustee that Leonard was not eligible to file a petition under Chapter 13. Whenever a debtor's unsecured debts exceed the ceiling set in bankruptcy law, Chapter 13 is not an option.

—2021 WL 638201 (So.Dist. N.Y.)

Filing a Chapter 13 adjustment plan is less expensive and less complicated than filing a Chapter 11 reorganization or a Chapter 7 liquidation. Another significant advantage of a Chapter 13 adjustment is that debtors retain possession of their assets.

A Chapter 13 bankruptcy can only be initiated by a debtor filing a voluntary petition or by converting a Chapter 7 petition. Creditors cannot force a debtor into an involuntary bankruptcy. After the bankruptcy trustee has been appointed by the court, the next step is to create a repayment plan.

For a visual comparison of the three types of bankruptcy relief discussed in this chapter, see Exhibit 34.1.

34-4a The Individual's Repayment Plan

Only the debtor may file a plan under Chapter 13. This plan may provide (1) for the payment of all obligations in full, or (2) for payment of an amount less than 100 percent of the total. The plan must provide for the following:

1. The turnover of the debtor's future income to the trustee in the amounts necessary for execution of the plan.

Exhibit 34.1 Bankruptcy—A Comparison of Chapters 7, 11, and 13

Issue	Chapter 7	Chapter 11	Chapter 13
Who Can Petition?	Debtor (voluntary) or creditors (involuntary).	Debtor (voluntary) or creditors (involuntary).	Debtor (voluntary) only.
Who Can Be a Debtor?	Any “person” (including partnerships and corporations) except railroads, insurance companies, banks, savings and loan institutions, investment companies licensed by the U.S. Small Business Administration, and credit unions. Farmers and charitable institutions cannot be involuntarily petitioned.	Any debtor eligible for Chapter 7 relief. Railroads are also eligible.	Any individual (not partnerships or corporations) with regular income who owes fixed, unsecured debts of less than \$394,725 or fixed, secured debts of less than \$1,184,200.
What Is the Procedure Leading to Discharge?	The voluntary or involuntary filing of a petition in bankruptcy court. Nonexempt property is sold with proceeds to be distributed to creditors. Dischargeable debts are terminated.	Reorganization plan is submitted. If it is approved and followed, debts are discharged.	Repayment plan is submitted and provides for either (1) payment of all obligations in full or (2) payment of less than 100 percent of the total owed. If the plan is followed, debts are discharged.

2. Full payment of all claims entitled to priority, such as taxes. Payments must be completed within three to five years, depending on the debtor’s family income. The debtor is allowed to deduct certain expenses to arrive at family income, including expenses for food, housing, and transportation.
3. The same treatment of each claim within a particular class of claims.

Good Faith Requirement The Code imposes the requirement of good faith on a debtor at the time of the filing of the petition and the time of the filing of the plan. If the circumstances indicate bad faith, the court can dismiss the debtor’s petition.

Example 34.2 Sharon files a Chapter 13 petition for bankruptcy relief from her creditors. The trustee objects to her proposed plan because she fails to include income from an online, work-at-home job. By intentionally omitting a portion of her disposable income from the plan, Sharon has acted in bad faith. Thus, a bankruptcy court can dismiss her petition. ■

Confirmation of the Plan After the plan is filed, the court holds a hearing at which interested parties (such as creditors) can object to the plan. Unsecured creditors do not have a vote, however. The court will confirm the plan with respect to each claim of a secured creditor under any of the following circumstances:

1. The secured creditors have accepted the plan.
2. The plan provides that secured creditors retain their liens until there is full payment or a discharge.
3. The debtor surrenders the collateral to the creditors.

34–4b Discharge Under Chapter 13

After the completion of all payments under the plan, the court grants a discharge of the debts provided for by the plan. All debts are dischargeable *except* claims not provided for by the plan, certain long-term debts provided for by the plan, certain tax claims, payments on retirement accounts, and claims for domestic-support obligations.

In addition, debts related to injury or property damage caused while driving under the influence of alcohol or drugs are not dischargeable. Certain student loan debts can be discharged under Chapter 13, but only if the court finds that payment of the debts would constitute an undue hardship for the debtor. Furthermore, a discharge can be revoked if it is discovered that the debtor acted fraudulently or dishonestly.

Chapter Summary—Bankruptcy

Learning Outcome 1: Describe three common types of bankruptcy relief.

Three common types of bankruptcy relief include the following:

- (1) Chapter 7—Provides for liquidation proceedings in which a bankruptcy trustee sells off the debtor's assets and distributes the cash proceeds among the creditors. Once this is done, any remaining debts are discharged, giving the debtor an opportunity for a fresh start.
- (2) Chapter 11—Governs the reorganization between creditors and the corporate debtor. In Chapter 11 proceedings, the parties create a plan under which the debtor pays a portion of the debts and is discharged of the remainder. Then the debtor is allowed to continue in business.
- (3) Chapter 13—Provides for the adjustment of debts of individuals (not businesses). Debtors in a Chapter 13 bankruptcy create a repayment plan that outlines how debt payments will be made. Debtors retain possession of most of their assets. The majority of debts are discharged within three years.

Learning Outcome 2: List the duties of a bankruptcy trustee.

A bankruptcy trustee's basic duty is to administer the debtor's estate by collecting the property of the estate and reducing it to money for distribution. The trustee first determines whether the debtor is entitled to relief under Chapter 7 or Chapter 13.

Learning Outcome 3: Identify the debtor and procedures in a Chapter 11 reorganization.

In a Chapter 11 reorganization, the debtor may be any debtor eligible for Chapter 7 relief. Railroads are also eligible. A petition may be filed by the debtor (voluntary) or by creditors (involuntary). A reorganization plan is submitted to creditors. If the creditors do not accept the plan, it may be "crammed down" on them by the court. If the plan is approved and followed, the debts are discharged, and the business continues.

Learning Outcome 4: Explain how a Chapter 13 plan differs from Chapter 7 and 11 plans.

A Chapter 13 adjustment plan can be initiated only by the filing of a voluntary petition by the debtor or the conversion of a Chapter 7 petition. It cannot be initiated by a creditor, as Chapter 7 and 11 petitions can. In addition, the individual repayment plan procedure makes a Chapter 13 adjustment less expensive and less complicated than the other two bankruptcy procedures.

Straight to the Point

1. What is an automatic stay? (See Learning Outcome 1.)
2. Where are bankruptcy proceedings held? (See Learning Outcome 1.)
3. Why might a bankruptcy petition be dismissed? (See Learning Outcome 1.)
4. Who can be a debtor in a Chapter 7 proceeding? (See Learning Outcome 2.)
5. What is the primary effect of a discharge in bankruptcy? (See Learning Outcome 2.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Al's Retail Store is a sole proprietorship. Smith & Jones is an advertising partnership. Roth & Associates, Inc., is a professional corporation. First State Savings & Loan is a savings and loan association. Which of these is not eligible for reorganization under Chapter 11? (See Learning Outcome 3.)
2. After graduating from college, Tina works briefly as a salesperson before filing for bankruptcy. As part of her petition, Tina reveals that her only debts are student loans, taxes accruing within the last year, and a claim against her based on her misuse of customers' funds during her employment. Are these debts dischargeable in bankruptcy? Explain. (See Learning Outcome 2.)

Real Law

34–1. Chapter 7—Liquidation. Daryll and Sharon Dykes filed a petition for Chapter 7 relief in a federal bankruptcy court, reporting just under \$400,000 in assets, over \$5.6 million in liabilities, and a monthly income that is insufficient to cover expenses. Both of the Dykeses were surgeons, at one time earning more than \$1 million per year and living in a \$3 million home. In schedules filed with the bankruptcy petition, the Dykeses did not explain the “hundreds of thousands of dollars” of lost property, nor did they disclose “substantial” transfers of their assets to their children. Creditors filing claims in the proceeding included the mortgagee that had foreclosed on their home, the home builder, and a jeweler. Before the Dykeses’ assets were fully gathered and the estate administered, the bankruptcy court denied a discharge. A Bankruptcy Appellate Panel upheld the denial on the basis of undocumented purchases and returns of hundreds of thousands of dollars in watches and jewelry. The Dykeses appealed to the U.S. Court of Appeals for the 8th Circuit. Should the appellate court reverse the decision to deny to the Dykeses bankruptcy protection? [*In re Dykes*, 954 Fed.3d 1157 (U.S. Ct. App. 8th Cir. 2020)] (See Learning Outcome 2.)

34–2. Liquidation Proceedings. Jeffrey Krueger and Michael Torres, shareholders of Cru Energy, Inc., were embroiled in litigation in a Texas state court, charging each other with attempts to control Cru through fraud. To delay the state

court proceedings, Krueger filed a petition for personal bankruptcy in a federal bankruptcy court. Ownership of Krueger’s Cru shares passed to the bankruptcy trustee, but Krueger ignored this. He called a meeting of Cru’s shareholders—except Torres—and voted those shares to remove Torres from the board and elect himself chairman, president, chief executive officer, and treasurer. The Cru board then dismissed all of Cru’s claims against Krueger in his suit with Torres. Are there sufficient grounds for the bankruptcy court to dismiss Krueger’s bankruptcy petition? Discuss. [*In re Krueger*, 812 F.3d 365 (5th Cir. 2016)] (See Learning Outcome 1.)

34–3. Discharge. Michael and Dianne Shankle divorced. An Arkansas state court ordered Michael to pay Diane alimony and child support and half of the couple’s \$184,000 in their investment accounts. Instead, he withdrew more than half of the investment funds and spent them on himself. Over the next several years, the court repeatedly held Michael in contempt for failing to pay Dianne. Six years later, Michael filed for Chapter 7 bankruptcy, including in the petition’s schedule the debt to Dianne of the unpaid alimony, child support, and investment funds. Is Michael entitled to a discharge of this debt, or does it qualify as an exception? Why or why not? [*In re Shankle*, 554 Fed.Appx. 264 (5th Cir. 2014)] (See Learning Outcome 2.)

Ethical Questions

34–4. Voluntary Bankruptcy. What are some of the factors that might be considered in deciding whether a debtor should be allowed to declare bankruptcy? (See Learning Outcome 2.)

34–5. Reorganization. Jevic Transportation Corporation filed a petition in a federal bankruptcy court for a Chapter 11 reorganization. A group of former Jevic truck drivers filed a suit and won a judgment against the firm for unpaid wages. This judgment entitled the workers to payment from Jevic’s estate ahead of its unsecured creditors. Later, some

of Jevic’s unsecured creditors filed a suit against some of its other unsecured creditors. The plaintiffs won a judgment on the ground that the firm’s payments to the defendants constituted fraud. These parties then negotiated—without the truck drivers’ consent—a settlement agreement that called for the workers to receive nothing on their claims while the creditors were to be paid proportionately. Why is this agreement unethical? [*Czyzewski v. Jevic Holding Corp.*, ___ U.S. ___, 137 S.Ct. 973, 197 L.Ed.2d 398 (2017)] (See Learning Outcome 3.)

Chapter 34—Work Set

True-False Questions

- _____ 1. A debtor must be insolvent to file a voluntary petition.
- _____ 2. An automatic stay is a suspension of all judicial proceedings on the occurrence of an independent event.
- _____ 3. The same principles govern the filing of a Chapter 7 petition and a Chapter 11 proceeding.
- _____ 4. A bankruptcy may be commenced by involuntary petition under Chapter 13.
- _____ 5. Generally, in a bankruptcy proceeding, any creditor's claim is allowed.
- _____ 6. When a business debtor files for Chapter 11 protection, the debtor is not allowed to continue in business.
- _____ 7. No small business can avoid creditors' committees under Chapter 11.
- _____ 8. Bankruptcy proceedings are held in federal bankruptcy courts.
- _____ 9. A discharge obtained by fraud can be revoked within one year.

Multiple-Choice Questions

- _____ 1. Jill's monthly income is \$2,000, her monthly expenses are \$2,800, and her debts are nearly \$40,000. To obtain a fresh start, Jill could file for bankruptcy under
 - a. Chapter 7.
 - b. Chapter 11.
 - c. Chapter 13.
 - d. none of these choices.
- _____ 2. Ishana files a Chapter 7 petition for a discharge in bankruptcy. Ishana may be denied a discharge on which of the following grounds?
 - a. Concealing property with the intent to defraud a creditor.
 - b. Paying for services received in the ordinary course of business.
 - c. Having obtained a bankruptcy discharge twelve years earlier.
 - d. Both a and c.
- _____ 3. Carol is the sole proprietor of Beekman Café, which owes debts in an amount more than Carol believes she and the café can repay. The creditors agree that liquidating the business would not be in their best interests. To stay in business, Carol could file for bankruptcy under
 - a. Chapter 7 only.
 - b. Chapter 11 only.
 - c. Chapter 13 only.
 - d. Chapter 11 or Chapter 13.
- _____ 4. Jerzy files a petition for relief in bankruptcy. He does not reveal enough information in the documents provided with the petition for a decision to be made about his financial circumstances. This can result in a dismissal of his petition under
 - a. Chapter 7 only.
 - b. Chapter 11 or 13 only.
 - c. Chapter 7, 11, or 13.
 - d. none of these choices.
- _____ 5. General Supplies Corporation (GSC) has not paid any of its fifteen creditors, six of whom have unsecured claims of more than \$18,000. Under which chapter of the Bankruptcy Code can the creditors force GSC into bankruptcy?

- a. Chapter 7 only.
- b. Chapter 11 only.
- c. Chapter 13 only.
- d. Chapter 7 or Chapter 11.

- _____ 6. Benas files a bankruptcy petition under Chapter 7 to have his debts discharged. If Benas' plan is approved, the debts most likely to be discharged include claims for
- a. back taxes accruing within three years before the petition was filed.
 - b. certain fines and penalties payable to the government.
 - c. domestic support.
 - d. student loans if the payment would impose undue hardship on Benas.
- _____ 7. National Stores, Inc., decides to file for bankruptcy. Under which chapter of the Bankruptcy Code can a corporation file a petition for bankruptcy?
- a. Chapter 7 only.
 - b. Chapter 11 only.
 - c. Chapter 13 only.
 - d. Chapter 7 or Chapter 11.

Answering More Legal Problems

1. Lorenzo was a realtor. For a few years, he made a substantial income. During and after a serious recession, however, his income matched the drop in property values and numbers of sales. As his business floundered, Lorenzo found himself unable to pay his debts. He approached Rosanna, a bankruptcy attorney, to explore his options. Rosanna suggested that filing a petition for bankruptcy under Chapter 7 might be Lorenzo's best course.

What are the requirements for filing a voluntary Chapter 7 bankruptcy petition? The debtor must be a _____—an individual, partnership, or corporation—not otherwise prohibited from using Chapter 7. The debtor must file a _____ that includes certain information, including a list of the debtor's creditors and the amounts owed to each. The forms must be completed accurately, sworn to under oath, and signed by the debtor. A debtor must include a certificate proving that they received _____ from an approved agency within the last six months.

2. Pauline borrowed funds from the federal government to attend flight school, where she learned to be a pilot. After graduation, Pauline started a business she called Otto Airshows with a helicopter decorated as "Otto the Clown." When the government tried to collect the amount of Pauline's unpaid loan from the assets of Otto Airshows, she formed Prop Aviation, Inc., and leased the Otto equipment to Prop. She then filed a Chapter 13 bankruptcy petition without noting the unpaid loan and the equipment lease.

Is the court likely to allow Pauline's petition to proceed? No. The court is likely to _____ the petition due to _____. The Bankruptcy Code imposes the requirement of good faith at the time of the filing of a petition and the time of the filing of a repayment plan under Chapter 13. Pauline did not include all of her assets and liabilities in her petition. For this reason, even if the petition was allowed to proceed, and a discharge was granted, the student loan debt would not be included. There would have been no finding that payment of the debt constituted _____.

35 Insurance

Conflict Presented

Tanya and Miguel are married and have two children. When they divorce, Tanya gives her interest in their house to Miguel and moves out. Miguel dies, leaving the house to the children. Because the children are minors, Tanya moves back into the house with them.

She keeps the house in good repair and takes out an insurance policy on the property. When the house is destroyed in a fire, the insurance company refuses to pay, arguing that Tanya could not legally take out insurance on the house because she did not own it—her children did.

Q Is Tanya entitled to payment under the insurance policy?

Protecting against loss is a foremost concern of all property owners. No one can predict whether an accident or a fire will occur, so individuals and businesses typically protect their personal and financial interests by obtaining insurance.

Insurance is a contract in which the insurance company (the insurer) promises to pay a sum of money or give something of value to another (either the insured or a beneficiary) to compensate for a particular loss. For instance, insurance protection may compensate for the injury or death of the insured or another, for damage to the insured's property, or for other types of losses, such as those resulting from lawsuits.

35-1 Insurance Terminology and Concepts

Insurance has its own terminology and concepts. A knowledge of these matters is essential to understanding insurance law.

35-1a Insurance Terminology

An insurance contract is called a **policy**. The consideration (money) paid to the insurer is referred to as a **premium**. The parties to an insurance policy are the insurer (the insurance company) and the insured (the person covered by the policy's provisions or the holder of the policy). The insurance company is sometimes called an **underwriter**.

Insurance contracts are usually obtained through an agent, who ordinarily works for the insurance company, or through a broker, who ordinarily is an independent contractor. A beneficiary receives proceeds under the policy. When a broker deals

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Define important insurance terms.
- 2 State when insurance coverage begins.
- 3 Explain how courts interpret insurance provisions.
- 4 Identify defenses an insurance company may have against payment on a policy.

insurance

A contract in which the insurer promises to reimburse the insured or a beneficiary in the event of a specified loss.

Learning Outcome 1

Define important insurance terms.

policy

A contract between an insurer and the insured.

premium

The price for insurance protection for a specified period of time.

underwriter

The one assuming a risk in return for the payment of a premium.

risk
A prediction concerning potential loss based on certain factors.

risk management
A contractual transfer of risk from the insured to the insurer.

with an applicant for insurance, the broker is the applicant’s agent. In other words, the broker has no relationship with the insurance company. By contrast, an insurance agent is an agent of the insurance company, not of the applicant. As a general rule, the insurance company is bound by the acts of its agents when they act within the agency relationship.

35–1b Risk Management and Risk Pooling

Risk can be described as a prediction concerning potential loss based on known and unknown factors. Basically, insurance is an arrangement for transferring and allocating risk through **risk management**. The most common method of risk management is the transfer of certain risks from an individual or business to an insurance company. (For a discussion of risk management in cyberspace, see this chapter’s Linking Business Law to Your Career feature.)

Insurance companies deal with risk through risk pooling. That is, they spread the risk among a large number of people—the pool—to make the premiums small compared with the coverage offered. For instance, life insurance companies know that only a small proportion of the individuals in any particular age group will die in any one year. If a large percentage of this age group pays premiums to the company in exchange for a benefit payment in case of death, there will be enough funds to pay the beneficiaries of the policyholders who die.

35–1c Classifications of Insurance

Insurance is classified according to the nature of the risk involved. Fire insurance, casualty insurance, life insurance, and title insurance apply to different types of risk. Policies also differ in relation to the persons and interests that they protect. This is reasonable because the types of losses that are expected and the types that are foreseeable or unforeseeable vary with the nature of the activity.

See Exhibit 35.1 for a list of various insurance classifications.

Exhibit 35.1 Examples of Insurance Classifications

Type of Insurance	Coverage
Automobile	Normally provides protection against liability for personal injuries and property damage resulting from the operation of the vehicle.
Disability	Replaces a portion of the insured’s monthly income from employment in the event that illness or injury causes a short- or long-term disability.
Fire	Covers losses caused to the insured as a result of fire.
Group	Provides individual life, medical, or disability insurance coverage; obtainable by persons who are members of certain groups; when the group consists of employees, the policy premium is paid either entirely by the employer or partially by the employer and partially by the employees.
Homeowners’	Protects homeowners against some or all risks of loss to their residences and the residences’ contents or liability related to the property.
Key-person	Protects a business in the event of the death or disability of a key employee.
Liability	Protects against liability imposed on the insured resulting from injuries to the person or property of another.
Life	Covers the death of the policyholder. On the death of the insured, an amount specified in the policy is paid by the insurer to the insured’s beneficiary.

35–1d Insurable Interest

A person must have an **insurable interest** in something in order to insure it. Without an insurable interest, there is no enforceable contract. The existence of an insurable interest is a primary concern in determining liability under an insurance policy.

insurable interest

A financial interest in a person's life or property.

Property Insurance In the case of real and personal property, an insurable interest exists when the insured derives a financial benefit from the preservation and continued existence of the property. Put another way, a person has an insurable interest in property if they would sustain a financial loss from its destruction. This interest in property must exist when the loss occurs but need not exist when the policy is purchased.

Life Insurance In the case of life insurance, a person must have a reasonable expectation of benefit from the continued life of another to have an insurable interest in that person's life. Unlike property insurance, life insurance requires that an insurable interest exist at the time the policy is obtained.

Example 35.1 Joan and Pedro are married with three children. Pedro buys life insurance on Joan's life, naming himself as the beneficiary. Five years later, they divorce. If Joan dies, the policy is still valid, and Pedro will receive the proceeds of that life insurance policy. Why? Because when the policy was created, Pedro had an insurable interest in Joan's life. ■

35–2 The Insurance Contract

An insurance contract is governed by the general principles of contract law. Consistent with these principles, consideration (in the form of a premium) must be given. The parties forming the contract must also have capacity.

Customarily, a party offers to purchase insurance by submitting an application to an insurance company. The company can either accept or reject the offer. Sometimes, the insurance company's acceptance is conditional—on the results of a life insurance applicant's medical examination, for instance.

35–2a The Application

The filled-in application form for insurance is usually attached to the policy and made a part of the insurance contract. The insurance company evaluates its risk factors based on the information included in the application. Consequently, misstatements or misrepresentations can void a policy, especially if the insurance company can show that it would not have extended insurance if it had known the facts.

35–2b The Effective Date

The effective date of an insurance contract—that is, the date on which the insurance coverage begins—is important. Any loss sustained before the effective date will not be covered by the policy.

In some instances, the insurance applicant is not protected until a formal written policy is issued. In other situations, the applicant is protected between the time an application is received and the time the insurance company either accepts or rejects it. In these situations, a binder may be written.

Binder An insurance broker is an agent of the applicant, not an agent of the insurance company. Therefore, if a person hires a broker to obtain insurance, and the broker fails to secure a policy, the applicant normally is not insured.

Learning Outcome 2

State when insurance coverage begins.

binder
A written, temporary insurance policy.

In contrast, a person who is obtaining insurance from an insurance company’s agent is usually protected from the moment the application is made, provided that some form of premium has been paid. Usually, the agent will write a memorandum, or **binder**, which indicates that a policy is pending and states its essential terms. The binder provides temporary coverage until a formal policy is accepted or denied.

Life Insurance Parties may agree that a life insurance policy will be binding at the time the insured pays the first premium. The policy, however, may be subject to the applicant’s passing a physical or medical examination. If the applicant pays the premium and passes the examination, then the policy coverage is continuously in effect.
 If the applicant pays the premium but dies before having the necessary examination, the policy may still be effective. To collect the money from the policy, the applicant’s estate normally must show that the applicant would have passed the examination had they not died.



Highlighting the Point

Neal pays a premium to Cox Insurance Company for a life insurance policy that is expressly contingent on Neal’s passing a medical examination. If Neal passes the examination, the policy coverage will date from the payment of the premium. Assume that Neal dies before having the medical examination.
Can Neal’s beneficiary collect on the policy? Yes. To collect, however, the beneficiary must show that Neal would have passed the examination had he not died.

Delayed Effective Dates If the parties agree that a policy will be issued and delivered at a later time, the contract is not effective until the policy is issued and delivered or sent to the applicant, depending on the agreement. Thus, any loss sustained between the time of application and the delivery of the policy is not covered.

35–2c Provisions and Clauses

Learning Outcome 3

Explain how courts interpret insurance provisions.

Insurance contracts contain certain provisions and clauses, including those mandated by state law. For instance, state statutes commonly require that a policy for life or health insurance include an incontestability clause. This clause and other important provisions and clauses in insurance contracts are listed and defined in Exhibit 35.2.

Exhibit 35.2 Insurance Contract Clauses and Descriptions

Type of Clause	Description
Antilapse clause	An antilapse clause provides that the policy will not automatically lapse if no payment is made on the date due. Ordinarily, under such a provision, the insured has a <i>grace period</i> of thirty or thirty-one days within which to pay an overdue premium before the policy is canceled.
Appraisal clause	Insurance policies frequently provide that if the parties cannot agree on the amount of a loss covered under the policy or the value of the property lost, either party can demand an appraisal, or estimate, by an impartial and qualified third party.
Arbitration clause	Many insurance policies include clauses that call for arbitration of disputes that arise between the insurer and the insured concerning the settlement of claims.
Incontestability clause	An incontestability clause provides that after a policy has been in force for a specified length of time—usually two or three years—the insurer cannot contest statements made in the application.

The courts realize that most people do not have the special training necessary to understand the intricate terminology used in insurance policies. So, courts interpret the words used in an insurance contract according to their ordinary meanings and in light of the nature of the coverage involved. When there is an ambiguity in the policy, the provision is interpreted against the insurance company. If there is no ambiguity, the insurance company will prevail.

Real Case



Kevin Taylor walked into Cole's Place, a Louisville, Kentucky, nightclub, and began shooting. Six of the patrons injured in the attack sued Cole's Place for negligence. The nightclub filed a claim with its insurer, United Specialty Insurance Company (USIC), to provide a defense against the lawsuits. USIC refused, based in part on an exclusion in Cole's Place's liability policy stating that the coverage did not apply to "bodily injury ... arising out of, or resulting from, [any] assault or battery." During the litigation, USIC argued that the terms "assault" and "battery" in the policy should be given their ordinary meaning. Cole's Place countered that the terms should be given their legal meaning.

Should Cole's Place prevail? No. In *United Specialty Insurance Company v. Cole's Place, Inc.*, the U.S. Court of Appeals for the 6th Circuit reasoned that, "whether in common or under criminal law, what happened at the nightclub was obviously an assault or battery." Therefore, the language in the policy excluding coverage for such actions was clear and unambiguous, and USIC was not required to defend Cole's Place.

—936 Fed.3d 386 (6th Cir.)

35–2d Cancellation

The insured can cancel a policy at any time. The insurer, however, can cancel a policy only under certain circumstances. For instance, automobile insurance can be canceled by the insurer for nonpayment of premiums or suspension of the insured driver's license. Property insurance also can be canceled for nonpayment of premiums. In addition, it can be canceled for the insured's fraud, negligence, or conviction of a crime. An insurer can cancel life and health policies if the insured made false statements in the policy application.

When an insurance company can cancel the insurance contract, the policy or a state statute usually requires that the insurer give advance written notice of the cancellation to the insured.

Highlighting the Point



As part of an employee benefits package, the Bobcat Company pays for a group life insurance plan that is provided by Eagle Insurance. To cut back on its financial risk, Eagle cancels the policy. A state statute requires written notice of the cancellation, but an Eagle employee merely telephones Bobcat to tell it about the cancellation. No written notice is sent to Bobcat or Bobcat's employees. When Meade, a Bobcat employee, dies, Eagle refuses to pay on the policy.

Can the company be required to pay on Meade's policy? Yes. The state statute requires written notice. A telephone call is not sufficient.

Note that an insurer cannot cancel—or refuse to renew—a policy for discriminatory or other reasons that violate public policy or because the insured has appeared as a witness in a case against the company.

35–2e Defenses Against Payment

Learning Outcome 4

Identify defenses an insurance company may have against payment on a policy.

An insurance company can raise any of the defenses that would be valid in an ordinary action on a contract, as well as the defenses discussed next.

Fraud or Misrepresentation If the insurance company can show that the policy was acquired through fraud or misrepresentation, the company may have a valid defense for not paying on a claim. (The insurance company may also have the right to cancel the insurance contract.)

Lack of an Insurable Interest An absolute defense exists if the insurer can show that the insured lacked an insurable interest—thus rendering the policy void from the beginning. For instance, key-person insurance coverage requires that to have an insurable interest, an organization expects to experience significant financial loss if a key employee dies.

Example 35.2 Conrad Computer Systems takes out key-person life insurance policies on several employees, including Robert, the cousin of Conrad's president. Robert is not part of management and works in the warehouse driving a forklift. If Robert dies, the insurance company can claim that Conrad had no insurable interest in Robert's life. ■

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Tanya and Miguel are married and have two children. When they divorce, Tanya gives her interest in their house to Miguel and moves out. Miguel dies, leaving the house to the children. Because the children are minors, Tanya moves back into the house with them.

She keeps the house in good repair and takes out an insurance policy on the property. When the house is destroyed in a fire, the insurance company refuses to pay, arguing that Tanya could not legally take out insurance on the house because she did not own it—her children did.

A Is Tanya entitled to payment under the insurance policy? Yes. Tanya had an insurable interest in the house. The funds she spent to keep the house in repair, the loss she suffered in having to obtain other housing, and the loss she suffered as guardian of the children indicate that Tanya had an insurable interest in the house, even if she did not own it.

Illegal Actions Improper actions, such as those that are against public policy or that are otherwise illegal, can also give the insurance company a defense against the payment of a claim or allow it to rescind the contract.

Example 35.3 Montrose Chemical obtains an insurance policy from Greenhaven Insurance to cover liability resulting from injuries to nonemployees or damage to their property. Following an explosion at Montrose's plant, a release of toxic chemicals results in injuries to nearby residents. An investigation reveals that the explosion was likely caused by Montrose's failure to comply with government

regulations for the safe handling of the chemicals. Greenhaven normally can assert this misconduct as a defense against payment on Montrose's policy. ■

When Defenses Are Not Available In some situations, the insurance company may be prevented from asserting defenses that normally are available. For instance, an insurance company ordinarily cannot escape payment on the death of an insured on the ground that the person's age was stated incorrectly on the application.

Additionally, incontestability clauses prevent the insurer from asserting certain defenses. Once a policy becomes incontestable, the insurer cannot later avoid a claim on the basis of, for instance, fraud on the part of the insured, unless the clause provides an exception for that circumstance.

The Need to Avoid Bad Faith Finally, a duty of good faith is imposed on the insurance industry. Both insurer and insured must be open and honest in their dealings. Most states recognize a "bad faith" tort action against insurers. Thus, if an insurer in bad faith denies coverage of a claim, the insured may sue. An insurer has a duty to investigate and provide reasons for any decision to deny or reduce a particular claim. In short, an insurance company cannot act in bad faith.



Linking Business Law to Your Career

Risk Management in Cyberspace

Your career may require you to evaluate risks to your business and obtain insurance against those risks. If your company does business online, you may be confronting risks that are not covered by traditional types of insurance.

Insurance for Web-Related Risks

Insurance to cover web-related risks is often referred to as network intrusion insurance. Such insurance protects companies from losses stemming from hackers and computer viruses; programming errors; network and website disruptions; theft of electronic data and assets, including intellectual property; web-related defamation, copyright infringement, and false advertising; and violations of users' privacy rights.

Customized Policies

Cyberinsurance policies are customized to provide protection against specific risks faced by a particular type of

business. For example, an internet service provider will face different risks than an online merchant, and a banking institution will face different risks than a law firm. The specific business-related risks are taken into consideration in determining the policy premium.

Qualifying Criteria

Many companies that offer network intrusion insurance require applicants to meet high security standards. For instance, an insurer might assess the applicant's security measures and refuse to provide coverage unless the business scores higher than 60 percent according to certain criteria. If the business does not score that high, it can contract with the company to improve its web-related security.

Chapter Summary—Insurance

Learning Outcome 1: Define important insurance terms.

The policy is the insurance contract. The premium is the consideration paid to the insurer for a policy. The parties include the insurer (the insurance company, also called the underwriter), the insured (the person covered by insurance), an agent (a representative of the insurance company) or a broker (ordinarily an independent contractor), and a beneficiary (a person to receive proceeds under the policy).

Learning Outcome 2: State when insurance coverage begins.

Coverage on an insurance policy can begin when a binder is written, when the policy is issued, when the contract is formed, or when a condition specified in the contract—such as passage of a certain period of time—is met.

Learning Outcome 3: Explain how courts interpret insurance provisions.

Words will be given their ordinary meanings, and any ambiguity in the policy will be interpreted against the insurance company.

Learning Outcome 4: Identify defenses an insurance company may have against payment on a policy.

Defenses that an insurance company may have against payment to the insured include (1) misrepresentation or fraud, (2) lack of an insurable interest, and (3) illegal actions.

Straight to the Point

1. When a broker deals with an applicant for insurance, the broker acts as an agent for whom? (See Learning Outcome 1.)
2. How is insurance classified? (See Learning Outcome 1.)
3. What general principles of law govern an insurance contract? (See Learning Outcome 2.)
4. What does an incontestability clause provide? (See Learning Outcome 3.)
5. If an insurance company does not act in good faith, what can the insured do? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Neal applies to Farm Insurance Company for a life insurance policy. On the application, Neal understates his age. Neal obtains the policy, but for a lower premium than he would have had to pay had he disclosed his actual age. The policy includes an incontestability clause. Six years later, Neal dies. Can the insurer refuse payment? Why or why not? (See Learning Outcome 2.)
2. Danilo is divorced and owns a house. Danilo has no reasonable expectation of benefit from the life of Bea, his former spouse, but applies for insurance on her life anyway. Danilo obtains a fire insurance policy on the house, then sells the house. Ten years later, Bea dies and the house is destroyed by fire. Can Danilo obtain payment for these events? Explain your answers. (See Learning Outcome 1.)

Real Law

35–1. Defenses Against Payment. Ida Cannon was injured in an auto accident while operating a vehicle owned by Ivy Harp. Cannon was hospitalized for nine days. Because she did not own a vehicle and was not covered under any other policy, she submitted a claim for benefits to Farm Bureau Insurance Company, the insurer of Harp's vehicle. Later, she filed a claim for attendant care services. Farm Bureau discovered that some of the claims were fraudulent. As a result, Farm Bureau cut off Cannon's benefits. Cannon sued to recover on her claims. Farm Bureau filed a motion for summary judgment, which the court denied. How should the appellate court rule? [*Cannon v. Farm Bureau Insurance*

Company, 2019 WL 845863 (Ct. App. Mich. 2019)] (See Learning Outcome 3.)

35–2. Defenses Against Payment. American National Property and Casualty Co. issued a policy to Robert Houston to insure a residence and its contents against fire and other hazards. Twenty months later, Houston issued a deed to the property to John and Judy Sykes. John paid the premiums on the American policy, even after Houston died. When a fire substantially damaged the property, John filed a claim with the insurer on Houston's behalf. American refused to pay, contending that it had no liability. Who suffers the loss in these circumstances? Why? How might the loss have

been avoided? Explain. [*American National Property and Casualty Co. v. Sykes*, 2016 WL 390069 (Miss. 2016)] (See Learning Outcome 2.)

35-3. Provisions and Clauses. Darling's Rent-a-Car carried property insurance on its cars under a policy issued by Philadelphia Indemnity Insurance Co. The policy listed Darling's as the "insured." Darling's rented a car to Joshua Farrington. In the rental contract, Farrington agreed to be

responsible for any damage to the car and declined the optional insurance. Later, Farrington collided with a moose. Philadelphia paid Darling's for the damage to the car and sought to collect this amount from Farrington. Farrington argued that he was an "insured" under Darling's policy. How should "insured" be interpreted in this case? Why? [*Philadelphia Indemnity Insurance Co. v. Farrington*, 37 A.3d 305 (Me. 2012)] (See Learning Outcome 2.)

Ethical Questions

35-4. Good Faith. Should an insurance agent be held to a duty to advise applicants about coverage? Why or why not? (See Learning Outcome 2.)

35-5. Bad Faith. Bernd Moving Systems owned a warehouse in Yakima, Washington. American Guarantee & Liability Insurance Company insured Bernd under a policy that included coverage of "Personal property of others in your care, custody and control." Before storing property in the warehouse, William and Colleen Merriman were told that their goods would be fully insured. Later, a

fire destroyed the warehouse and the Merrimans' property. American Guarantee did not inform the couple of Bernd's insurance coverage. Instead, the Merrimans were advised to file a claim under their homeowners' insurance. On what grounds might the Merrimans base a legal action against American Guarantee? Are there also sufficient grounds to argue that American Guarantee acted unethically? Discuss. [*Merriman v. American Guarantee & Liability Insurance Co.*, 198 Wash.App. 594 (Div. 3 2017)] (See Learning Outcome 4.)

Chapter 35—Work Set

True-False Questions

- _____ 1. Risk management involves the transfer of certain risks from an individual or a business to an insurance company.
- _____ 2. Insurance is classified by the nature of the person or interest protected.
- _____ 3. An insurance broker is an agent of an insurance company.
- _____ 4. An insurance applicant is usually protected from the time an application is made, if a premium has been paid, possibly subject to certain conditions.
- _____ 5. A person can insure anything in which they have an insurable interest.
- _____ 6. An application for insurance is not part of the insurance contract.
- _____ 7. The insurable interest in life insurance must exist at the time the policy is obtained.
- _____ 8. An antilapse clause provides that an insurance policy lapses if the insured does not pay a premium exactly on time.
- _____ 9. In courts, the words used in an insurance policy are given special meaning.

Multiple-Choice Questions

- _____ 1. Satellite Communications, Inc., takes out an insurance policy on its plant. For which of the following reasons could the insurer cancel the policy?
 - a. Satellite's president appears as a witness in a case against the insurance company.
 - b. Satellite begins using grossly careless manufacturing practices.
 - c. Two of Satellite's drivers have their driver's licenses suspended.
 - d. All of the above.
- _____ 2. Sue applies for a fire insurance policy for her warehouse from A&I Insurance Company. To obtain a lower premium, she misrepresents the age of the property. The policy is granted. After the warehouse is destroyed by fire, A&I learns the truth. In this situation, A&I
 - a. can refuse to pay on the ground of fraud in the application.
 - b. can refuse to pay on the ground that the warehouse has been destroyed by fire.
 - c. cannot refuse to pay because an application is not part of an insurance contract.
 - d. cannot refuse to pay because the warehouse has been destroyed by fire.
- _____ 3. Technon Corporation manufactures computers. To cover injuries to consumers if the products prove defective, Technon should buy
 - a. group insurance.
 - b. liability insurance.
 - c. major medical insurance.
 - d. life insurance.
- _____ 4. Moussa is an executive with E-Tech Corporation. Because his death would cause a financial loss to E-Tech, the firm insures his life. Later, Moussa resigns to work for MayCom, Inc., one of E-Tech's competitors. Six months later, Moussa dies. Regarding payment for the loss, E-Tech
 - a. can collect because its insurable interest existed when the policy was obtained.
 - b. cannot collect because its insurable interest did not exist when a loss occurred.
 - c. cannot collect because it suffered no financial loss from the death of Moussa, who resigned to work for one of its competitors.
 - d. None of the above.

- _____ 5. Tom takes out a mortgage with First National Bank to buy a house. Tom obtains a fire insurance policy, partially payable to the bank. After Tom makes the last mortgage payment, the house is destroyed by fire. Regarding payment for the loss, the bank
- a. can collect because its insurable interest existed when the policy was obtained.
 - b. can collect because its mortgage required Tom to take out the policy.
 - c. cannot collect because its insurable interest did not exist when a loss occurred.
 - d. cannot collect because its mortgage required Tom to take out the policy.
- _____ 6. Ace Manufacturing, Inc., has property insurance with National Insurer, Inc. When Ace suffers a loss in a burglary, Ace and National cannot agree on the amount of recovery. Under an appraisal clause,
- a. only Ace can demand an appraisal by a third party.
 - b. only National can demand an appraisal by a third party.
 - c. either party can demand an appraisal by a third party.
 - d. the government sets the value of the loss, which both parties must accept.
- _____ 7. Lee buys BizNet, a company that provides internet access, and takes out property insurance with InsCo to cover a loss of the equipment. Two years later, Lee sells BizNet. Six months after the sale, BizNet's equipment is stolen. Under InsCo's policy, Lee can recover
- a. the total amount of the insurance.
 - b. the total amount of the loss.
 - c. InsCo's proportionate share of the loss to the total amount of insurance.
 - d. nothing.
- _____ 8. Insurance premiums are small relative to the coverage offered because
- a. the risks are spread among a large number of people.
 - b. agents and brokers receive only a small percentage of the premiums.
 - c. insurance companies rarely have to pay any claims.
 - d. the government guarantees insurance payments up to a certain amount.

Answering More Legal Problems

1. Trimpoint Maintenance, Inc. (TMI), a property maintenance service, leased storage and office space at Hilltop Corporate Complex. TMI also maintained and operated the complex's lighting, ventilation systems, and common areas. Marketplace Insurance Co. insured TMI against losses caused by damage to "property owned, leased, used, or controlled" by TMI. When fire destroyed Hilltop, TMI filed a claim with Marketplace.
2. Marco applied to Commercial Insurance Co. for a policy to cover Hooligan's, Marco's nightclub. The application indicated that the premises had a sprinkler system. Commercial issued a policy that required such a system. One year later, when Hooligan's sustained more than \$250,000 in fire damage, Marco filed a claim for payment under the policy. Before paying the claim, Commercial learned that there was no sprinkler system.

Was TMI entitled to recover for the loss of its Hilltop operations? Yes. TMI was entitled to compensation for the loss of all of its operations at Hilltop. For property insurance, an insurable interest must exist at the time that the _____. TMI's Marketplace policy included coverage for property that the insured "owned, leased, used, or controlled." At the time of the loss at Hilltop, TMI _____ an insurable interest in the storage and office space that it leased in the buildings, as well as the common areas that it maintained and on which its income depended.

Could Commercial refuse to pay Marco's claim and cancel the policy? Yes. Commercial can refuse to pay the claim and can cancel the policy. An insurance company can raise any of the defenses that would be valid in an ordinary action on a contract, as well as others. If an insurance company can show that a policy was procured through _____ or _____, it may have a valid defense for not paying. In the application for insurance, Marco _____ that Hooligan's had a sprinkler system.



Unit 8 | Property

Unit Contents

Chapter 36

Personal Property

Chapter 37

Bailments

Chapter 38

Real Property

Chapter 39

Landlord and Tenant Law

Chapter 40

Wills and Trusts

36 | Personal Property

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Explain the nature of personal property.
- 2 Identify different types of property ownership.
- 3 State how ownership of personal property is acquired.
- 4 Define mislaid, lost, and abandoned property.

Learning Outcome 1

Explain the nature of personal property.

personal property

Property that is movable.

Conflict Presented

Benjamin has a new laptop and would like to access the high-speed internet without paying for it. He lives in an apartment building in which many of the tenants subscribe to Array Communications, a local high-speed internet service provider. Benjamin uses an unsuspecting tenant's password so that he can connect to the web without Array's knowledge.

Q Has Benjamin committed a theft of personal property?

Property consists of the legally protected rights and interests a person has in anything with an established value that is subject to ownership. The law defines the right to use property, to sell or dispose of it, and to prevent trespass onto it.

In this chapter, we look at the nature and different types of personal property, the methods of acquiring ownership of personal property, and issues relating to mislaid, lost, and abandoned personal property.

36–1 The Nature of Personal Property

Property is divided into two categories. Real property consists of the land and everything permanently attached to the land. All other property is personal property. Essentially, **personal property** is movable, while real property is not.

Personal property can be tangible or intangible. Tangible personal property, such as a smart TV or a car, has physical substance. Intangible personal property represents some set of rights and interests but has no real physical existence. Stocks and bonds, patents, and copyrights are examples of intangible personal property.

Over time, the concept of personal property has expanded to take account of new types of ownership rights. Gas, water, and telephone services, for instance, are considered personal property for the purpose of criminal prosecution when they are stolen or used without authorization.

Example 36.1 Lee and Edna are neighbors. While Edna is gone on a two-month vacation, Lee taps into her backyard irrigation system so he can water his extensive organic garden. He thereby reduces his own water bill. If Edna discovers Lee's theft, she can ask the district attorney to pursue criminal charges against him for violating her ownership rights in the water. ■

36–2 Property Ownership—Rights of Possession

Ownership of property—both real and personal property—can be viewed as a bundle of rights, including the right to possess the property and to dispose of it by sale, gift, lease, or other means. The right of ownership in property is often referred to as title.

Learning Outcome 2

Identify different types of property ownership.

36–2a Fee Simple

A person who holds the entire bundle of rights to property is the owner in **fee simple**. Owners in fee simple are entitled to use, possess, or dispose of the property as they choose during their lifetimes. On death, the interest in the property passes to their heirs.

Example 36.2 Emily owns stock in ETC Mobile and in Dickson Entertainment. Based on Emily's ownership of ETC stock, she exercises her shareholder's right to vote in an election for the directors. Later, she decides to sell half of her ETC shares and use the proceeds to increase the number of her shares in Dickson. On Emily's death, her interest in the stock of the two companies will pass to her heirs. ■

fee simple

A form of property ownership entitling the owner to the entire bundle of property rights.

36–2b Concurrent Ownership

Persons who share ownership rights simultaneously in particular property are concurrent owners. There are two principal types of concurrent ownership: tenancy in common and joint tenancy. A less common type of concurrent ownership exists when owners hold community property.

Tenancy in Common In a **tenancy in common**, each co-owner owns an undivided, fractional interest in the property. The fractional interests do not need to be equal. When one tenant dies, that party's interest passes to their heirs.

tenancy in common

Co-ownership of property in which each party owns an undivided interest that passes to their heirs at death.

Joint Tenancy In a **joint tenancy**, each co-owner owns an undivided interest in the property. When a co-owner dies, their interest passes to the surviving co-owner(s). This "right of survivorship" is the main feature distinguishing a joint tenancy from a tenancy in common.

joint tenancy

Co-ownership of property in which each party owns an undivided interest that, on the owner's death, automatically passes to the surviving owners.

A joint tenancy can be terminated at any time by gift or by sale before a joint tenant's death. If termination occurs, the co-owners become tenants in common. In most states, it is presumed that a tenancy is a tenancy in common unless it is clear that the parties intended to establish a joint tenancy. In those states, specific language in the contract is necessary to create a joint tenancy.

Example 36.3 Jeanne and Perry are software programmers. They sign a contract that provides they own the rights to their programs as joint tenants. Their contract clearly states, "Jeanne and Perry as joint tenants with rights of survivorship." Jeanne and Perry each have a spouse, but if Jeanne dies, her interest in the programs automatically passes to Perry, not to her spouse. ■

Community Property In several states, property can be held by a married couple as **community property**. Each spouse technically owns an undivided one-half interest in the property. Community property applies to most property acquired by the spouses during their marriage. It does not apply to most property acquired before the marriage or to property acquired by gift or inheritance during the marriage. After divorce, community property is divided equally in some states and according to the discretion of a court in other states.

community property

Concurrent ownership in which each spouse owns an undivided one-half interest in most property acquired during a marriage.

36–3 Acquiring Ownership of Personal Property

The most common way to acquire personal property is to purchase it. Often, personal property is acquired by will or inheritance. Here, we look at additional ways to acquire ownership of personal property, including acquisition by possession, production, gift, accession, and confusion.

Learning Outcome 3

State how ownership of personal property is acquired.

36–3a Possession

Sometimes, a person can become the owner of personal property by possessing it. For instance, wild animals belong to no one in their natural state. The first person to take possession of a wild animal normally owns it. The killing of a wild animal amounts to assuming ownership of it.

There are two exceptions to this basic rule. First, any wild animals captured by a trespasser are the property of the landowner, not the trespasser. Second, if wild animals are captured or killed in violation of wild game statutes, the state, not the capturer, obtains title to the animals.

Those who find abandoned property can also acquire ownership rights through mere possession of the property.

36–3b Production

Production—the fruits of labor—is another means of acquiring ownership of personal property. Writers, inventors, and manufacturers all produce personal property and thereby acquire title to it. In some situations, however, the producer does not own what is produced. For instance, a researcher hired by a company to develop a new product may not own the rights to the product developed.

36–3c Gift

gift

A voluntary transfer of property ownership made without consideration.

A **gift** is a voluntary transfer of property ownership without consideration. For a gift to be effective, three requirements must be met: (1) donative intent on the part of the donor (the one giving the gift), (2) delivery, and (3) acceptance by the donee (the one receiving the gift). Until these requirements are met, no effective gift has been made.

In addition, a gift must be transferred or delivered in the present rather than in the future. In other words, a promise to make a gift tomorrow or next year is not a gift.

Example 36.4 Olena tells Elmore that she is going to give him a Fender Stratocaster electric guitar with a cherry heritage finish on his next birthday. Olena has made a promise to make a gift. But there is no gift until the guitar is delivered and accepted. ■

Donative Intent There must be evidence of the donor's intent to give the donee the gift. Donative intent is determined from the language of the donor and the surrounding circumstances. When a gift is challenged in court, the court may look at the relationship between the parties and the size of the gift in relation to the donor's other assets to determine intent.

dominion

The right to own, use, and possess property.

Delivery An effective delivery requires giving up complete control of, and **dominion** over, the subject matter of the gift. Dominion refers to ownership rights.

Most often, delivery is obvious, but when the physical object cannot be delivered, a constructive, or symbolic, delivery is sufficient. **Constructive delivery** is a general term for acts that the law holds to be equivalent to acts of real delivery. The delivery of intangible property—such as stocks, bonds, insurance policies, contracts, and so on—is always accomplished by constructive delivery. This is because the documents represent rights and are not, by themselves, the true property.

Example 36.5 Geneva wants to make a gift to Harlan of gold coins that she has stored in a safe-deposit box. Of course, she cannot deliver the box itself to Harlan, and she does not want to take the coins out of the bank. Geneva can deliver the key to the box to Harlan and authorize his access to the box and its contents. This is a constructive delivery of the contents of the box. ■

constructive delivery

An act equivalent to the physical delivery of property that cannot be physically delivered.

Acceptance The final requirement of a valid gift is acceptance by the donee. This rarely presents any problems, as most donees readily accept their gifts. The courts generally assume acceptance unless shown otherwise.

36–3d Accession

An **accession** occurs when someone adds value to personal property by supplying either labor or materials. Generally, there is no dispute about who owns the property after accession has occurred, especially when the accession is accomplished with the owner's consent.

Example 36.6 Martin buys all the materials necessary to customize his Corvette. He hires Zach, a customizing specialist, to come to his house to perform the work. Martin pays Zach for the value of the labor, obviously retaining title to the property. ■

accession

An addition that increases the value of property (such as the addition of a diamond to a ring).

36–3e Confusion

Confusion is the commingling (mixing together) of goods to such an extent that one person's personal property cannot be distinguished from another's. Confusion frequently occurs with fungible goods, such as grain and oil, that consist of identical units.

If confusion is caused by a person who wrongfully and willfully mixes goods for the purpose of rendering them indistinguishable, the innocent party acquires title to the whole. If confusion occurs as a result of agreement, an honest mistake, or the act of some third party, the owners share ownership as tenants in common and share any loss in proportion to their shares of ownership of the property.

Example 36.7 Five farmers enter into a cooperative arrangement. Each fall, the farmers harvest the same amount of number 2–grade yellow corn and store it in silos that are held by the cooperative. Each farmer owns one-fifth of the total corn in the silos. If a fire burns down one of the silos, each farmer will bear one-fifth of the loss. ■

confusion

The mixing together of goods so that they are indistinguishable.

36–4 Mislaid, Lost, and Abandoned Property

One of the methods of acquiring ownership of property is to possess it. Simply finding something and holding onto it, however, does not necessarily give the finder any legal rights in the property. Different rules apply depending on whether the property was mislaid, lost, or abandoned.

Learning Outcome 4

Define mislaid, lost, and abandoned property.

36–4a Mislaid Property

Property that has been placed somewhere by the owner voluntarily and then inadvertently forgotten is **mislaid property**. Because it is highly likely that the true owner will return for mislaid property, the finder does not obtain title to the goods. Instead, the finder is obligated to return the property to the true owner.

Example 36.8 Milica goes to the theater. While paying for popcorn at the concessions stand, she sets her smartphone on the counter and then leaves it there, where an employee finds it. The smartphone is mislaid property, and the theater owner is entrusted with the duty of taking reasonable care of it—that is, taking the same care as would any reasonable person in similar circumstances. ■

mislaid property

Property that the owner has voluntarily parted with and then cannot find or recover.

Real Case



Tracy Bylan sold her family's home to Christina Mouradjian. The property included land, a residence, a garage, and a shed and barn with a loft. The real estate contract included a provision that the property should be delivered in "broom clean" condition, meaning that it had to be empty of all personal property, except as may be included in the sale. After vacating the property, the buyers discovered that a hay elevator (used to move

(Continues)

bales of hay or straw up to a loft) had been left in the barn. Bylan sued to recover the hay elevator.

Was the hay elevator mislaid property? No. In *Bylan v. Mouradjian*, the court defined mislaid property as “that which is intentionally placed by the owner where he can obtain custody of it, but afterwards forgot.” There was no evidence that the hay elevator was mistakenly left behind in the rush to move off the property. It was not left intentionally and therefore not abandoned either. Therefore, Bylan remained the owner of the hay elevator.

—2020 WL 5535673 (Jud. Dist. Tolland at Rockville, CT.)

lost property

Property that the owner has involuntarily parted with and then cannot find or recover.

36–4b Lost Property

Lost property is property that is left involuntarily and forgotten. A lost property’s finder can claim title to it against the whole world, except the true owner. If a third party attempts to take possession of the property from the finder, the third party cannot assert a better title than the finder.



Highlighting the Point

Karina works in a hotel. On her way home one evening, she finds a piece of gold jewelry in the courtyard of the hotel. Covered with dust and dirt, the piece appears to have been lost. The piece also looks like it has several precious stones in it. Karina takes it to Lawrence Jewelry to have it appraised. While pretending to weigh the jewelry, a Lawrence employee removes several of the stones. When Karina discovers that the stones are missing, she sues Lawrence.

Will Karina win her lawsuit? Yes. Karina will win, because she found lost property and holds valid title against everyone except the true owner. Because the property was lost, rather than mislaid, the owner of the hotel is not the caretaker of the jewelry. Instead, Karina acquires title good against the whole world (except the true owner).

estray statutes

A statute defining finders’ rights in property when the true owners are unknown.

Conversion of Lost Property If the true owner of the lost property demands that it be returned, the finder must return it. In fact, many states require the finder to make a reasonably diligent search to locate the true owner. When a finder of lost property knows the true owner’s identity and fails to return the property to that person, the finder has committed the tort of conversion.

Estray Statutes Many states have **estray statutes**, which encourage and facilitate the return of property to its true owner and then reward the finder for honesty if the property remains unclaimed. These laws provide an incentive for finders to report their discoveries by making it possible for them, after the passage of a specified period of time, to acquire legal title to the property they found.

Generally, the item must be lost property, not merely mislaid property, for estray statutes to apply. Estray statutes vary from state to state. Most, however, usually require that the finder report the finding to the town clerk, post a public notice, and advertise the property in a local newspaper. Estray statutes attempt to help the owner recover what has been lost.

36–4c Abandoned Property

Property that has been discarded by the true owner, who has no intention of reclaiming title to it, is **abandoned property**. Someone who finds abandoned property acquires title to it, and this title is good against the whole world, including the original owner. An owner of lost property who eventually gives up any further attempt to find the lost property is frequently held to have abandoned the property.

Example 36.9 Whitney is hiking a section of the Pacific Coast Trail and drops her Garmin GPS watch. She retraces her route and searches for the watch, but she cannot find it. She finally gives up her search and proceeds to her destination thirty miles down the trail. When Nicos later finds the watch along the trail, he acquires title to it that is good even against Whitney. By completely giving up her search, Whitney abandoned the watch just as effectively as if she had intentionally discarded it. ■

Note that if a person finds abandoned property while trespassing on the property of another, title goes to the owner of the land, not the finder. (See Exhibit 36.1 for a summary of who can claim title to each of these properties.)

abandoned property
Property that has been discarded by the owner, who has no intention of recovering it.

Exhibit 36.1 Title to Mislaid, Lost, and Abandoned Property

Type of Property	Who Acquires Title
Mislaid Property	A finder of mislaid property will not acquire title to the goods, and the owner of the place where the property was mislaid becomes a caretaker of the mislaid property.
Lost Property	A finder of lost property can claim title to the property against the whole world except the true owner.
Abandoned Property	A finder of abandoned property can claim title to it against the whole world, including the original owner.

Conflict Resolved

In the Conflict Presented feature at the beginning of the chapter, Benjamin wants a high-speed access to the internet without paying. Many of the tenants in his apartment building subscribe to Array Communications, a local high-speed internet service provider. Benjamin uses an unsuspecting tenant’s password so he can connect to the web through Array’s service without its knowledge.

A **Has Benjamin committed a theft of personal property?** Yes. Although Array and Benjamin’s neighbors may not know what he has done, high-speed internet access is considered personal property for the purpose of criminal prosecution when it is used without permission.

Chapter Summary—Personal Property

Learning Outcome 1: Explain the nature of personal property.

Personal property includes all property not classified as real property. Personal property is movable and can be tangible (such as a car) or intangible (such as stocks or bonds). Gas, water, telephone, and internet access services are considered personal property for the purpose of criminal prosecution when they are stolen or used without authorization.

Learning Outcome 2: Identify different types of property ownership.

Fee simple exists when an individual has the right to use, possess, or dispose of the property as they choose during their lifetime and to pass on the property to their heirs at death. Concurrent ownership includes tenancy in common, joint tenancy, and community property.

Learning Outcome 3: State how ownership of personal property is acquired.

In addition to purchase and inheritance, property can be acquired by possession, production, gift, accession, and confusion.

Learning Outcome 4: Define mislaid, lost, and abandoned property.

Mislaid property is property that is placed somewhere voluntarily by the owner and then inadvertently forgotten. Lost property is property that is involuntarily left and forgotten. Abandoned property is property that has been discarded by the true owner, who has no intention of claiming title to the property in the future.

Straight to the Point

1. What types of owners share ownership rights simultaneously in particular property? (See Learning Outcome 2.)
2. How can a gift be delivered when physical delivery is impossible? (See Learning Outcome 3.)
3. Who owns property after an accession? (See Learning Outcome 3.)
4. Who can claim title to lost property against the whole world, except the true owner? (See Learning Outcome 4.)
5. What is an estray statute? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Dave and Caleb share ownership rights in a multimedia computer. When they acquired the computer, they agreed in writing that if one dies, the other inherits his interest. Are Dave and Caleb tenants in common or joint tenants? Explain. (See Learning Outcome 2.)
2. Evelyn works in the commercial loan department of Westbrook Bank. In the bank's parking lot, she finds an envelope that contains \$10,000 in cash. The envelope is addressed to Geo Properties, LLC, a firm familiar to Evelyn through her work at Westbrook. Can she keep the envelope and its contents? Explain. (See Learning Outcome 4.)

Real Law

36–1. Abandoned Property. Dannielle Zephier lived in Minnesota. She had a pet dog named Oliver. On moving to California to attend school, where her housing situation did not allow dogs, Zephier arranged with Derrick Agate, a close friend in Minnesota, to care for Oliver. During the next few years, she sometimes returned to visit the dog. Eventually, Agate refused to allow any more visits. After her attempts to contact Agate and reclaim Oliver were unsuccessful, she filed suit. A trial court, applying the common law of abandonment, found that Zephier

had abandoned Oliver and denied her recovery. Should an appellate court reverse this decision? If so, why? [*Zephier v. Agate*, 942 N.W.2d 380 (Ct. App. Minn. 2020)] (See Learning Outcome 4.)

36–2. The Nature of Personal Property. American Multi-Cinema, Inc. (AMC) owns movie theaters. To determine the amount of taxes it owed to Texas, AMC subtracted its cost of goods sold (COGS) from its total revenue. AMC included the cost of showing movies in its COGS. In other

words, it treated showing movies as a “good.” Texas, however, refused to allow AMC to claim this cost. AMC protested, arguing it was in the business of showing movies. Specifically, AMC sold its “product”—the right to watch films in its theaters—to moviegoers. The state countered that this right is intangible “non-property,” arguing that an AMC customer exits a theater with memories but not a copy of the film. Thus, AMC’s product is not considered a “good” for the purpose of COGS. Does the right to watch a film in a movie theater constitute property? Discuss. [*American Multi-Cinema, Inc. v. Hegar*, 580 S.W.3d 663 (Tex.App.—Austin 2017)] (See Learning Outcome 1.)

36–3. Lost Property. Sara Simon lost her cellphone in Manhattan, Kansas. Days later, Shawn Vargo contacted her, claiming to have the phone. He promised to mail it to her if she would wire him \$100 through a third party, Mark Lawrence. When Simon spoke to Lawrence about the wire transfer, she referred to the phone as hers and asked, “Are you going to send my phone to me?” Simon paid, but she did not get the phone. Instead, Lawrence took it to a Best Buy store and traded it in for credit. Charged with theft, Lawrence claimed that he did not know Simon was the phone’s owner. Was Simon’s phone lost, mislaid, or abandoned? Explain. [*State of Kansas v. Lawrence*, 347 P.3d 240 (Kan.App. 2015)] (See Learning Outcome 4.)

Ethical Questions

36–4. The Nature of Personal Property. Is it unethical to download a digital file without the owner’s permission? Discuss. (See Learning Outcome 1.)

36–5. Abandoned Property. Mansoor Akhtar lived rent-free in the basement of Anila Dairkee’s duplex in Minneapolis, Minnesota, for more than a year. When Dairkee asked Akhtar to move out, he refused. She then changed the locks and advised him to remove his property from the duplex, but he did not. About a year later, while Dairkee was staying

in New York, her father had the basement cleaned out. When Dairkee returned four months later, she learned that her father had disposed of Akhtar’s property. Akhtar filed a suit in a Minnesota state court against Dairkee, alleging that she had wrongfully disposed of his property. She contended that he had abandoned it. Is she correct? Did she act ethically with respect to his property? Explain. [*Akhtar v. Dairkee*, 2017 WL 1210140 (Minn.App. 2017)] (See Learning Outcome 4.)

Chapter 36—Work Set

True-False Questions

- _____ 1. Generally, those who produce personal property have title to it.
- _____ 2. If goods are confused due to a wrongful act and the innocent party cannot prove what percentage is theirs, all of the goods belong to the wrongdoer.
- _____ 3. To constitute a gift, a voluntary transfer of property must be supported by consideration.
- _____ 4. One who finds abandoned property acquires good title to the property against the whole world, except the true owner.
- _____ 5. Co-ownership in which each of two or more persons owns an undivided, fractional interest in the property is a tenancy in common.
- _____ 6. Gas, water, and other utility services are considered personal property.
- _____ 7. If an object cannot be physically delivered, it cannot be a gift.
- _____ 8. The most common way to acquire personal property is to produce it.

Multiple-Choice Questions

- _____ 1. While walking to work at Miller's Bakery, Bill finds a Rolex watch lying on the sidewalk directly in front of the bakery. He gives the watch to his son, Otto. Two weeks later, Martin, the watch's true owner, discovers that Bill found his watch. He demands his watch from Otto. Who has title to the lost watch?
 - a. Martin.
 - b. Otto.
 - c. Bill.
 - d. Miller's Bakery.
- _____ 2. Hector sells his Microsoft Xbox to Paul and Amy. Each takes a one-half interest in it. Paul and Amy are not married. Nothing is said about the form of the buyers' ownership. They own the system as
 - a. tenants in common.
 - b. joint tenants.
 - c. community property.
 - d. a and b.
- _____ 3. Hermosa sells her boat to Chris and Nora. Chris and Nora are not married. The contract of sale says that each of the buyers has a right of survivorship in the boat. Chris and Nora own the boat as
 - a. tenants in common.
 - b. joint tenants.
 - c. community property.
 - d. b and c.
- _____ 4. Meg wants to give Lori a pair of diamond earrings that Meg has in her safe-deposit box at First National Bank. Both Lori and Meg are signatories for that safe deposit box. Meg gives Lori the key to the box and tells her to go to the bank and take the earrings from the box. Lori does so. Two days later, Meg dies. To whom do the earrings belong?
 - a. Lori.
 - b. Meg's heirs.
 - c. First National Bank.
 - d. The state government.

- _____ 5. Saskia goes to Don's Salon for a haircut. Behind a plant on a table in the waiting area, Saskia finds a wallet containing \$5,000. The party entitled to possession of the wallet is
- a. Saskia.
 - b. Don.
 - c. the owner of the building in which the salon is located.
 - d. the state.
- _____ 6. Jane, Mark, and Guy are farmers who store their grain in three silos. Jane contributes half of the grain, Mark a third, and Guy a sixth. A tornado hits two of the silos and scatters the grain. If each farmer can prove how much they deposited in the silos, how much of what is left belongs to each?
- a. Jane owns half, Mark a third, and Guy a sixth.
 - b. Because only a third is left, Mark owns it all.
 - c. Because Jane and Mark lost the most, they split what is left equally.
 - d. Jane, Mark, and Guy share what is left equally.
- _____ 7. Doug wants to give Kim a laptop computer that is stored in a locker at the airport. Doug gives Kim the key to the locker and tells her to take the laptop from the locker. Kim says that she doesn't want the computer and leaves the key on Doug's desk. The next day, Doug dies. Who gets the computer?
- a. Kim.
 - b. Doug's heirs.
 - c. The airport.
 - d. The state government.
- _____ 8. Ethan owns stock in Fast Burgers, Inc. He sells one-third of the shares and buys stock in Good Brew Corporation with the proceeds. On his death, his stock in the two companies will pass to his heirs. Ethan owns the stock as
- a. a concurrent owner.
 - b. a joint tenant.
 - c. a tenant in common.
 - d. an owner in fee simple.

Answering More Legal Problems

1. Hobie and Colleen designed and developed a smartphone app called Do It. Do It is a game in which players cooperate rather than compete to complete a task, such as draw a picture, play a tune, or score a point. Documents evidence each party's investment, ownership, and share of profits and losses in the app. In the documents, Hobie and Colleen are referred to as "joint owners" and "tenants."

Is the ownership interest of each party a tenancy in common or a joint tenancy? The ownership interest of each party is a _____.

With this type of co-ownership, each of two or more persons owns an undivided, fractional interest in the property, and on one tenant's death that interest passes to their heirs. In contrast, with a _____, each of two or more persons owns an undivided interest, and a deceased owner's interest passes to the surviving co-owner or co-owners. In most states, it is presumed that a tenancy is a _____ unless it is clear that the parties intended to establish a _____. Under that rule, Hobie and Colleen did not state or otherwise make clear that they intended to share the ownership of their business in a _____.

2. Charlie is hiking along a trail on forested land in the state of Maine near the United States' border with Canada. Beside the trail, Charlie finds a backpack that contains \$100,000 in cash. He reports the find to U.S. Customs agents, who take custody of it. A drug-sniffing dog alerts the agents to the scent of drugs on the backpack and the cash, which evidences its use in illegal drug transactions. The federal government claims title to the property under criminal forfeiture laws. Charlie objects, claiming title under Maine's estray statute.

Is Charlie entitled to the \$100,000 under the state's estray statute? No. Like many states, Maine has an estray statute. This estray statute requires a finder to notify the nearest town's clerk in writing within seven days after finding the property. The _____ is also required to post a public notice and _____ the find in the town's newspaper. _____ has not fulfilled these estray statute requirements. Therefore, _____ has not acquired title to the property under the estray statute. Instead, the federal government has a legitimate right to the \$100,000.

37 | Bailments

Conflict Presented

Mercy Medical Clinic has problems with the hard drive that contains all of its patients' records. The clinic contracts with Quest Computer Service to repair or replace the hard drive. Before backing up the data on the drive, however, a Quest employee unintentionally erases it. Mercy Medical thereby loses all of its patients' records and contact information.

Q Can Mercy Medical successfully sue Quest for negligence?

Almost every business is affected by the law of bailments at one time or another. A **bailment** is formed by the delivery of personal property, without transfer of title, by one person (called a **bailor**) to another (called a **bailee**). Usually, a bailment is created to serve a particular purpose—for instance, storage, repair, or transportation. On completion of the purpose, the bailee must return the bailed property to the bailor or to a third person or dispose of it as directed.

Most bailments are created by agreement, but not necessarily by contract, because many bailments do not include all of the elements of a contract. **Example 37.1** If Arianna loans her mountain bike to a friend, a bailment is created, but there is no contract because there is no consideration. ■ In contrast, many commercial bailments, such as the delivery of a suit to the cleaners for dry cleaning, are based on contract.

37–1 The Elements of a Bailment

Not all transactions involving the delivery of property from one person to another create a bailment. For such a transfer to become a bailment, the following three conditions must be met:

1. The property involved must be personal property.
2. The property must be delivered to the bailee.
3. An agreement for the return or disposal of the property must be made.

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Outline the elements of a bailment.
- 2 List a bailee's rights.
- 3 Identify a bailee's basic responsibilities.
- 4 What are the bailor's duties?
- 5 Outline special types of bailments.

bailment

An agreement in which the personal property of a bailor is entrusted to a bailee.

bailor

One who entrusts goods to a bailee.

bailee

One to whom goods are entrusted by a bailor.

Learning Outcome 1

Outline the elements of a bailment.

37–1a Personal Property Requirement

A bailment involves only personal property. Neither a person nor real property can be the subject of a bailment. **Example 37.2** Grace is traveling to New York on business. When she checks her luggage at the airport, a bailment of her luggage is created when it is transported by the airline. As a passenger, though, Grace is not the subject of a bailment. ■

Bailments most commonly involve tangible items—such as jewelry, cattle, and cars. Nevertheless, intangible personal property, such as promissory notes and shares of stock, may also be bailed.

37–1b Delivery of Possession

Delivery of possession means transfer of possession of the property to the bailee. For delivery to occur, the bailee must be given exclusive possession and control over the property, and the bailee must knowingly accept the property. In other words, the bailee must intend to exercise control over it. If either delivery of possession or knowing acceptance is lacking, there is no bailment relationship.



Highlighting the Point

Gordon and his wife, Della, go to Chez Felix, a five-star French restaurant to celebrate their twenty-fifth wedding anniversary. As part of its customer service, Chez Felix offers coat check in its lobby. Both Gordon and Della check their coats at the door. Inadvertently, Gordon leaves Della's gift—a \$10,000 diamond bracelet—in his coat pocket.

Do Chez Felix and Gordon have a bailment agreement for both his coat and the bracelet? No. A bailment of the coat exists because Chez Felix (the bailee) has exclusive possession and control over the coat and has knowingly accepted it. In accepting the coat, however, the restaurant has not knowingly also accepted the \$10,000 bracelet. Thus, there is no bailment agreement for the bracelet.

Physical Versus Constructive Delivery Either physical or constructive delivery will result in the bailee's exclusive possession of and control over the property. Constructive delivery is a substitute, or symbolic, delivery. What is delivered to the bailee is not the actual property bailed (such as a car) but something so related to the property (such as the car keys) that the requirement of delivery is satisfied.

Involuntary Bailments In certain unique situations, a bailment is found even though the required elements of control and knowledge seem to be lacking. One instance occurs when the bailee acquires the property accidentally or by mistake—as in finding someone else's lost or mislaid property. A bailment is created even though the bailor did not voluntarily deliver the property to the bailee. Such bailments are called constructive or involuntary bailments.

Example 37.3 Several corporate managers attend an urgent meeting at the law firm of Jacobs & Matheson. One of the managers, Kyle, inadvertently leaves his briefcase at the firm's offices at the conclusion of the meeting. In this situation, a court could find that an involuntary bailment was created, even though Kyle did not voluntarily deliver the briefcase and the law firm did not intentionally accept it. ■

37–1c The Bailment Agreement

No written agreement is required for bailments of less than one year—that is, the Statute of Frauds does not apply. Nevertheless, it is a good idea to have one, especially when valuable property is involved.

Express or Implied Agreements A bailment agreement can be express or implied. The bailment agreement expressly or impliedly provides for the return of the bailed property to the bailor or to a third person, or it provides for disposal by the bailee. The agreement assumes that the bailee will return the identical goods originally given by the bailor.

In certain types of bailments, however, such as bailments of fungible goods, only equivalent property must be returned. **Example 37.4** Holman stores his grain (fungible goods) at Central Valley Grange’s facilities. At the end of the storage period, Central Valley is not obligated to return the exact same grain that Holman originally stored. As long as Central Valley returns grain of the same type, grade, and quantity, the company has performed its obligation as the bailee. ■

Ordinary Versus Special Bailments Bailments are either ordinary or special (extraordinary). Most bailments are ordinary and distinguished according to which party receives a benefit from the bailment. This factor will dictate the rights and liabilities of the parties. In addition, the courts may use it to determine the standard of care required of the bailee in possession of the personal property.

37–2 The Rights of the Bailee

Generally, the bailee has the right to take possession of the property, to utilize the property for accomplishing the purpose of the bailment, to receive some form of compensation, and to limit their liability for the bailed goods. These rights are present (with some limitations) in varying degrees in all bailment transactions.

Learning Outcome 2

List a bailee’s rights.

37–2a The Right of Possession

A bailee has the right to possess and control the bailed property for the duration of the bailment. This right allows the bailee to recover damages from any third party for loss or damage to the property. If the property is stolen, the bailee has a right to regain its possession.

37–2b The Right to Use Bailed Property

A bailee has a right to use the bailed property to carry out the ordinary purpose of the bailment.

Example 37.5 Lenna volunteers to drive her friend Mark to the airport. To do so, she borrows Mark’s car. Lenna, as the bailee, obviously is expected to use the car. In contrast, if Mark decides to drive his own car to the airport and park it in long-term parking, the airport facility, as the bailee, is not expected to use the car. The ordinary purpose of a storage bailment does not include use of the property. ■

37–2c The Right of Compensation

A bailee has a right to be compensated according to the terms of the bailment agreement. This includes reimbursement of costs incurred in keeping the bailed property. To enforce the right of compensation, a bailee can place a lien on the property. If the bailor does not pay, the bailee can foreclose on the lien and sell the property to recover the amount owed.



Highlighting the Point

Nivi leaves her car at Edison Automotive for repairs. Edison informs Nivi that the car needs a new transmission, and she authorizes the work. When Nivi returns to pick up the car, she refuses to pay for the transmission job.

Can Edison keep the car and place a lien on it until Nivi pays for the repairs? Yes. Edison has the right to be compensated for its work. If Nivi continues to refuse to pay, Edison can follow the state's statutory process for foreclosing on the lien and selling the car to recover what is owed.

37–2d The Right to Limit Liability

In an ordinary bailment, a bailee can limit their liability. To be effective, the limit must be called to the attention of the bailor. **Example 37.6** A sign in Nikolai's cell-phone repair shop states that he is not responsible "for any loss due to theft, fire, or vandalism." Whether the sign is enough to constitute notice depends on the sign's size, its location, and any other circumstances affecting the likelihood that customers will see it. ■

Of course, a limit on liability cannot be against public policy. Courts may, for instance, refuse to enforce exculpatory clauses, which limit a party's liability for its own wrongful acts. **Example 37.7** Spencer's Parking Garage (a bailee) disclaims liability for any damage to parked cars, regardless of the cause. Because Spencer's has attempted to exclude liability for its own negligence, the clause will likely be unenforceable. ■

37–3 The Duties of the Bailee

Learning Outcome 3

Identify a bailee's basic responsibilities.

The bailee has two basic responsibilities: (1) to take appropriate care of the property and (2) to surrender the property to the bailor or dispose of it in accordance with the bailor's instructions at the end of the bailment.

37–3a The Duty of Care

The bailee must exercise reasonable care in preserving the bailed property. What constitutes reasonable care in a bailment situation normally depends on the nature and circumstances of the bailment. Generally speaking, there are three types of ordinary bailments, and each calls for a different level of care.

1. A bailment for the sole benefit of the bailor exists for the convenience and benefit of the bailor. Basically, the bailee is caring for the bailor's property as a favor. In this type of bailment, the bailee need exercise only a slight degree of care and will be liable only if grossly negligent in caring for the property.
2. A bailment for the sole benefit of the bailee exists for the convenience and benefit of the bailee. Typically, this sort of bailment arises when the bailor lends an article to the bailee. Because the bailee is borrowing the item for their own benefit, the bailee owes a duty to exercise the utmost care and will be liable for even slight negligence.
3. A bailment for the mutual benefit of the bailee and the bailor, the most common type of bailment, involves some form of compensation for storing items or holding property. Here, the bailee must exercise ordinary care, which is the care that a reasonably careful person would use under the

circumstances. If the bailee fails to exercise reasonable care, they will be liable for ordinary negligence.

Real Case



Toll Processing Services bought a second-hand pickle line, which is equipment used to remove impurities and rust from steel. It had nowhere to put it. Kastalon, Inc., a company that services pickle lines, agreed to store the machinery until Toll Processing filed a reconditioning purchase order. Kastalon would then perform any necessary repairs on the pickle line and return it. No specific time frame for this process was discussed. After more than two years, not having heard from Toll Processing, a Kastalon employee assumed that the company had gone out of business. Kastalon had the pickle line scrapped. Six months later, Toll Processing learned of this and sued Kastalon for negligence.

Did Kastalon, as the bailee, meet its duty of care? No. In *Toll Processing Services v. Kastalon*, the U.S. Court of Appeals for the 7th Circuit did not agree with the initial lower court's dismissal of the case. The lower court had failed to determine whether Kastalon had taken reasonable steps to protect the bailed property. Why, for example, didn't someone from Kastalon simply contact Toll Processing to learn of its intentions regarding the pickle line?

—880 F.3d 820 (U.S. Ct. App. 7th Cir.)

Exhibit 37.1 illustrates these concepts.

37–3b The Duty to Return Bailed Property

At the end of the bailment, the bailee normally must hand over the original property to either the bailor or someone the bailor designates or must otherwise dispose of it as directed. This is usually a contractual duty arising from the bailment agreement. Failure to give up possession at the time the bailment ends is a breach of contract and could result in the tort of **conversion** or an action based on the bailee's negligence.

conversion
The wrongful taking or using of another's personal property.

Highlighting the Point



American Cranes, Inc., lends a crane to Builder Brothers, LLC, to encourage the contractor to buy it. When the parties cannot agree on a price, American Cranes asks for the crane to be returned. Before Builder Brothers returns the crane, however, it is damaged while in use at a construction site. Builder Brothers moves the crane to another location and bills American Cranes for transportation and storage costs.

Is Builder Brothers liable for conversion? Yes. The transaction between American Cranes and Builder Brothers is a bailment. The contractor's failure to return the crane after the owner demands its return is conversion.

Exhibit 37.1 Degree of Care Required of a Bailee



37–3c Liability for Lost or Damaged Property

If the bailed property has been lost or is returned damaged, a court will presume that the bailee was negligent. The bailee's obligation is excused, however, if the property was destroyed, lost, or stolen through no fault of the bailee (or claimed by a third party with a superior claim).

Conflict Resolved

In the Conflict Presented feature at the beginning of the chapter, Mercy Medical Clinic experiences trouble with the hard drive that holds all of its patients' records. Quest Computer Service is engaged to repair or replace the drive. Before backing up the data, however, a Quest employee unintentionally erases it. Mercy Medical loses all of its patients' information.

A Can Mercy Medical successfully sue Quest for negligence? Yes. A bailee has a duty to exercise reasonable care to return bailed property in the condition it was in when delivered. Mercy Medical entrusted Quest with a drive loaded with data. Quest accidentally erased the data. This is negligence.

37–4 The Duties of the Bailor

Learning Outcome 4

What are the bailor's duties?

The duties of the bailor are the same as the rights of a bailee. A bailor has a duty to compensate the bailee. The bailor also has an all-encompassing duty to provide the bailee with the goods that are free from known defects that could cause injury to the bailee.

37–4a Bailor's Duty to Reveal Defects

The bailor's duty to reveal defects to the bailee translates into two rules:

1. In a mutual-benefit bailment, the bailor must notify the bailee of all known defects and any hidden defects that the bailor knows of or could have discovered with reasonable diligence.
2. In a bailment for the sole benefit of the bailee, the bailor must notify the bailee of any known defects.

Example 37.8 Rentco (the bailor) rents a tractor to Franco. Unknown to Rentco (but discoverable by reasonable inspection), the brake mechanism on the tractor is defective. Franco uses the defective tractor without knowledge of the brake problem and is injured. In this situation, Rentco is liable for the injuries sustained by Franco because it negligently failed to discover the defect and to notify Franco. ■

37–4b Warranty Liability for Defective Goods

A bailor can also incur warranty liability under contract law for injuries resulting from the bailment of defective articles. Property that is leased from a bailor must be fit for the intended purpose of the bailment. The bailor's knowledge or ability to discover any defects is immaterial.

Warranties of fitness arise by law in sales contracts. Courts have held that those warranties apply to bailments "for hire." Article 2A of the Uniform Commercial Code extends the implied warranties of merchantability and fitness for the particular purpose to bailments, that includes rights to use the bailed goods.

37–5 Special Bailments

In some special types of bailment transactions, the bailee's duty of care is extraordinary, and the bailee's liability for loss or damage to the property is absolute. Such situations usually involve common carriers and hotel operators. Warehouse companies also have special responsibilities but are liable only for loss or damage resulting from negligence.

Learning Outcome 5

Outline special types of bailments.

37–5a Common Carriers

Common carriers provide transportation services to the general public. They are required to carry all passengers or freight as long as there is enough space, the fee is paid, and there are no reasonable grounds to refuse service. (In contrast, a private carrier provides service to a select clientele, not to every person or business.)

The delivery of goods to a common carrier creates a bailment between the shipper (bailor) and the carrier (bailee). With respect to the goods, the carrier is subject to a higher standard than just reasonable care. The carrier is absolutely, or strictly, liable for any loss or damage unless it is caused by a natural disaster or war. Common carriers can limit their liability, however, to an amount stated on the shipment contract. Carriers may also limit the value of property that they will transport.

37–5b Warehouse Companies

Warehousing is the business of providing storage of property in exchange for compensation. Like ordinary bailees, warehouse companies are liable for loss or damage resulting from negligence. But because a warehouse company is a professional bailee, it is expected to exercise a high degree of care to protect and preserve the goods.

A warehouse company can limit the dollar amount of its liability. The bailor, however, must be given the option of paying a higher rate to increase the limit.

37–5c Hotel Operators

Hotel operators are strictly liable for any loss or damage to their guests' personal property. In many states, hotels can avoid strict liability by providing a safe for their guests' valuables. State statutes may limit the liability for articles that are not kept in a safe. In addition, the availability of damages may be limited in the absence of negligence.

Chapter Summary—Bailments

Learning Outcome 1: Outline the elements of a bailment.

The elements of a bailment are as follows:

- (1) Personal property—Bailments involve only personal property.
- (2) Delivery of possession—The bailee (the one receiving the property) must be given exclusive possession and control over the property. In a voluntary bailment, the bailee must knowingly accept the personal property.
- (3) Bailment agreement—The agreement provides for the return of the bailed property to the bailor or a third party, or for the disposal of the bailed property by the bailee.

Learning Outcome 2: List a bailee's rights.

A bailee has the right to take possession of the bailed property, to use the property for accomplishing the purpose of the bailment, to receive some form of compensation, and to limit liability for loss or damage to the bailed goods.

Learning Outcome 3: Identify a bailee's basic responsibilities.

A bailee has two responsibilities:

- (1) to take appropriate care of the bailed property, and
- (2) to surrender the bailed property to the bailor or dispose of it in accordance with the bailor's instructions at the end of the bailment.

Learning Outcome 4: What are the bailor's duties?

Every bailor has a duty to reveal defects in the personal property that is being bailed. A bailor who fails to give the appropriate notice of a defect is liable to the bailee.

Learning Outcome 5: Outline special types of bailments.

There are three special types of bailments:

- (1) Common carriers—Carriers that provide transportation services to the general public are held to a standard of care based on strict liability.
- (2) Warehouse companies—Warehouse companies are expected to exercise a high degree of care to protect and preserve bailed goods but are liable only for loss or damage resulting from negligence.
- (3) Hotel operators—Operators of hotels are subject to strict liability for loss or damage to their guests' personal property. A state statute may limit this liability in certain circumstances.

Straight to the Point

1. Which type of property does a bailment involve? (See Learning Outcome 1.)
2. How can a bailment occur if the bailor does not voluntarily deliver the property to the bailee? (See Learning Outcome 1.)
3. By what means can a bailee enforce their right to compensation? (See Learning Outcome 2.)
4. On what does the degree of reasonable care required in a bailment situation depend? (See Learning Outcome 3.)
5. How can a bailor overcome a limit that a warehouse company places on its liability? (See Learning Outcome 2.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Thiago leaves his clothes with Corner Dry Cleaners to be cleaned. When the clothes are returned, some are missing, and others are greasy and smell bad. Is Corner liable? Why or why not? (See Learning Outcome 1.)
2. Rosa de la Mar Corporation ships a load of goods via Southeast Delivery Company. The load of goods is lost in a hurricane in Florida. Who suffers the loss? Explain. (See Learning Outcome 5.)

Real Law

37–1. Duties of the Bailee. Michelle and Joseph Ardito owned two horses. At one point in time, both Michelle and Joseph were incapacitated. They agreed to have the horses transferred to the Woodbridge Animal Services Farm. Woodbridge eventually “adopted” out the horses to separate new owners. Woodbridge never attempted to contact either Michele or Joseph prior to the adoptions. Had Woodbridge

entered into a bailment agreement, thereby making the municipality liable for the unauthorized disposal of the animals? [*Ardito v. Woodbridge Animal Control*, 70 Conn. L. Rptr. 1 (New Haven, 2020)] (See Learning Outcome 3.)

37–2. Duties of the Bailee. James Heal owned a vehicle salvage yard in Homestead, Iowa. Brian Anderson contracted with Heal to run the business. Anderson cleaned up the

property, removed trash, installed heat and fixed the plumbing in the buildings, and brought in tools and equipment. He used his own resources to rebuild the aging inventory. Anderson reinvested all of the profits in the business. When Anderson sold a 2004 Ford F-150 that he had bought with his own money for his own use, however, Heal pocketed the proceeds and locked Anderson out of the business. Heal filed a suit in an Iowa state court against Anderson, alleging breach of contract, and obtained an injunction to keep him off the property. Do these circumstances create a bailment? What is the appropriate standard of care if there is a bailment? Discuss. [*Heal v. Brian Anderson*, 900 N.W.2d 617 (Iowa App. 2017)] (See Learning Outcome 3.)

37-3. Duty of Care. Christie's Fine Art Storage Services, Inc. (CFASS), is in the business of storing fine works of art at its

warehouse in Brooklyn, New York. The warehouse is next to the East River in a flood zone. Boyd Sullivan owns works of art by Alberto Vargas, including *Beauty and the Beast* and *Miss Universe*. Sullivan contracted to store the works at CFASS's facility under an agreement that limited the warehouse's liability for damage to the goods to \$200,000. A few months later, as Hurricane Sandy approached, CFASS was warned of the potential for damage from the storm. CFASS e-mailed its clients that extra precautions were being taken. Despite this assurance, Sullivan's works were left exposed on a ground-level floor and sustained severe damage in the storm. Who is most likely to suffer the loss? Why? [*Sullivan v. Christie's Fine Art Storage Services, Inc.*, 2016 WL 427615 (N.Y.Sup.) (Trial Order)] (See Learning Outcome 3.)

Ethical Questions

37-4. Duty of Care. What standard of care over bailed property should be expected of bailees? (See Learning Outcome 3.)

37-5. Duties of the Bailee. KZY Logistics, LLC, transported a load of Mrs. Ressler's Food Products from New Jersey to California. When KZY's driver delivered the cargo, the customer rejected it—its temperature was higher than expected, making it unsafe. Mrs. Ressler's filed a suit against KZY in a federal district court. KZY contended that the temperature

in its refrigerated trailer was proper and that Mrs. Ressler's had delivered a "hot" product for transport. KZY supplemented its allegations with temperature readings from the unit during the time in question. In transporting the cargo, what level of care did KZY owe Mrs. Ressler's? From an ethical perspective, did KZY meet this standard? Explain. [*Mrs. Ressler's Food Products v. KZY Logistics, LLC*, 675 Fed.App. 136 (3d Cir. 2017)] (See Learning Outcome 5.)

Chapter 37—Work Set

True-False Questions

- _____ 1. A bailment includes a transfer of title.
- _____ 2. Most bailments are created by agreement.
- _____ 3. A bailment can occur even if a bailee acquires property accidentally or by mistake.
- _____ 4. A written agreement is required for all bailments.
- _____ 5. A bailee does not have the right to limit their liability for loss or damage to bailed goods.
- _____ 6. A bailee must exercise reasonable care to preserve the bailed property.
- _____ 7. A common carrier is not liable for loss or damage to bailed property in the carrier's possession.
- _____ 8. Any delivery of personal property from one person to another creates a bailment.

Multiple-Choice Questions

- _____ 1. Orley agrees to lease an F-150 Ford truck to Pete, who tells Orley that he plans to use the truck to haul trash and debris from his property. As a bailee, Pete has a responsibility to
 - a. limit his liability for loss or damage to the truck.
 - b. provide transportation services to the general public.
 - c. take appropriate care of the truck.
 - d. none of the choices.
- _____ 2. Queenie agrees to rent a bicycle from Ride City Bikes for a day. As a bailor, Ride City must
 - a. deliver the bike to Queenie.
 - b. provide storage of the bike for compensation.
 - c. surrender the bike to Queenie at the end of the day.
 - d. accept liability for any loss or damage to the bike.
- _____ 3. Ridgeline Transport is a common carrier. Sentinel Inn is a hotel. Temp Space is a warehouse company. In a bailment situation, the companies that are absolutely (strictly) liable for loss or damage to the bailed property are
 - a. Sentinel Inn and Temp Space.
 - b. Ridgeline Transport and Sentinel Inn.
 - c. Ridgeline Transport and Temp Space.
 - d. none of the choices.
- _____ 4. Reliable Storage is a warehouse company. Shippers Choice is a common carrier. In a bailment, the dollar amount of liability for loss or damage to bailed goods can be limited by
 - a. Shippers Choice only.
 - b. Reliable Storage only.
 - c. both Reliable Storage and Shippers Choice.
 - d. none of the choices.
- _____ 5. Hasty Pudding, a dessert café, features an area near its dining room where its patrons can leave their coats and other possessions while on the premises. To limit liability for loss or damage to these items, Hasty Pudding must
 - a. call the limit to the customers' attention.
 - b. disclaim liability regardless of the cause.
 - c. exclude liability for its own negligence.
 - d. obtain insurance coverage with a low limit.

- _____ 6. Altin leaves his Mazda Miata at Nate's Service Center to obtain new tires and brakes. When the work is done, Altin refuses to pay. Nate's
- a. can retain possession of the car and place a lien on it.
 - b. can retain possession of the car even if its owner later pays.
 - c. must return the car but can file a suit in the appropriate court.
 - d. must return the car but can first "undo" its work.
- _____ 7. Ann rents a kayak from Boaters Marina for a day's paddling on Clearwater Creek. When Ann takes a break onshore, Donnie steals the kayak. Ann can attempt to
- a. recover the price of the kayak from Donnie.
 - b. recover the price of the rental from Boaters Marina.
 - c. regain possession of the kayak from Donnie.
 - d. replace the stolen kayak with a free rental from Boaters Marina.
- _____ 8. After a meeting at Creed & Dibbs CPA, Eduardo inadvertently leaves his smartphone in the firm's conference room. With respect to the smartphone, this is
- a. an involuntary bailment.
 - b. not a bailment because Eduardo did not voluntarily deliver it.
 - c. not a bailment because Eduardo still considers it his property.
 - d. not a bailment because the firm did not intentionally accept it.

Answering More Legal Problems

1. On learning that Sébastien planned to travel abroad, Roslyn asked him to deliver \$25,000 in cash to her family in Mexico. During a customs inspection at the border, Sébastien told the customs inspector that he carried less than \$10,000. The officer discovered the actual amount of cash that Sébastien was carrying, seized it, and arrested Sébastien. Roslyn asked the government to return what she claimed was her money, arguing that the arrangement with Sébastien was a bailment and that she still held title to the cash.
2. Baubles, a jewelry store, contacts United Parcel Service (UPS) to ship a diamond ring worth \$105,000. The owner of the store arranges for the shipment on UPS's website, which requires the customer to click on an on-screen box to agree to "My UPS Terms and Conditions." Among the terms, UPS limits its liability on packages to \$50,000. The carrier disclaims liability entirely for items worth more than \$50,000 and refuses to ship them. Despite these terms, Baubles schedules shipment of the ring. The ring is lost in transit.

Is Roslyn entitled to the return of the money? Yes. A bailment is formed by the delivery of personal property, without transfer of _____, by one person (the bailor) to another (the bailee), usually under an agreement for a particular purpose. On completion of the purpose, the bailee is obligated to deliver the property to the bailor or a third person, or to dispose of it as directed. Here, Roslyn delivered the cash to Sébastien for the purpose of delivering it to her family in Mexico. She did not transfer _____ to the money to Sébastien. Thus, she had the right to assert her _____ to it against any person, including the government.

Is Baubles entitled to recover from UPS for the loss? No. As a _____ carrier, UPS must accept all freight as long as there is space, the fee is paid, and there is no reasonable ground to refuse. In most situations, the carrier is absolutely or _____ liable for loss or damage to the goods. Liability _____ be limited to an amount stated on the shipment contract, however. Thus, UPS's online disclaimer of liability _____ enforceable, and Baubles is not entitled to recover for the loss of the ring.

38 Real Property

Conflict Presented

Rosa and Santiago are neighbors living in rural northern California. On her property, Rosa plants grapes and begins to operate a vineyard and winery. A few years later, Santiago, who operates a small gravel pit on his land, wants to enlarge his business. The expanded excavation will throw more dust into the air, and large trucks and other equipment will come and go from Santiago's property more often. The increased dust and vibrations will harm Rosa's agricultural operation.

Q Can Santiago use his property as he sees fit, regardless of the effect on his neighbor's business?

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Define real property.
- 2 Identify common types of real property ownership.
- 3 Explain how real property ownership is transferred.
- 4 Describe eminent domain.

Throughout history, property has been considered an indicator of family wealth and social position. Indeed, the protection of people's right to their property is one of their most important rights. In this chapter, we look at real property and the various ways in which real property can be owned. We also examine how ownership rights in real property are transferred from one person to another.

38-1 The Nature of Real Property

Personal property generally is movable. In contrast, real property—also called real estate or realty—normally is immovable. **Real property** consists of land and the buildings, plants, and trees that it contains. It also includes subsurface and air rights. Personal property that has become permanently attached to real property (such as a mobile home that is connected to utilities and otherwise anchored to the land) is also considered part of the land.

Learning Outcome 1

Define real property.

real property

Land and everything attached to it.

38-1a Land

Land includes the soil on the surface of the earth and the natural or artificial structures that are attached to the land. It further includes all the waters contained on or under the surface and much, but not necessarily all, of the airspace above it. The exterior boundaries of land extend straight down to the center of the earth and straight up to the sky (subject to certain qualifications).

38–1b Airspace Rights and Subsurface Rights

The owner of real property has relatively exclusive rights to the airspace above the land, as well as to the soil and minerals underneath it. Significant limits on air or subsurface rights normally must be indicated on the deed or other document transferring title to the land.

Airspace Rights Disputes concerning airspace rights may involve the right of commercial and private planes to fly over property, as well as the right of individuals and governments to seed clouds and produce artificial rain. Flights over private land normally do not violate the property owners' rights unless the flights are low and frequent, causing direct interference with the enjoyment and the use of the land.

Subsurface Rights Subsurface rights include the ownership of minerals and, in most states, oil and natural gas. In many states, the owner of the surface of a parcel of land is not necessarily the owner of the subsurface. Hence, the land ownership can be separated. When the ownership is separated into surface and subsurface rights, each owner can pass title to what they own without the consent of the other.

An owner of subsurface rights has a right to go onto the surface of the land to, for instance, find and remove minerals. The subsurface owner cannot excavate in a way that causes the surface to collapse, however. In many states, a subsurface owner who excavates is also responsible for any damage that the excavation causes to buildings on the surface. State statutes typically provide exact guidelines as to the requirements for excavations.

38–1c Plant Life and Vegetation

Plant life, both natural and cultivated, is also considered real property. In many instances, natural vegetation, such as trees, adds greatly to the value of realty. When a parcel of land is sold and the land has growing crops on it, the sale includes the crops, unless otherwise specified in the sales contract. When crops are sold by themselves, however, they are considered personal property. Consequently, the sale of crops is a sale of goods. It is governed by the Uniform Commercial Code rather than by real property law.

38–1d Fixtures

Certain personal property can become so closely associated with the real property to which it is attached that the law views it as real property. Such property is known as a **fixture**—a thing affixed to realty. A thing is affixed to realty when it is attached to the realty by roots, embedded in it, or permanently attached by means of cement, plaster, bolts, nails, or screws.

Fixtures are included in the sale of land if the sales contract does not provide otherwise. The sale of a house includes the land and the house and garage on it, as well as the built-in cabinets, plumbing, and windows.

Generally, to determine whether an item is a fixture, a court examines the intention of the party who placed the object on the real property. If the facts indicate that the person intended the item to be a fixture, then it is normally considered a fixture.

Example 38.1 Judeline and Mark are selling their home. When potential buyers come to visit the property, they often ask if the unique birdbath in the front yard is included in the sale. Because the birdbath is not attached to the ground and is a family heirloom, it is not a fixture nor is it intended to be part of the home sale. The tile and wall-to-wall carpeting in the house, however, are intended as fixtures because they are permanently attached to the floor. ■

fixture

An item of personal property that is attached to real property.

38-2 Ownership Interests

Property ownership is often viewed as a bundle of rights. One who possesses the entire bundle of rights is said to hold the property in fee simple. When some of the rights in the bundle are transferred to another person, the effect is to limit the ownership rights of both the one transferring the rights and the one receiving them.

Learning Outcome 2

Identify common types of real property ownership.

38-2a Ownership in Fee Simple

The most common type of property ownership is the fee simple. Generally, the term fee simple ownership designates a **fee simple absolute**, in which the owner has the greatest aggregation of rights, privileges, and power possible. The fee simple is owned absolutely by a person and their heirs and is assigned forever without limitation or condition.

fee simple absolute

An interest in land with no limitations.

Rights of Owner The rights that accompany a fee simple include the right to use the land for whatever purpose the owner sees fit. Of course, certain laws, including applicable zoning, noise, and environmental laws, may limit the owner's ability to use the property in certain ways. A person cannot use their property in a manner that unreasonably interferes with others' right to use or enjoy their own property.

Conflict Resolved

In the Conflict Presented feature at the beginning of the chapter, Rosa and Santiago are adjacent property owners. Rosa operates a vineyard and winery. Santiago wants to expand a small gravel pit on his land. The increased dust and vibrations will harm Rosa's business.

A Can Santiago use his property as he sees fit, regardless of the effect on his neighbor's business? No. Property owners can use their property for whatever purpose they see fit so long as the use does not unreasonably interfere with a neighbor's use or enjoyment of their property. The negative impact of an expanded gravel-mining operation on a neighbor's vineyard and winery would likely result in an injunction or an imposition of damages.

Highlighting the Point



An area is zoned as a residential district with small businesses permitted so long as they do not adversely affect the character of the neighborhood. Within the district, Harmony Bank owns property in fee simple on which it wants to build and open a branch office. The bank shows the local zoning board that the office, parking lot, and landscaping will conform to the style of the surrounding properties.

Can Harmony Bank use its land in a residential zone to operate a branch office? Most likely, yes. A fee simple owner can use their property for whatever purpose the owner sees fit. Zoning laws can restrict an owner's ability to use property in certain ways, however. In this situation, the law permits a different use if the property owner shows that it will not harm the immediate neighborhood. The bank shows that its desired use will conform to the style of the surrounding properties.

life estate

An interest in land that exists only for the duration of someone's life.

easement

A nonpossessory right to use another's property.

profit

The right to remove things from another's property.

Duration A fee simple is potentially infinite in duration. The owner can dispose of it by deed or by will (by selling or giving it away). When there is no will, the fee simple passes to the owner's legal heirs. The owner of a fee simple absolute also has the rights of exclusive possession and use of the property.

38–2b Life Estates

A **life estate** is an estate that lasts for the life of a specified individual. For instance, a conveyance “to Alvin Mueller for his life” creates a life estate. The rights of the holder of a life estate—called a life tenant—cease to exist on the life tenant's death.

The life tenant has the right to use the land, provided that they do not use the land in a way that would adversely affect its value. **Example 38.2** Julius, who is a life tenant, can use the land to harvest crops. If mines and oil wells are already on the land, Julius can extract minerals and oil from it. He cannot, however, further exploit the land by creating new wells or mines. ■

With few exceptions, owners of life estates have exclusive rights to possession during their lives. Along with these rights, the life tenant also has some duties—in particular, to keep the property in repair and to pay property taxes.

38–2c Nonpossessory Interests

Some interests in land do not include any rights to possess the property. These interests, known as nonpossessory interests, include easements, profits, and licenses. Easements and profits are similar, and the same rules apply to both.

Easements and Profits An **easement** is the right of a person to make limited use of another person's real property without taking anything from the property. For instance, the right to walk across a neighbor's property is an easement.

In contrast, a **profit** is the right to go onto land owned by another and take away some part of the land itself or some product of the land. **Example 38.3** Akmed owns Sandy View. Akmed gives Kathy the right to go there to remove all the sand and gravel that she needs for her cement business. Kathy has a profit. ■

Creation of an Easement or Profit Most easements and profits are created by an expressed grant in a contract, a deed, or a will. There are three other ways to create them:

1. **Necessity.** An easement by necessity does not require a division of property for its existence. A person who rents an apartment, for instance, has an easement by necessity of the private road leading to the apartment building.
2. **Implication.** An easement or profit may arise by implication when the circumstances surrounding the division of a parcel of property implies its existence. **Example 38.4** Cecilia divides a parcel of land that has only one well for drinking water. If Cecilia conveys the half without a well to Stan, a profit by implication arises because Stan needs drinking water. ■
3. **An Easement of Profit by Prescription.** An easement or profit may rise by prescription when one person uses another person's land without the landowner's consent. The use must be apparent and continue for the length of time required by the applicable statute of limitations. (In much the same way, title to property may be obtained by adverse possession, which is discussed later.)

Real Case



For over 13 years, Charles and Mary Fee used a roadway located on the property of their neighbors Richard and Gale Cheatham. The Fees use this roadway to haul livestock to and from a nearby highway and for deliveries of products, such as feed, fertilizer, and lime. Then Richard told the Fees that the road was now off limits. He erected a gate to block their passage. The Fees filed a lawsuit claiming that they had a right to access the roadway by prescriptive easement. A state statute holds that such an easement is created if the use is “unobstructed, open, peaceable, [and] continuous” without expressed permission of the landowner for at least fifteen years. A trial court ruled in favor of the Cheathams based on what turned out to be its mistaken view that the relevant time period started when the gate was erected.

When did the relevant time period start and what are the implications? In *Fee v. Cheatham*, the Court of Appeals of Kentucky corrected the error. It noted that the Fees had used the roadway for many years before the gate was built. Given Richard’s testimony that he had seen the Fees’ vehicles on the road “every now and then” at least once a year during that entire time, the appeals court found that the Fees had met the statutory requirements for easement by prescription.

—2019 WL 2712604 (Ct. App. KY)

Licenses Like an easement, a **license** involves the right of a person to come onto another person’s land. Additionally, a license is a personal privilege that arises from the landowner’s consent and that can be withdrawn or recalled by the owner.

license

A revocable privilege to enter onto another’s land.

Highlighting the Point



Carlotta buys a ticket to attend a movie at a Cineplex Sixteen theater. When she tries to enter the theater, Glenn, the manager, refuses to admit Carlotta because she is not wearing any shoes. Carlotta argues that she has a ticket, which guarantees her the same right as an owner to come onto the property. Glenn explains that a ticket is a right that he, as the representative of the owner, can take back.

Is Glenn correct? Yes. A movie ticket is only a license, not a conveyance of an interest in property. Ticket holders have no right to force their way into a theater.

38–3 Transfer of Ownership

Ownership interests in real property are most often transferred by sale, and the terms of the transfer are specified in a real estate sales contract. When real property is sold, the details of the transfer normally are set forth in a deed. Real property ownership can also be transferred by will or inheritance, by adverse possession, or by eminent domain.

Learning Outcome 3

Explain how real property ownership is transferred.

deed

A document by which title to property is passed.

warranty deed

A deed under which the grantor provides guarantees to the grantee concerning title.

covenant of quiet enjoyment

A promise not to disturb a buyer's possession of land.

38–3a Deeds

When real property is sold or transferred, title to the property is conveyed by means of a **deed**—the instrument of conveyance of real property. A valid deed must contain the following elements:

1. The names of the buyer (grantee) and seller (grantor).
2. Words indicating an intent to convey (transfer) the property.
3. A legally sufficient description of the land.
4. The grantor's signature.
5. Delivery of the deed.

Warranty Deeds Different types of deeds provide various degrees of protection against defects of title. A defect of title exists, for instance, if an undisclosed third person has an ownership interest in the property.

A **warranty deed** contains the most covenants, or promises, against defects of title and thus provides the greatest protection for the buyer, or grantee. Generally, a warranty deed must include a written promise to protect the buyer against all claims of ownership of the property.

Warranty deeds also commonly include the **covenant of quiet enjoyment**. This covenant guarantees that the buyer will not be disturbed in their possession of the land by the seller or any third persons.



Highlighting the Point

Siaka sells a two-acre lot and office building by warranty deed to the Lynn Company. Subsequently, Perkins shows that he, not Siaka, actually owns the property and proceeds to evict the business. The Lynn Company sues Siaka on the ground that he has breached the covenant of quiet enjoyment.

Will the Lynn Company succeed in its suit? Yes. The covenant of quiet enjoyment has been breached. Thus, the Lynn Company can recover the purchase price of the lot and building, plus any other damages incurred as a result of the eviction.

quitclaim deed

A deed conveying a grantor's interest with no other promises.

Quitclaim Deeds A **quitclaim deed** offers the least amount of protection against defects in the title. Basically, a quitclaim deed conveys to the grantee whatever interest the grantor had. Therefore, if the grantor had no interest, then the grantee receives no interest. Quitclaim deeds are often used when sellers, or grantors, are uncertain as to the extent of their rights in the property.

38–3b Will or Inheritance

Property that is transferred on an owner's death is passed either by will or by state inheritance laws. If the owner of land dies with a will, the owner's property passes in accordance with the terms of the will. If the owner dies without a will, state inheritance statutes prescribe how and to whom the property will pass.

38–3c Adverse Possession

adverse possession

Acquiring real property by openly occupying it without the owner's consent.

Adverse possession is a means of obtaining title to land without delivery of a deed. Essentially, when one person possesses the property of another for a certain period of time, that person—called the adverse possessor—acquires title to the land and cannot be removed from it by the original owner.

For property to be held adversely, four elements must be satisfied:

1. Possession must be actual and exclusive—that is, the adverse possessor must take sole physical occupancy of the property.
2. The possession must be open and visible. It cannot be secret. In short, the adverse possessor must occupy the land for all the world to see.
3. Possession must be continuous and peaceable for the required period of time. The adverse possessor must not have been interrupted in the occupancy by the true owner or by the courts.
4. Possession must be hostile and adverse. In other words, the adverse possessor must claim the property as against everyone else. They cannot be living on the property with the permission of the owner.

38–3d Eminent Domain

The government has an ultimate ownership right in all land. This right, known as **eminent domain**, is sometimes referred to as the condemnation power of the government to take land for public use. It allows the government to acquire possession of real property in the manner directed by the U.S. Constitution and the laws of the state whenever the public interest requires it.

The Taking When the government takes land owned by a private party for public use, it is referred to as a **taking**. The government must compensate the private party. Under the so-called takings clause of the Fifth Amendment to the U.S. Constitution, private property may not be taken for public use without “just compensation.”

Example 38.5 Bosque Systems proposes to build a liquefied natural gas pipeline across the property of more than two hundred landowners in Franklin County, Iowa. Some property owners consent to this use and accept Bosque’s offer of compensation. Others refuse the firm’s offer. A court will likely deem the pipeline to be a public use. Under the Fifth Amendment, the government can “take” the land, provided the Franklin County property owners are justly compensated for the taking. ■

Condemnation The power of eminent domain generally is invoked through condemnation proceedings. For instance, when a new public highway is to be built, the government decides where to build it and how much land to condemn.

Learning Outcome 4

Describe eminent domain.

eminent domain

The government’s power to take private land for public use for just compensation.

taking

The taking of private property by the government for public use and for just compensation.

Chapter Summary—Real Property

Learning Outcome 1: Define real property.

Real property is immovable. It includes land, subsurface and airspace rights, plant life and vegetation, and fixtures.

Learning Outcome 2: Identify common types of real property ownership.

Fee simple absolute is the most complete form of real property ownership. A life estate is an interest that lasts for the life of a specified individual, during which time the individual is entitled to possess, use, and benefit from the estate. The life tenant’s ownership rights in the life estate end on their death. A nonpossessory interest is an interest that involves the right to use real property but not to possess it. Easements, profits, and licenses are nonpossessory interests.

Learning Outcome 3: Explain how real property ownership is transferred.

Real property can be transferred by deed, will or inheritance, adverse possession, and eminent domain.

Learning Outcome 4: Describe eminent domain.

The right of eminent domain allows the government to take private land for public use, with just compensation, when public interest requires the taking.

Straight to the Point

1. What are subsurface rights? (See Learning Outcome 1.)
2. What is a fixture? (See Learning Outcome 1.)
3. Which rights, privileges, and powers are held by an owner in fee simple? (See Learning Outcome 2.)
4. Which interests in land do not include any rights to possess the property? (See Learning Outcome 2.)
5. When real property is sold, how is title to the property conveyed? (See Learning Outcome 3.)
6. For a claim of adverse possession to succeed, what four elements must be satisfied? (See Learning Outcome 3.)
7. How is the power of eminent domain invoked? (See Learning Outcome 3.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Eve and Frank own twenty acres of land. On the land, there is a warehouse surrounded by a fence. What is the most important factor in determining whether the fence is a fixture? (See Learning Outcome 1.)
2. Varney owns an acre of land on Red River. The government dams the river. A lake forms behind the dam, covering Varney's land. Does the government owe Varney anything? If so, what? If not, why? (See Learning Outcome 4.)

Real Law

38–1. Transfer of Ownership—Adverse Possession. Gary and Christina Worden own the Mainstreet Inn, a bed and breakfast, in Parkville, Missouri. A stone wall ran the length of the property behind the inn. A driveway and walkway along the wall were used to access the service entrance to the inn for the delivery of supplies and equipment. The Wordens also maintained the landscaping on their side of the wall. After owning the inn for eleven years, the Wordens sold the business to A2 Creative Group, whose principals, Jason and Kathy Ayers, lived in the inn and had been operating it for the sellers. At the same time, Soheil Anderson, owner of the property on the other side of the stone wall, obtained a survey of her property. The survey revealed that a 400-square-foot tract on the inside of the stone wall was actually Anderson's property. A2 filed a petition against Anderson to establish its title to the tract based on a claim of adverse possession. A2 prevailed at trial. Anderson appealed, claiming that A2 had not proved that its possession was exclusive and continuous. How should an appellate court rule? [*A2 Creative Group, LLC v. Anderson*, 596 S.W.3d 214 (Missouri Ct. App., Western Dist. 2020)] (See Learning Outcome 3.)

38–2. Eminent Domain. In Tarrytown, New York, Citibank operated a branch that included a building and a parking lot with thirty-six spaces. Tarrytown leased twenty-one of the spaces from Citibank for use as public parking. When Citibank closed the branch and decided to sell the building, the public was denied access to the parking lot. After a public hearing, the city concluded that it should exercise its power of eminent domain to acquire the twenty-one spaces to provide public parking. Is this an appropriate use of the power of eminent domain? Suppose that Citibank opposes the plan and alternative sites are available. Should Tarrytown be required to acquire those sites instead of Citibank's property? In any event, what is Tarrytown's next step? Explain. [*Citibank, N.A. v. Village of Tarrytown*, 149 A.D.3d 931 (2 Dept. 2017)] (See Learning Outcome 3.)

38–3. Real Estate Sales Contracts. A California state statute requires sellers to provide a real estate "Transfer Disclosure Statement" (TDS) to buyers of residential property. Required disclosures include information about significant defects, including hazardous materials, encroachments,

easements, fill, settling, flooding, drainage problems, neighborhood noise, damage from natural disasters, and lawsuits. Mark Hartley contracted with Randall Richman to buy Richman's property in Ventura, California. The property included a commercial building and a residential duplex. Richman did not provide a TDS, claiming that it was not

required because the property was "mixed-use." Hartley refused to go through with the deal. Did Hartley breach their contract, or did Richman's failure to provide a TDS excuse Hartley's nonperformance? Discuss. [*Richman v. Hartley*, 224 Cal.App.4th 1182, 169 Cal.Rptr.3d 475 (2 Dist. 2014)] (See Learning Outcome 3.)

Ethical Questions

38-4. Adverse Possession. What public policies might underlie the doctrine of adverse possession? (See Learning Outcome 3.)

38-5. Easements. Class A Investors Post Oak and the Cosmopolitan Condominium Owners Association each owned adjacent pieces of property in Houston, Texas. Each organization planned to build a high-rise tower on its lot. They signed an agreement that granted each of them an easement in the other's property to "facilitate the development." Cosmopolitan built its residential high-rise first. Later, Class A began moving forward with its plan for a mixed-use high-rise. Cosmopolitan—representing its condominium's residents—objected to the proposed tower.

Cosmopolitan complained that Class A's high-rise would "be vastly oversized for its proposed location; situated perilously close to [Cosmopolitan's] building; create extraordinary traffic hazards; impede fire protection and other emergency vehicles in the area, and substantially interfere with the use and enjoyment of [Cosmopolitan's] property." Despite Cosmopolitan's claims, on what basis can Class A proceed with its building plan? On what ethical ground might Cosmopolitan continue to oppose its neighbor's project? Discuss. [*Cosmopolitan Condominium Owners Association v. Class A Investors Post Oak*, 2017 WL 1520448 (Tex. App.—Houston 2017)] (See Learning Outcome 2.)

Chapter 38—Work Set

True-False Questions

- _____ 1. A fee simple absolute is potentially infinite in duration and can be disposed of by deed or by will.
- _____ 2. The owner of a life estate has the same rights as a fee simple owner.
- _____ 3. An easement allows a person to use land and take something from it, but a profit allows a person only to use land.
- _____ 4. Deeds offer different degrees of protection against defects of title.
- _____ 5. The government can take private property for public use without just compensation.
- _____ 6. The government can take private property for private uses only.
- _____ 7. A license is a revocable right of a person to come onto another person's land.
- _____ 8. When real property is sold, the title to the property is conveyed by a deed.

Multiple-Choice Questions

- _____ 1. Lou owns two hundred acres next to Brook's lumber mill. Lou sells to Brook the privilege of removing timber from his land to cut into lumber. The privilege of removing the timber is
 - a. an easement.
 - b. a profit.
 - c. a license.
 - d. none of the above.
- _____ 2. Kwame owns an apartment building in fee simple. Kwame can
 - a. give the building away.
 - b. sell the building for a price or transfer it by a will.
 - c. do both a and b.
 - d. do none of the above.
- _____ 3. Gina conveys her warehouse to Sam under a warranty deed. Later, Hannah appears, holding a better title to the warehouse than Sam's. Hannah proceeds to evict Sam. Sam can recover from Gina
 - a. the purchase price of the property.
 - b. damages from being evicted.
 - c. both a and b.
 - d. none of the above.
- _____ 4. Metro City wants to acquire undeveloped land within the city limits to convert into a public park. Metro City brings a judicial proceeding to obtain title to the land. This is
 - a. adverse possession.
 - b. an easement.
 - c. constructive eviction.
 - d. the power of eminent domain.
- _____ 5. Dan owns a half acre of land that fronts on Blue Lake. Rod owns the property behind Dan's land. No road runs to Dan's land, but Rod's driveway runs between a road and Dan's property, so Dan uses Rod's driveway. The right-of-way that Dan has across Rod's property is
 - a. an easement.
 - b. a profit.
 - c. a license.
 - d. none of the above.

- _____ 6. Dave owns an office building. Dave sells the building to P&I Corporation. To be valid, the deed that conveys the property from Dave to P&I must include a description of the property and
- only Dave's name and P&I's name.
 - only words evidencing Dave's intent to convey.
 - only Dave's signature.
 - words evidencing Dave's intent to convey, Dave's name, P&I's name, and Dave's signature.
- _____ 7. Noemi owns a cabin on Long Lake. Bob takes possession of the cabin without Noemi's permission and puts up a sign that reads "No Trespassing by Order of Bob, the Owner." The statutory period for adverse possession is ten years. Bob is in the cabin for eleven years. Noemi sues to remove Bob. She will
- win because she sued Bob after the statutory period for adverse possession.
 - win because Bob did not have permission to take possession of the cabin.
 - lose because the no-trespassing sign misrepresented ownership of the cabin.
 - lose because Bob acquired the cabin by adverse possession.
- _____ 8. Kaiden sells his house and yard to Jill. When Jill arrives to take possession, she learns that Kaiden has removed the kitchen cabinets from the house and the plastic lawn furniture from the yard. Jill is entitled to the return of
- the lawn furniture only.
 - the cabinets only.
 - the lawn furniture and the cabinets.
 - none of the above.
- _____ 9. Betty owns a farm. On the land are a barn and other farm buildings. Under the surface of the land are valuable minerals. Betty's deed does not indicate any significant limits on her rights to the realty. Betty owns
- only the surface of the land.
 - only the surface of the land and the buildings on it.
 - the surface of the land, the buildings on it, and the minerals beneath the surface.
 - none of the above.

Answering More Legal Problems

1. Cici owned a building in Whitewater Village. She lived in the building and operated Cici's Canyon Wall Flower Shop there. Declan owned the building next door, in which he operated Declan's Sandspit Steak House & Brew Pub. The noise from Sandspit kept Cici awake at night. When the two neighbors were unable to come to an accommodation, Cici filed a suit against Declan.

Was Cici entitled to relief from a neighbor's noise? Yes. Cici is entitled to an injunction to reduce the effect of the operation of Declan's business on Cici's enjoyment of her property. The owner of a fee simple absolute has the greatest aggregation of rights, privileges, and power with respect to the _____. The rights that accompany this ownership include the right to use the land for whatever purpose the owner sees fit. The owner cannot, however, use their property in a way that _____ interferes with others' right to use or enjoy their own property.

2. Sloan operated ChoCo, a gourmet chocolate factory. When the business doubled and then tripled in size, Sloan wanted to expand ChoCo's facilities. To accomplish the

expansion, Sloan needed to buy fifty feet of the adjacent property, which was owned by Corporate Park Holdings, Inc. Sloan made an offer to which Corporate Park agreed, and the parties arranged to exchange Sloan's payment for a deed to the fifty feet.

Would a buyer of real property prefer a warranty deed or a quitclaim deed, and why? A buyer would most likely prefer a _____ deed. Different types of deeds provide different degrees of protection against defects of title. A _____ deed contains the most covenants, or promises, of title and thus provides the greatest protection for the owner. These promises include the covenant of quiet enjoyment, which guarantees that the owner will not be disturbed in their possession of the land by any other persons. Generally, the deed must state a promise to protect the owner against all others' claims of ownership of the property. A _____ deed offers the least amount of protection against defects in title. A _____ deed conveys only whatever interest the grantor had in the property. If the grantor had no interest, no interest is conveyed.

39

Landlord and Tenant Law

Conflict Presented

Zenith Coding signs a one-year lease to occupy an office suite. The lease does not contain a renewal clause. Eleven months and two weeks later, the landlord tells Zenith that the suite has been rented to another company, and Zenith must move out at the end of the month. Zenith argues that the landlord did not give enough notice.

Q Does Zenith have to move out at the end of the month?

A **lease agreement** is a contract by which a real property owner (the landlord) grants someone else (the tenant) an exclusive right to use and possess the property, usually for a specified period of time. In return, the owner receives payment, most often called rent. Rent is the tenant's payment to the landlord for the tenant's occupancy or use of the landlord's real property.

In this chapter, we discuss leased property and landlord–tenant relationships.

39–1 Types of Tenancy

A lease creates a tenancy. In a tenancy, the tenant has a qualified right to exclusive possession of the property. In other words, the tenant's right is qualified by the landlord's right to enter the premises to ensure that no damage is being done. The tenant can use the land—for instance, by harvesting crops—but cannot commit **waste**. In other words, the tenant cannot do anything that damages the property or destroys its value.

Several types of tenancy can be created when real property is leased. They include fixed-term tenancy, periodic tenancy, tenancy at will, and tenancy at sufferance.

39–1a Fixed-Term Tenancy

In a **fixed-term tenancy**, also known as a tenancy for years, property is leased for a specified period of time, such as a month or a year. The tenancy is created by an express contract that specifies the lease period. At the end of the specified period, the lease ends without notice, and possession of the property returns to the landlord. If the tenant dies during the period of the lease, the lease interest passes to the tenant's heirs as personal property. Often, such leases include provisions for renewal or extension.

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Identify different types of tenancies.
- 2 Describe a lease agreement.
- 3 Outline the rights and duties under a lease agreement.
- 4 Discuss the transfer of rights to leased property.
- 5 Explain how a lease usually terminates.

lease agreement

A contract whereby a landlord transfers the right to possession and use of property to a tenant for rent.

Learning Outcome 1

Identify different types of tenancies.

waste

The abuse or destructive use of real property.

fixed-term tenancy

A tenancy for a specified period of time.

periodic tenancy

A tenancy for an indefinite period of time with payment at fixed intervals.

39–1b Periodic Tenancy

A **periodic tenancy** is created by a lease that does not specify how long it is to last but does specify that rent is to be paid at certain intervals, such as weekly, monthly, or yearly. This type of tenancy is automatically renewed for another rental period unless properly terminated. **Example 39.1** Jewell enters into a lease with Capital Properties. The lease states, “Rent is due on the tenth day of every month.” This provision creates a periodic tenancy from month to month. ■ Sometimes, after a fixed-term tenancy ends, a periodic tenancy arises when the landlord allows the tenant to retain possession of the property by continuing to pay weekly or monthly rent.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Zenith Coding signs a one-year lease to occupy an office suite. The lease does not contain a renewal clause. Eleven months and two weeks later, the landlord tells Zenith that the suite has been rented to someone else and the company must move out at the end of the month. Zenith argues that the landlord did not give it enough notice.

A Does Zenith have to move out at the end of the month? Yes. The lease signed by Zenith and the landlord creates a fixed-term tenancy. At the end of the period specified in the lease, the lease ends without notice, and possession of the property returns to the landlord. Although leases often include renewal provisions, this lease did not.

To terminate a periodic tenancy, the landlord or tenant must give at least one period’s notice to the other party. **Example 39.2** If Grecia’s tenancy is month to month, she must give at least one month’s notice to her landlord before moving out. ■

39–1c Tenancy at Will

tenancy at will

A tenancy that either party can terminate without notice.

With a **tenancy at will**, either party can terminate without notice. This type of tenancy can arise if a landlord rents property to a tenant “for as long as both agree” or allows a person to live on the premises without paying rent. Certain events—such as the death of either party or the voluntary commission of waste by the tenant—automatically terminate a tenancy at will.

39–1d Tenancy at Sufferance

tenancy at sufferance

A tenant’s possession of premises after a lease has terminated.

The possession of land without right is a **tenancy at sufferance**. A tenancy at sufferance is not a true tenancy because it is created by a tenant’s wrongfully retaining possession of property. When a fixed-term tenancy or a periodic tenancy ends and the tenant retains possession of the premises without the owner’s permission, a tenancy at sufferance is created.

When a tenant wrongfully retains possession, the landlord is entitled to damages. Typically, the damages are based on the fair market rental value of the premises after the expiration of the lease.

39–2 The Lease Agreement

Learning Outcome 2

Describe a lease agreement.

The lease agreement creates a landlord–tenant relationship. The agreement may be oral or written. An oral lease may be valid, but a party who seeks to enforce an oral lease may have difficulty proving its existence. Furthermore, in most states, some leases must be in writing (such as those for terms exceeding one year).

To ensure the validity of a lease agreement, it should be in writing. In addition, it should do the following:

1. Express an intent to establish the landlord–tenant relationship.
2. Provide for the transfer of the property’s possession to the tenant at the beginning of the term.
3. Provide for the landlord’s future interest, which entitles the landlord to retake possession at the end of the term.
4. Describe the property—such as provide its street address.
5. Indicate the length of the term, the amount of the rent, and how and when the rent is to be paid.

State or local laws often dictate additional lease terms. For instance, a statute or ordinance might prohibit the leasing of a structure that is not in compliance with local building codes. Or a statute might prohibit the leasing of property for a particular purpose—such as a state law that prohibits gambling houses. Thus, if a landlord and a tenant intend to house an illegal betting operation in a leased property in that state, their lease is unenforceable.

39–3 Rights and Duties of Landlords and Tenants

Under a lease agreement, the rights and duties of landlords and tenants generally pertain to the following broad areas of concern: the possession, use, maintenance of leased property, and rent.

Learning Outcome 3

Outline the rights and duties under a lease agreement.

39–3a Possession of the Leased Property

The landlord has a duty to deliver possession of the leased property to the tenant at the beginning of the lease term. The tenant has a corresponding right to obtain possession and retain it until the lease expires.

Covenant of Quiet Enjoyment Under the covenant of quiet enjoyment, the landlord promises that during the lease term, neither the landlord nor any third party with an unlawful claim will interfere with the tenant’s use and enjoyment of the property. This covenant forms the essence of the landlord–tenant relationship. If it is breached, the tenant can terminate the lease and sue for damages.

Eviction When the landlord deprives the tenant of possession of the leased property or interferes with the tenant’s use or enjoyment of it, an **eviction** occurs.

Example 39.3 Enrique is the landlord at Sunrise Meadow Apartments. One day, Enrique changes the locks on Fatima’s apartment door and refuses to give her a new key. Enrique has evicted Fatima from her apartment. ■

eviction

Depriving a lessee of the possession of property.

Constructive Eviction A **constructive eviction** occurs when the landlord wrongfully makes the tenant’s use and enjoyment of the property exceedingly difficult or impossible. **Example 39.4** Peter, the landlord at Rocky Butte Estates in Anchorage, Alaska, fails to fix the central heating system in David’s rental house for months. As a result, David is forced to sleep next to a wood stove in his living room. Once winter arrives, he leaves to stay at his parents’ home. This is a constructive eviction. ■

constructive eviction

Depriving a lessee of the possession of property by rendering the premises unfit for occupancy.

39–3b Use and Maintenance of the Leased Property

If the parties’ agreement does not limit the uses to which the property may be put, the tenant may make any use of it, as long as the use is legal. The use also must reasonably relate to the purpose for which the property is adapted or ordinarily used and must not injure the landlord’s interest.

The tenant is responsible for all damage that they cause intentionally or negligently. The tenant may be held liable for the cost of returning the property to the physical condition it was in when the lease began. Unless the parties have agreed otherwise, the tenant is not responsible for ordinary wear and tear.



Highlighting the Point

BRB Restaurants, Inc., leases property from Dahl Enterprises, Inc. The lease provides for lower payments of rent than normal but requires BRB to return the property in the condition in which BRB received it. On the property, BRB operates a restaurant. When the lease expires, BRB moves off the property, leaving it in a state of disrepair. Dahl replaces the roof, the air-conditioning unit, and the restroom fixtures. Dahl also repaves the parking lot.

Is BRB liable for the cost of these repairs? Yes. Except for ordinary wear and tear, a tenant is responsible for all damage that they cause intentionally or negligently. In addition, BRB and Dahl—parties of “equal bargaining power”—signed a lease in which BRB agreed to pay the cost of returning the property to the physical condition it was in at the beginning of the lease.

Compliance With Ordinances Usually, the landlord must comply with state statutes and city ordinances that identify standards for building construction and maintenance. Typically, these codes contain structural requirements common to the construction, wiring, and plumbing of residential and commercial buildings. In some jurisdictions, landlords of residential property are required by statute to maintain the premises in good repair.

implied warranty of habitability

A presumed promise that a rented residence is fit for human habitation.

Implied Warranty of Habitability The **implied warranty of habitability** requires a landlord who leases residential property to ensure that the premises are habitable—that is, safe and suitable for people to occupy—at the beginning of a lease term and to maintain the premises in that condition for the lease’s duration. Some state legislatures have enacted this warranty into law. In other jurisdictions, courts base the warranty on the existence of a landlord’s statutory duty to keep leased premises in good repair, or they have simply applied it as a matter of public policy.

Example 39.5 Carol and Gary Cooper own a house within the city limits of Redmond. The house does not have a proper sewer system. A Redmond public health regulation requires all residential rental properties to have an approved sewer system before anyone, including tenants, can live in the house. Thus, the Coopers’ house is not legally habitable. ■

Generally, this warranty applies to major—or substantial—physical defects that the landlord knows or should know about and has had a reasonable time to repair. A large hole in the roof, for instance, is a substantial defect.

39–3c Rent for the Leased Property

In return for the tenant’s use of the landlord’s property, the tenant pays rent. Usually, the tenant must pay the rent even if they refuse to occupy the property or move out, as long as the refusal or the move is unjustified and the lease is in force.

Example 39.6 Lifetime Insurance Agency enters into a lease with Mallory for a suite of offices in Mallory’s building. Lifetime’s revenue is less than the company had projected, however, and the rent is now more than it wants to pay. Lifetime vacates the offices before the end of the lease. In terms of the landlord–tenant

relationship, the move is unjustified, and the lease remains in force. Lifetime must continue to pay the rent. ■

The situation is different if the leased premises are destroyed by fire or flood. In such circumstances, most state laws do not require tenants to continue to pay rent. In some situations, such as when a landlord breaches the implied warranty of habitability, a tenant may be allowed to withhold rent as a remedy.

39–3d Commercial Lease Terms

State statutes often allow tenants and landlords more flexibility in negotiating the terms of a commercial lease.

Real Case



Lynwood Place, LLC, owned an office building in Newton, Connecticut. Sandy Hook Hydro, LLC, agreed to lease a part of the building containing a hydroelectric turbine. The lease required Sandy Hook to pay a base annual rent, plus an additional amount of rent equal to 6 percent of any increase in operating expenses incurred by the landlord. When Sandy Hook did not pay the additional rent due under this provision, Lynwood Place filed a suit in a Connecticut state court to take immediate possession of the property.

Should the landlord prevail? Yes. In *Lynwood Place, LLC v. Sandy Hook Hydro, LLC*, an appellate court affirmed the trial court's judgment in the landlord's favor. The court concluded that Sandy Hook had signed the lease, which clearly indicated that the rent was subject to a 6 percent increase for operating expenses. Therefore, even though Sandy Hook occupied only part of the building, the lease gave the landlord the right to increase its rent by that amount.

—92 A.3d 996 (Conn. App.)

39–4 Transferring Rights to Leased Property

Either the landlord or the tenant may wish to transfer their rights to the leased property during the term of the lease. If the landlord sells the leased property, the tenant becomes the tenant of the new owner. The new owner may collect rent and normally must abide by the terms of the existing lease.

Learning Outcome 4

Discuss the transfer of rights to leased property.

39–4a Assignment

The tenant's transfer of their entire interest in the leased property to a third person is an assignment of the lease. Many leases require that the assignment have the landlord's written consent. An assignment that lacks consent can be voided by the landlord, and the assignee can be evicted. A landlord who knowingly accepts rent from the assignee, however, will be held to have waived the consent requirement.

Tenants do not end their liabilities on a lease on assignment because tenants may assign rights but not duties. Thus, even though the assignee of the lease is required to pay rent, the original tenant is still obligated to pay the rent if the assignee fails to do so.

39–4b Sublease

A tenant may also transfer all or part of the premises for a period shorter than the lease term. This arrangement is called a **sublease**. The same restrictions that apply to an assignment of the tenant's interest in leased property apply to a sublease.

sublease

A tenant's transfer of leased premises to a third person for a period shorter than the lease term.

Example 39.7 Derek, a student, leases an apartment for a two-year period. Although Derek had planned on attending summer school, he decides to accept a job offer in Europe for the summer months instead. Derek obtains his landlord's consent to sublease the apartment to Ava. Ava is bound by the same terms of the lease as Derek, and the landlord can hold Derek liable if Ava violates the lease terms. ■

39–5 Terminating the Lease

Learning Outcome 5

Explain how a lease usually terminates.

Usually, a lease terminates when its term ends. The tenant surrenders the property to the landlord, who retakes possession. If the lease states the time it will end, the landlord is not required to give the tenant notice. The lease terminates automatically. In contrast, a periodic tenancy renews automatically unless one of the parties gives timely notice of termination (usually one rental period).

Once the lease terminates, the tenant has no right to remain unless the parties have agreed that the tenant will stay on. If the lease is renewable and the tenant decides to exercise the option, the tenant must comply with any conditions requiring notice to the landlord.

Suppose that a tenant abandons the premises—that is, moves out completely with no intention of returning before the lease expires. In this situation, the tenant, in most states, may remain obligated to pay the rent for the remainder of the term. The landlord, however, may be required to mitigate the tenant's damages, which means that the landlord must make a reasonable attempt to lease the property to another party.



Highlighting the Point

Artisan Creations, a jewelry store, leases space in Butte Falls Mall from Coral Commercial Properties. The lease has a term of three years. Two years into the lease, Artisan Creations vacates the mall premises and moves to another location. Soon after, Coral Commercial seeks a new tenant for the empty space. Three months later, Gable Gold & Coin agrees to move into Artisan Creations' former space.

Is Artisan Creations obligated to pay its former landlord, Coral Commercial, any remaining rent? Yes. Artisan Creations owes Coral Commercial rent for the time between when it left the space and when Gable Gold & Coin took possession of it. Thus, Artisan Creations owes Coral Commercial three months' rent.

If a tenant terminates a fixed-term tenancy before the end of the term, such as a one-year lease, then the tenant has breached the lease contract. Exceptions to this would be if the landlord wrongfully evicted the tenant or rendered the premises uninhabitable.

Chapter Summary—Landlord and Tenant Law

Learning Outcome 1: Identify different types of tenancies.

Types of tenancies include:

- (1) Fixed-term tenancy—A tenancy for a period of time stated by an express contract.
- (2) Periodic tenancy—A tenancy for a period determined by the frequency of rent payments. It is automatically renewed unless proper notice is given.

- (3) Tenancy at will—A tenancy for as long as both parties agree. No notice of termination is required.
- (4) Tenancy at sufferance—Possession of land without legal right.

Learning Outcome 2: Describe a lease agreement.

A lease agreement creates the landlord–tenant relationship. The agreement may be oral or written, but to ensure its validity, it should be in writing. It should express an intent to establish a landlord–tenant relationship, provide for transfer of possession to the tenant, provide for the landlord’s future interest, describe the property, and indicate the term of the lease and the rent. State or local laws may dictate additional lease terms.

Learning Outcome 3: Outline the rights and duties under a lease agreement.

The rights and duties that arise under a lease agreement generally pertain to the possession, use, and maintenance of the leased property, and rent.

Learning Outcome 4: Discuss the transfer of rights to leased property.

If the landlord transfers complete title to the leased property, the tenant becomes the tenant of the new owner. The new owner may then collect the rent but must abide by the existing lease. Generally, in the absence of an agreement to the contrary, tenants may assign their rights (but not their duties) under a lease contract to a third person. Tenants may sublease leased property to a third person, but the original tenant is not relieved of any obligations to the landlord under the lease. In either situation, the landlord’s consent may be required.

Learning Outcome 5: Explain how a lease usually terminates.

Usually, a lease terminates when its term ends. The tenant surrenders the property to the landlord, who retakes possession. If the lease states the time it will end, the landlord is not required to give the tenant notice. The lease terminates automatically.

Straight to the Point

1. What distinguishes a fixed-term tenancy from a periodic tenancy? (See Learning Outcome 1.)
2. When a tenant wrongfully retains possession of property, what is the landlord entitled to? (See Learning Outcome 1.)
3. What is the basis for a landlord–tenant relationship? (See Learning Outcome 2.)
4. What does the warranty of habitability require a landlord to do? (See Learning Outcome 3.)
5. On an assignment of a lease, who is obligated to pay the rent? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Fetia leases an office in Ted’s building for a one-year term. At the end of the period specified in the lease, the lease ends without notice, and possession of the office returns to Ted. If Fetia dies during the period of the lease, what happens to the leased property? (See Learning Outcome 1.)
2. Eve orally agrees to rent an apartment to Nancy for a six-month term. Is this lease enforceable if it is not in writing? (See Learning Outcome 2.)

Real Law

39–1. Rights and Duties of Landlords and Tenants. Constellation-F, LLC, leased warehouse space to World Trading 23, Inc., a retailer of drones and remote-controlled toys. By the terms of the agreement, World Trading’s rent would increase by 150 percent if it still occupied the warehouse after the lease expired. When World Trading overstayed its lease by more than two months, Constellation sued to recover the holdover rent at the higher rate. At trial, the court ruled in favor of World Trading after determining that the holdover rent was too high and therefore, under California law, an unenforceable penalty for breach of contract. What should a state appeals court decide? [*Constellation-F, LLC v. World Trading 23, Inc.*, 45 Cal.App. 5th 22 - Cal (Ct. App. 2nd Dist. Div. Eight 2020)] (See Learning Outcome 3.)

39–2. Maintenance of the Leased Property. Ocean Prime, LLC, owns buildings at 1 West Street and 17 Battery Park Place in New York City in an area known to be vulnerable to flooding. The buildings include nearly five hundred residential apartments and fifteen floors of commercial space. During Superstorm Sandy, water flooded the buildings’ basements and garages, damaging mechanical and electrical systems. Heating oil that had been delivered a few days earlier was released into the water. The damage and the fumes made the

premises uninhabitable for a month for residential tenants and longer for commercial tenants. The tenants filed a suit in a New York state court against the landlord. They alleged that the landlord had been negligent in failing to protect the property from flooding and had breached the warranty of habitability. Do these circumstances indicate a violation of the landlord’s duty to maintain the premises? What are the tenants’ options? Discuss. [*Roberts v. Ocean Prime, LLC*, 148 A.D.3d 525 (1 Dept. 2017)] (See Learning Outcome 3.)

39–3. Rent. Flawlace, LLC, leased unfinished commercial real estate in Las Vegas, Nevada, from Francis Lin to operate a beauty salon. The lease required Flawlace to obtain a “certificate of occupancy” from the city to commence business. This required the installation of a fire protection system. The lease did not allocate responsibility for the installation to either party. Lin voluntarily undertook to install the system. After a month of delays, Flawlace moved out. Three months later, the installation was complete, and Lin leased the premises to a new tenant. Did Flawlace owe rent for the three months between the time that it moved out and the new tenant moved in? Explain. [*Tri-Lin Holdings, LLC v. Flawlace, LLC*, 130 Nev. 1256 (Nev. 2014)] (See Learning Outcome 3.)

Ethical Questions

39–4. Maintenance of the Leased Property. What is a landlord’s ethical duty with respect to keeping rental premises “fit for human habitation”? (See Learning Outcome 3.)

39–5. Maintenance of the Leased Property. F.A. Investment Group, Inc., owned an apartment building in Philadelphia, Pennsylvania. Over a two-year period, the city cited F.A. Investment for a variety of housing code violations. These violations included failure to maintain regular electrical service, a nonfunctioning fire-detection system, inappropriate emergency lighting, and insufficient heat. Concluding that

the violations presented a danger to human life, the city closed the building and relocated the tenants. F.A. Investment did not try to correct the violations or contact the city. It also simply stopped paying property taxes on the building. Consequently, the city demolished the building and sold the property for failure to pay taxes. What do F.A. Investment’s actions suggest about its corporate ethics? How might the property have been managed to avoid this situation? Explain. [*F.A. Investment Group, Inc. v. City of Philadelphia*, 2017 WL 1739714 (Pa.Cmwlth. 2017)] (See Learning Outcome 3.)

Chapter 39—Work Set

True-False Questions

- _____ 1. A covenant of quiet enjoyment guarantees that a tenant will not be disturbed in their possession of leased property by the landlord or any third person.
- _____ 2. If the covenant of quiet enjoyment is breached, the tenant can sue the landlord for damages.
- _____ 3. Generally, a tenant must pay rent even if they move out, if the move is unjustified.
- _____ 4. A constructive eviction occurs when the landlord wrongfully makes the tenant's use and enjoyment of the property exceedingly difficult or impossible.
- _____ 5. A fixed-term tenancy is a lease for a specified period of time.
- _____ 6. When a landlord sells leased premises to a third party, any existing leases terminate automatically.
- _____ 7. When a tenant assigns a lease to a third party, the tenant's obligations under the lease terminate automatically.
- _____ 8. A landlord who leases residential property must deliver the premises in a condition that is safe and suitable for human habitation.

Multiple-Choice Questions

- _____ 1. Reuben leases an apartment from Maria. With Maria's consent, Reuben assigns the lease to Nell for the last two months of the term, after which Nell exercises an option under the original lease to renew for three months. One month later, Nell moves out. Regarding the rent for the rest of the term,
 - a. no one is liable.
 - b. Reuben can be held liable.
 - c. only Nell is liable.
 - d. Maria is liable.
- _____ 2. Paul rents an office from Diego for an eighteen-month term. Their lease
 - a. must be oral to be enforceable.
 - b. must be in writing to be enforceable.
 - c. is enforceable whether or not it is in writing.
 - d. is not enforceable whether or not it is in writing.
- _____ 3. Sahil signs a one-year lease for an apartment. Kim is the landlord. Six months later, Sahil moves out of the apartment leaving it in a state of extreme disrepair, including ripped-up flooring and holes in the walls. Sahil will be
 - a. liable for the cost of returning the apartment to its original condition.
 - b. able to sue Kim for damages.
 - c. given a constructive eviction by Kim.
 - d. none of the above.
- _____ 4. Andrei rents an apartment from Sue. Two months later, Andrei moves out and arranges with Lee for Lee to move in and pay the rent to Sue for the rest of the term. This is
 - a. an assignment.
 - b. a sublease.
 - c. both a and b.
 - d. none of the above.

- _____ 5. Ray operates the Apple Spice Restaurant in space that he leases in Village Mall. Village Mall is owned by VM Associates. VM Associates sells the mall to BB Properties. For the rest of the lease term, Ray owes rent to
- VM Associates.
 - BB Properties.
 - the Apple Spice Restaurant.
 - none of the above.
- _____ 6. Natasha signs a lease for an apartment, agreeing to make rental payments before the fifth of each month. The lease does not specify a termination date. This tenancy is
- a periodic tenancy.
 - a fixed-term tenancy.
 - a tenancy at will.
 - a tenancy at sufferance.
- _____ 7. Max leases a house from Nina for a two-year term. To ensure the validity of the lease, it should include
- a description of the property.
 - a due date for the payment of the property taxes.
 - a requirement that Nina carry liability insurance.
 - none of these choices.

Answering More Legal Problems

1. Jasper leases commercial space from Retro Enterprises for a three-year term. In the space, Jasper opens Suite Potato, a restaurant. The building's plumbing is defective, and six months into the term, a pipe connected to the upstairs restroom bursts, spewing sewage into the kitchen. Jasper is forced to close and does not pay rent for the remainder of the lease.

Can Jasper recover damages from Retro? Yes. The covenant of _____ applies to leased premises. Under this covenant, the landlord promises that during the lease term, the landlord will not interfere with the tenant's _____ and _____ of the property. If this covenant is breached, the tenant can terminate the lease and sue for damages. A landlord must comply with state and city codes that specify standards for structural requirements, such as plumbing. Here, it can be assumed that Retro did not comply with the codes. This failure interfered with Jasper's _____ and _____ of the premises.

2. McKenna leases ten thousand square feet of space in Midtown Lofts to Home Gallery, an interior design firm,

for a five-year term. Less than two years into the term, Home Gallery ceases doing business. Without McKenna's consent, Home Gallery assigns its lease to Cloud Cover, a small server farm. Cloud Cover pays rent to McKenna, who accepts it. With eight months left in the original lease term, Cloud Cover abandons the premises. Before the term expires, McKenna unsuccessfully attempts to re-lease the premises.

Can McKenna recover the unpaid rent from Home Gallery? Yes. The tenant's transfer of the entire interest in the leased property to a third party is an assignment of the lease. Many leases require that an assignment have the landlord's _____, and without it, the assignment can be _____. But a landlord who knowingly accepts rent from the assignee will be held to have waived the requirement. A tenant's _____ on a lease do not end on an assignment. If the assignee fails to pay the rent, the _____ is required to pay it. In some jurisdictions, the landlord is required to mitigate the damages on a tenant's abandonment of the leased premises. McKenna made the attempt, but it proved to be unsuccessful.



40 | Wills and Trusts

Conflict Presented

Fran's will provides that \$100,000, which is one-tenth of her estate, is to be divided among a group of local charities. These charities include a food bank, a homeless shelter, a refuge for victims of domestic abuse, and an animal-rescue facility. The charities are listed in a written memorandum that Fran gives to her lawyer on the same day the will is signed.

Q Is this list a valid part of Fran's will?

After someone dies, all of the real and personal property they owned will be transferred to others. In this chapter, we examine how property is passed on the death of its owner. Our laws require that on death, the rights to ownership of all of the property of the decedent (the one who has died) must be transferred somewhere. This transfer can be done (1) through a decedent's will, (2) through state laws prescribing distribution of property among heirs, or (3) through various types of trusts.

40-1 Wills

A **will** is the final declaration of how a person wishes to have their property disposed of after death. A will is a formal instrument that must follow exactly the requirements of state law to be effective. The reasoning behind such a strict requirement is obvious. A will becomes effective only after death. No attempts to modify it after death are allowed because the court cannot ask the decedent to confirm the attempted changes.

40-1a Terminology of a Will

A person who makes a will is known as a **testator**. After the testator dies, their will is subject to probate. To probate a will means to establish its validity and to carry the administration of the estate through a court process. The court that oversees this process is a **probate court**.

A personal representative of the decedent's estate often becomes involved in probate. The personal representative settles the affairs of the deceased, such as collecting and taking inventory of the deceased's assets, getting appraisals, and sorting out creditor claims. A personal representative should be familiar with the testator's business and family. Thus, when matters arise during probate, they will have the testator's wishes and intent in mind.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Outline the requirements of a will.
- 2 Discuss how to revoke or modify a will.
- 3 Describe intestate distribution of property.
- 4 List the elements of a trust.

will

An instrument made by a person directing what is to be done with their property after death.

testator

One who makes and executes a will.

probate court

A court having jurisdiction over the settlement of a person's estate.

executor

A person appointed by a testator to administer a will.

administrator

A person appointed by a court to dispose of an estate.

devise

A gift of real property by a will.

legacy

A gift of personal property by a will.

devisee

A person who inherits real property under a will.

legatee

A person who inherits personal property under a will.

An **executor** is a personal representative named in a will. An **administrator** is a personal representative appointed by a court for a decedent who dies without a will. An administrator may also be named when a decedent (1) fails to name an executor in the will, (2) names an executor lacking the capacity to serve, or (3) writes a will that the court refuses to accept.

A gift of real estate by will is generally called a **devise**. A gift of personal property by will is called a **legacy** or a bequest. The recipient of a gift by will is a **devisee** or a **legatee**, depending on whether the gift was a devise or a legacy.

40–1b Types of Gifts

Gifts by will can be specific, general, or residuary. A specific devise or legacy describes property that can be distinguished from all the rest of the testator's estate. For instance, a specific devise may consist of a particular piece of real estate.

A general devise or bequest (legacy) does not single out any particular item of property to be transferred by will. Instead, it usually specifies the property's value in monetary terms (such as “two diamonds worth \$10,000” or “an acre of land worth \$50,000”) or simply states a sum of cash.

Sometimes, a will provides that any assets remaining after gifts are made and debts are paid are to be distributed through a residuary clause. This clause is necessary when the exact amount to be distributed cannot be determined until all other gifts and payouts are made.

40–1c Requirements of a Valid Will

A will must comply with certain formalities to ensure that testators understood their actions at the time the will was made. These formalities are intended to help prevent fraud. For a valid will, most states require proof of the following:

1. The testator's capacity.
2. The testator's intent.
3. A written document.
4. The testator's signature.
5. The signatures of persons who witnessed the testator sign the will.

Testamentary Capacity The testator must have capacity. In other words, the testator must be of legal age and sound mind at the time the will is made. In most states, the minimum age is eighteen years. The “sound mind” requirement refers to the testator's ability to formulate and understand a personal plan for the disposition of property. Further, testators must intend the document to be their will, comprehend the kind and character of the property being distributed, and remember the names of family and friends.

Testamentary Intent A valid will represents the testator's intention to transfer and distribute their property. Generally, testators must be able to do the following:

- Know the nature of the act (of making a will).
- Comprehend and remember the “natural objects of their bounty” (usually, family members and persons for whom the testators have affection).
- Know the nature and extent of their property.
- Understand the distribution of assets called for by the will.

When it can be shown that the decedent's plan of distribution was the result of fraud or undue influence, the will is declared invalid. If the testator ignored blood

Learning Outcome 1

Outline the requirements of a will.

relatives and named as a beneficiary a nonrelative who was in constant close contact with the testator, for instance, a court might infer undue influence.

There is no requirement that testators give their estate to blood relatives. A testator may decide to disinherit, or leave nothing to, a certain relative or individual for various reasons. Most states have laws that attempt to prevent accidental disinheritance, however. Therefore, testators' intent to disinherit needs to be made clear in their wills for them to be upheld in court should a dispute arise.

Writing Requirements A will must be in writing. The writing can be informal.

Example 40.1 Earl writes out his will on a scrap of paper before going into emergency surgery. ■ A will that is completely in the handwriting of the testator is a **holographic will**. A will can also refer to a written memorandum that itself is not in the will but that contains information necessary to carry out the will and is in existence when the will is signed. **Example 40.2** Dallas executes a will that contains a bequest to Ewan. The bequest states that Ewan should receive “the items on Ewan’s List, which is located in my safety deposit box at Fidelity Bank.” ■

holographic will

A will entirely in the testator’s handwriting.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Fran’s will provides that a certain sum of money is to be divided among a group of charities named in a written memorandum that Fran gives to her lawyer on the same day her will is signed.

A **Is this list a valid part of Fran’s will?** Yes. The written list of charities will be “incorporated by reference” into the will. It is in existence when the will is signed, and it is sufficiently described in the will so that it can be identified.

Signature Requirements A formal, nonholographic (not handwritten) will must be signed by the testator. The testator’s signature must appear in the will, generally at the end. Each jurisdiction dictates by statute and court decision what constitutes a signature. **Example 40.3** Malcolm Enders signs his will with his initials, “ME.” If he intended this to be his signature, it likely will be upheld as valid. ■

Witness Requirements A formal, nonholographic (not handwritten) will normally must be witnessed. A will must be attested (affirmed to be genuine) by two, and sometimes three, witnesses. The number of witnesses, their qualifications, and the manner in which the witnessing must be done are generally set out in a statute. Some states require a witness to be disinterested—that is, not a beneficiary under the will. There are no age requirements. Witnesses must be mentally competent, however.

40–1d Transfer of Digital Assets Upon Death

At any one time, you have a growing list of digital assets. You may have accounts with Facebook, Instagram, Twitter, and other social media companies. You may have several e-mail accounts. As time goes on, this list will become longer for just about everyone in the world. You also have personal files with videos, audio, and photos.

Passwords Galore Most of your files are password protected. If you want your loved ones to gain access to these files upon your death, they have to be provided with those passwords. Before you can do that, you have to take an inventory of all of your digital assets. Unless you take stock of what you have, it is going to be hard to think about what you want to happen should you die. Think of big categories, such as:

1. Personal files and local storage
2. Personal files in the Cloud
3. Videos
4. Photos
5. Documents
6. E-mail accounts
7. Social media accounts
8. Financial accounts, including bank accounts and even PayPal

Add a Digital Executor to Your Will If you have not made a will, it is easy to add a digital executor. If you already have a will, you need to add a codicil, which is a written document apart from the will. Your digital executor can identify, manage, and distribute your digital property. You can give your digital executor the powers to access your online accounts.

Note that in some states, your existing executor may already have this ability even without a direct statement in the will. Normally, individuals name their spouses or one of their children as a digital executor.

Adding Digital Heirs to Your Accounts Some social media companies, such as Facebook, allow you to assign and add a legacy contact. If you die, Facebook will allow this person to take some actions on your account. The digital heir might be able to download a copy of what you have shared on Facebook, thereby memorializing your profile so others know you have passed.

Use a Password Manager The easiest way to pass on passwords to your digital heirs or your digital executor is to use a password management system, such as Dashlane. You can set up emergency access and designate an emergency contact.

40–1e Revocation of a Will

Learning Outcome 2

Discuss how to revoke or modify a will.

The testators can revoke executed wills at any time during their lives, either by a physical act or by a subsequent writing. Wills can also be revoked when a marriage, a divorce, or the birth of a child takes place after a will has been made. Revocation can be partial or complete.

Revocation by a Physical Act of the Testator Revocation of a will can be effected by a physical act of the testator. These acts include intentionally burning it; intentionally tearing, canceling, or destroying it; or having someone else perform such an act in the presence of the testator and at the testator's direction.



Highlighting the Point

Heidi executes a will that includes gifts to her older brother and sister, Norbert and Opal. Shortly before Heidi's death, she asks her friend Pauline to tear up the will, which Pauline does. After Heidi's death, Norbert and Opal seek to admit an unsigned copy of

the will to a probate court. Pauline testifies that she destroyed the original will according to Heidi's instructions.

Is Heidi's will effectively revoked? Yes. A testator can revoke a will by having someone else tear it up.

In some states, partial revocation by physical act is recognized. Thus, those portions of a will crossed out or torn away are dropped, and the remaining parts of the will are valid. In no case, however, can a provision be crossed out and an additional or substitute provision written in. To add new provisions, the testator and witnesses must sign the will again.

Revocation by a Subsequent Writing A will may be wholly or partially revoked by a **codicil**, a written instrument separate from the will. The codicil must be executed with the same formalities required for a will, and it must refer expressly to the will.

codicil

A formal written supplement or modification to a will.

A second will, or new will, may revoke a prior will. The second will must use specific language, such as "This will hereby revokes all prior wills." If such an express declaration of revocation is missing, then both wills are read together. If any of the dispositions made in the second will are inconsistent with the first will, the second will controls.

Revocation by Marriage In most states, when a testator marries after making a will that does not include the new spouse, the spouse receives the amount that would have been taken had the testator died without a valid will. The rest of the estate is then distributed according to the terms of the will. In most states, the surviving spouse receives the entire estate if the couple had no children.

Example 40.4 Keyari is not married and has no children. She executes a will, disposing of her estate to "my brother and sister, Henry and Liliana." Later, Keyari marries Jason. They have no children. Keyari does not execute a new will before she dies. On her death, Jason is entitled to receive her entire estate. ■

If, however, the testator intentionally omitted the future spouse from the existing will or otherwise provided for the spouse in the will (or through a transfer of property outside the will), the omitted spouse will not receive a share.

Revocation by Divorce Divorce does not necessarily revoke an entire will. A divorce occurring after a will has been written revokes dispositions of property made under the will to the former spouse.

Example 40.5 Masego executes a will, leaving her estate to "my husband, Donald, but if he should predecease me, then to our children, Evan and Faye, in equal shares." Later, Masego and Donald divorce. Masego dies without executing a new will. The divorce revokes the disposition of Masego's property to Donald. Her entire estate descends to Evan and Faye. ■

Revocation by Children If a child is born after a will has been executed and if it appears that the testator would have made a provision for the child, then the child is entitled to receive whatever portion of the estate allowed under state intestacy laws. Most states allow a child to receive some portion of the estate if no provision is made in a will, unless it appears from the terms of the will that the testator intended that the child receive nothing.

Example 40.6 Xavier executes a will, providing that "if my wife, Jayla, should predecease me, my estate is to descend to my children, Teresa and David, in equal shares." Later, Xavier's third child, Alexia, is born. Jayla predeceases Xavier, who subsequently dies without executing a new will. Because it appears from the language of the will that Xavier would have provided for a share of his estate to descend to Alexia, she normally is entitled to a portion of the estate. ■

Learning Outcome 3

Describe intestate distribution of property.

intestate

As a noun, one who has died without a valid will. As an adjective, without a will.

intestacy laws

State laws determining the distribution of the property of one who dies intestate.

40–2 Intestacy Laws

Statutes of descent and distribution regulate how property is distributed when a person dies **intestate**—that is, without a will. These statutes—called **intestacy laws**—attempt to carry out the likely intent and wishes of the decedent.

40–2a Order of Distribution

Intestacy laws specify the order in which the heirs of an intestate share in the estate. First, the debts of the decedent must be paid out of the estate. Then the remaining assets pass to the surviving spouse and to the decedent's children. When there is no surviving spouse or child, then grandchildren, brothers and sisters, and, in some states, parents of the decedent are next in line. These relatives are usually called lineal heirs. If there are no lineal heirs, then collateral heirs—nieces, nephews, aunts, and uncles of the decedent—make up the next group.

If the decedent has no surviving relatives in these groups, most statutes provide that the property will be distributed among the next of kin of any collateral heirs. Stepchildren are not considered kin. Legally adopted children, however, are recognized as lawful heirs of their adoptive parents. If no heirs exist, then the property reverts to the state—that is, the state assumes ownership of the property.

40–2b Surviving Spouse and Children

A surviving spouse usually receives only a share of the estate—one-half, if there is also a surviving child, and one-third, if there are two or more children. A surviving spouse receives the decedent's entire estate only if there are no surviving children or grandchildren.



Highlighting the Point

Mario dies intestate and is survived by his wife, Delia, and his children, Francisco and Tara. Mario's property passes according to intestacy laws.

Do Delia and the children receive any of Mario's property? Yes. After Mario's outstanding debts are paid, Delia will receive the homestead and usually one-third of all other property. The remaining real and personal property will pass to Francisco and Tara in equal portions.

40–2c Grandchildren

When an intestate is survived by descendants of deceased children—that is, grandchildren of the intestate, there are two methods of dividing the intestate's assets: the *per stirpes* method and the *per capita* method.

per stirpes

A method of distributing an intestate's estate in which a group take the share to which their deceased ancestor would have been entitled.

per capita

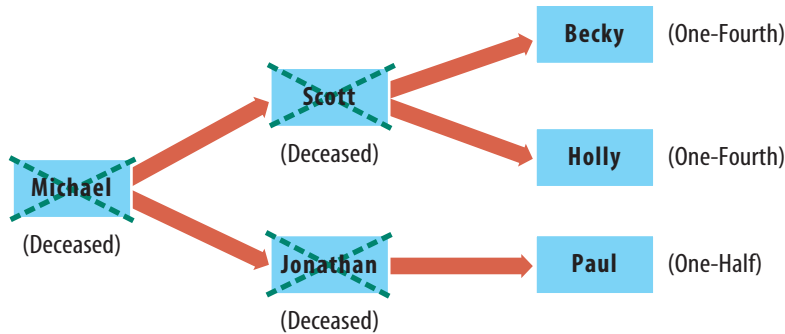
A method of distributing the property of an intestate's estate by which all the heirs receive equal shares.

Per Stirpes Distribution Under the **per stirpes** method, an heir in a class or group of distributees (such as grandchildren) takes the share that the deceased parent would have inherited had that parent lived. Thus, a grandchild with no siblings inherits all of the parent's share, while grandchildren with siblings divide their parent's share. (See Exhibit 40.1.)

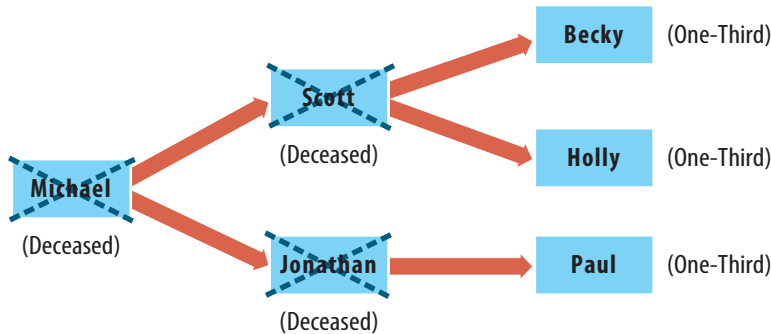
Per Capita Distribution An estate may also be distributed on a **per capita** basis, which means that each person in a class or group takes an equal share of the estate. For instance, if a grandfather's estate is distributed *per capita* to three grandchildren,

Exhibit 40.1 *Per Stirpes* Distribution

Under the *per stirpes* method of distribution, an heir takes the share that the deceased parent would have been entitled to inherit, had the parent lived. This may mean that a class of distributees—the grandchildren in this exhibit—will not inherit in equal portions. Note that Becky and Holly receive only one-fourth of Michael's estate while Paul inherits one-half.

**Exhibit 40.2** *Per Capita* Distribution

Under the *per capita* method of distribution, all heirs in a certain class—in this exhibit, the grandchildren—inheritor equally. Note that Becky and Holly in this situation each inherit one-third, as does Paul.



each grandchild will receive a one-third share of the estate. Exhibit 40.2 illustrates the *per capita* method of distribution.

40–3 Trusts

A **trust** is any arrangement through which property is transferred from one person to a trustee to be administered for the first person's or another party's benefit. A trust can also be defined as a right or property held by one party for the benefit of another. A trust can be express or implied.

The essential elements of a trust are as follows:

1. A designated beneficiary.
2. A designated trustee.
3. A fund sufficiently identified to enable title to pass to the trustee.
4. Actual delivery by the settlor or grantor (the person who creates the trust) to the trustee with the intention of passing title.

Learning Outcome 4

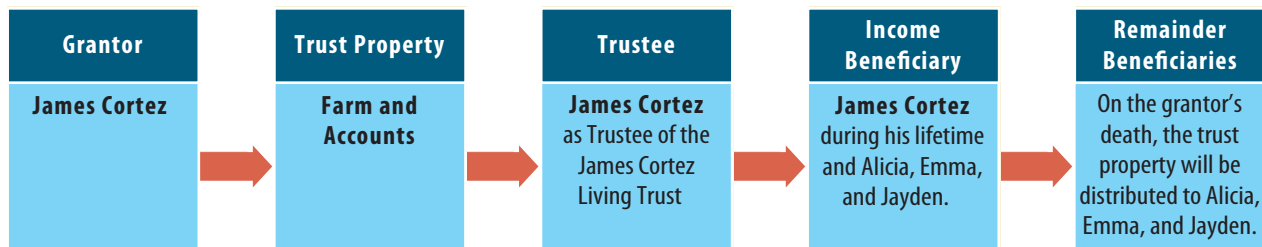
List the elements of a trust.

trust

An arrangement to administer property for the benefit of another.

40–3a Express Trusts

An express trust is created or declared in definite terms, usually in writing. Here, we discuss two types of express trusts: living trusts and testamentary trusts.

Exhibit 40.3 A Revocable Living Trust Arrangement**living trust**

A trust created by and effective during the grantor's lifetime.

Living Trusts A **living trust** is created by a grantor to be effective during the grantor's lifetime. At the grantor's death, assets held in a living trust can pass to the heirs without going through probate.

In revocable living trusts, grantors retain control over the trust property during their lifetimes. The grantor deeds the property to the trust but retains the power to amend, alter, or revoke the trust. The grantor may also serve as a trustee or co-trustee and can arrange to receive income earned by the trust assets. Unless the trust is revoked, the principal of the trust is transferred to the trust beneficiaries on the grantor's death.

Example 40.7 James Cortez owns a large farm. After his wife dies, James decides to create a living trust for the benefit of his three children, Alicia, Emma, and Jayden. He executes a deed conveying the farm to the trust. The trust designates James as the trustee. James and each of the children will receive income from the trust while James is alive. When James dies, the farm will pass to them without having to go through probate. By holding the property in a revocable living trust, James retains control over the farm during his life. This trust arrangement is illustrated in Exhibit 40.3. ■

In contrast, in an irrevocable living trust, the grantor permanently gives up control over the property to the trustee. The grantor executes a trust deed, and legal title to the trust property passes to the named trustee. The trustee has a duty to administer the property as directed by the grantor for the benefit and in the interest of the beneficiaries.

testamentary trust

A trust that is created by a will.

Testamentary Trusts A **testamentary trust** is created by a will and comes into existence on the settlor's death. After the death, a trustee takes title to the trust property, but their actions are subject to judicial approval. The responsibilities of this trustee are the same as those of the trustee of a living trust. The trustee of a testamentary trust can be named in the will or be appointed by the court.

If the will setting up a testamentary trust is invalid, then the trust will also be invalid. The property that was supposed to be in the trust will then pass according to intestacy laws.

40–3b Implied Trusts

Sometimes, a trust is imposed by law in the absence of an express trust. Customarily, these implied trusts are of two types: constructive trusts and resulting trusts.

constructive trust

A trust that is imposed by a court to promote fairness.

Constructive Trusts A **constructive trust** is imposed by a court in the interests of fairness and justice. In a constructive trust, the owner of the property is declared to be a trustee for the parties who are, in equity, entitled to the benefits that flow from the property. If someone wrongfully holds legal title to property—because the property was obtained through fraud, for instance—a court may impose a constructive trust. Courts often impose constructive trusts when someone who is in a fiduciary relationship with another person, such as a guardian of a ward, has breached a duty to that person.



Real Case

When Yvonne Ryan died, her daughter Ruby Revell—as a beneficiary of a trust set up by Ryan’s mother—was entitled to 50 percent of the trust’s assets. Revell was unaware that the trust existed. The same could not be said for Bret Lovett, who was working for Revell on an unrelated matter. Without telling her why, Lovett had Revell initial an “Agreement” under which he would receive 85 percent of the value of any real property “left behind” by her mother that he was able to recover for Revell. Revell later fired Lovett, but he continued to misrepresent himself as Revell’s attorney. Without Revell’s knowledge, Lovett convinced the trustee to sell property controlled by the trust. He then conspired to place the proceeds from the sale—Revell’s inheritance—in an escrow account from which he paid himself 85 percent, or about \$96,000.

Should a court void the escrow account and if so, what should it do? Yes. In *Revell v. Burlison Law Group*, a California appellate court affirmed the trial court’s decision that voided the escrow account. The appellate court agreed that Lovett had been holding the proceeds from the sale of the property in a constructive trust for Revell’s benefit.

—2020 WL 1227140 (Ct. App. 2d Dist. Cal.)

Resulting Trusts A **resulting trust** arises from the conduct of the parties, indicating an apparent intention to create a trust. When circumstances raise an inference that the party holding legal title to the property does so for the benefit of another, a trust is created.

resulting trust

A trust implied in law.

Example 40.8 Indira wants to sell one acre of land she owns. Because she is going out of the country for two years, she transfers the property to her friend Oswald. Oswald will attempt to sell the property while Indira is gone. The property will be held in trust (a resulting trust) by Oswald for Indira’s benefit. On her return, Oswald will be required either to deed the property back to Indira or, if the property has been sold, to turn over the proceeds. ■

Chapter Summary—Wills and Trusts

Learning Outcome 1: Outline the requirements of a will.

The requirements of a will include the following:

- (1) The testator must have capacity—that is, be of legal age and sound mind at the time the will is made.
- (2) A will must represent the testator’s intention to transfer and distribute property owned by the testator.
- (3) A will must be in writing.
- (4) A will must be signed by the testator.
- (5) A will must be witnessed in the manner prescribed by state statute.

Learning Outcome 2: Discuss how to revoke or modify a will.

A testator can revoke or modify a will through a physical act, such as intentionally burning or tearing up all (or part) of the will. A testator can also revoke or modify a will through a subsequent writing, such as a codicil or a new will. Revocation can also occur when a marriage, a divorce, or the birth of a child takes place after a will has been written. In general, it is assumed that the testator would wish to provide for the new spouse and for the new child and to revoke any provisions for the former spouse.

Learning Outcome 3: Describe intestate distribution of property.

Intestacy laws (statutes of descent and distribution) vary widely from state to state. Usually, the law provides that the surviving spouse and children inherit the property of the decedent. If there is no surviving spouse or child, then lineal heirs inherit. If there are no lineal heirs, then collateral heirs inherit.

Learning Outcome 4: List the elements of a trust.

The essential elements of a trust are a beneficiary, a trustee, a fund sufficiently identified to enable title to pass to the trustee, and delivery to the trustee with the intention of passing title.

Straight to the Point

1. What is a personal representative? (See Learning Outcome 1.)
2. What is the definition of codicil? (See Learning Outcome 1.)
3. What does it mean to die intestate? (See Learning Outcome 3.)
4. What is the difference between the *per stirpes* and *per capita* methods of distribution? (See Learning Outcome 3.)
5. How does a living trust differ from a testamentary trust? (See Learning Outcome 4.)
6. What is a constructive trust? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Sheila makes out a will, leaving her property in equal thirds to Mark and Paula, her children, and Carol, her niece. Two years later, Sheila is adjudged mentally incompetent, and that same year, she dies. Can Mark and Paula have Sheila's will revoked on the ground that she did not have the capacity to make a will? Explain. (See Learning Outcome 1.)
2. Lee's will provides for a distribution of his property. First, the assets must be collected and inventoried, however. They may also need to be appraised. Creditors' claims must be sorted out. Federal and state income taxes must be paid. Finally, the assets must be distributed. Who performs these tasks? (See Learning Outcome 1.)

Real Law

40–1. Wills. James Thorn had two daughters, Kimberly Tolley and Jamea Wilson. When he visited Jennifer Stolz, an experienced estate-planning attorney, he expressed concerns that Wilson was irresponsible. He wanted her share of the estate to be held in trust, to be paid at \$500 per month, protected from creditors. Thorn also was concerned that Wilson might contest his will. After a discussion with Stolz, he agreed to add an *in terrorem* clause that would disinherit anyone who contested the will unless that person had probable cause to do so. Less than two months later, Thorn died. Kimberly Tolley petitioned a Kansas state court to admit Thorn's will to probate. Wilson filed an objection, claiming in part that Thorn lacked testamentary capacity. The court admitted the will to probate and enforced the *in terrorem* clause. Wilson appealed. Did the court properly

admit Thorn's will to probate and enforce the *in terrorem* clause? [*In the Matter of the Estate of Thorn*, 461 P.3d 84 (Ct. App. Kansas, 2020)] (See Learning Outcome 1.)

40–2. Requirements of a Will. Andrew Walker executed a will giving a certain parcel of real estate to his three children from a previous marriage—Mark, Michelle, and Andrea—with a “life use” in the property granted to his current spouse, Nora. A year later, Andrew told Nora that he wished to execute a new will to change the disposition of the property to leave half of it to her. Nora recorded his wish and took her notes to the office of attorney Frederick Meagher to have the document drafted. Meagher did not see Nora's notes, and he did not talk to Andrew. Additionally, no one from Meagher's office was present at the will's

signing, and when Andrew signed it, he did not declare that it was his will, as required by state law. Is it a valid will? Explain. [*In re Estate of Walker*, 124 A.D.3d 970, 2 N.Y.S.3d 628 (3 Dept. 2015)] (See Learning Outcome 1.)

40-3. Requirements of a Will. Sherman Hemsley was a well-known actor from the 1970s. Most notably, he played George Jefferson on the television shows *All in the Family* and *The Jeffersons*. He was born to Arsenia Chisolm and William Thornton. Thornton was married to another woman, and Hemsley never had a relationship with his father or that side of the family. Hemsley never

married and had no children. He lived with Flora Bernal, his business manager. Diagnosed with cancer, Hemsley executed a will naming Bernal the sole beneficiary of his estate. At the signing, Hemsley indicated that he knew he was executing his will and that he had deliberately chosen Bernal, but he did not discuss his relatives or the nature of his property with his attorney or the witnesses. After his death, the Thorntons challenged the will. Was Hemsley of sound mind? Discuss. [*In re Estate of Hemsley*, 460 S.W.3d 629 (Tex.App.–El Paso 2014)] (See Learning Outcome 1.)

Ethical Questions

40-4. Requirements of a Will. Under what circumstances might it be appropriate to ignore the provisions in a will? (See Learning Outcome 1.)

40-5. Personal Representative. Ann Dewey's financial planner, Timothy Bultman, referred her to his friend Robert Wilmot for estate-planning services. Wilmot did not know Dewey, her family situation, or anything about her affairs until they met. He drafted a will for her and named himself as personal representative. The will was silent as to Dewey's intent—and in no way did the will indicate that Wilmot

was her choice as personal representative. When Dewey died two years later, Wilmot offered the will for probate. Dewey's three children objected to Wilmot's appointment as personal representative, claiming that he had a conflict of interest. Wilmot asserted that Dewey had declined to name one of her children or a bank or other institution as her personal representative. Identify Wilmot's "conflict of interest." Was his conduct unethical? Explain. [*In re Estate of Ann H. McMaster Dewey*, 375 Wis.2d 798 (Wis.App. 2017)] (See Learning Outcome 1.)

Chapter 40—Work Set

True-False Questions

- _____ 1. A will is revocable only after the testator's death.
- _____ 2. The testator generally must sign a will.
- _____ 3. If a person dies without a will, all of their property automatically passes to the state in which that person lived most of their life.
- _____ 4. A living trust is created by a grantor during their lifetime.
- _____ 5. A testamentary trust is created by will and begins on the settlor's death.
- _____ 6. If a person marries after executing a will that does not include the spouse, the spouse gets nothing when the person dies.
- _____ 7. If a will setting up a testamentary trust is invalid, the trust is also invalid.
- _____ 8. A constructive trust does not differ from an express trust.

Multiple-Choice Questions

- _____ 1. Donna dies without a will, but with many relatives—a spouse, children, adopted children, sisters, brothers, uncles, aunts, cousins, nephews, and nieces. Who gets what is determined by the state's
 - a. intestacy law.
 - b. Statute of Frauds.
 - c. trustee, who is appointed by Donna's executor.
 - d. personal representative, who is appointed by a probate court.
- _____ 2. Hadji executes a will that leaves all his property to Dave. Two years later, Hadji executes a will that leaves all his property to Nora. The second will does not expressly revoke the first will. Hadji dies. Who gets his property?
 - a. Dave because he was given the property in the first will, which always controls.
 - b. Dave because the second will did not expressly revoke the first will.
 - c. Nora because when there is no express declaration of revocation and the wills are not consistent in dispositions, the second will controls.
 - d. Nora because two years separated the execution of the wills.
- _____ 3. Tony dies intestate, survived by Lisa, his mother; Grace, his wife; Abby and Selena, his two daughters; and Brock, his grandson. Brock is the son of Cliff, Tony's son, who has already died. Under intestacy laws,
 - a. Grace receives one-third of Tony's estate, and Abby, Selena, and Brock receive equal portions of the rest.
 - b. Abby and Selena receive half of Tony's estate, and Grace receives the rest.
 - c. Lisa and Grace receive equal portions of Tony's estate.
 - d. Grace receives all of Tony's estate.
- _____ 4. Kate wants Bev and Nina, her daughters, to get the benefit of her farm when she dies. She does not believe that her daughters can manage the farm effectively, because they live in other states. She can provide for them to get the farm's income, under another party's management, by setting up
 - a. a constructive trust.
 - b. a resulting trust.
 - c. a testamentary trust.
 - d. none of the above.

- _____ 5. Al's will provides, "I, Al, leave all my computer equipment to my good friend, Ray." When Al dies, the personal representative gives Ray the computer equipment. Ray is
- a devisee.
 - a legatee.
 - a residuary.
 - none of the above.
- _____ 6. Joan, a nurse, cares for Ted for one year before Ted's death. Joan is named the sole beneficiary under Ted's will, to the exclusion of Ted's family members. Ted's family may challenge the will on the basis of
- the state's intestacy laws.
 - undue influence.
 - both a and b.
 - none of the above.
- _____ 7. Georgi's will provides that each of his lineal heirs living at the time of his death is to take an equal share of his estate. This means that Georgi intends for his estate to be distributed on
- a *per capita* basis.
 - a *per stirpes* basis.
 - a residuary basis.
 - the basis of none of the above.
- _____ 8. Eve dies without a will but is survived by her brother, Frank; her daughter, Gail; and her parents. The party with the first priority to receive Eve's estate is
- Eve's brother, Frank.
 - Eve's daughter, Gail.
 - Eve's parents.
 - the state.

Answering More Legal Problems

1. After the death of his wife, Thorne executed a will that transferred all of his assets to a trust for the benefit of his only daughter, Evelin. Later, Thorne married Dyan. Fourteen months into the marriage, Thorne died. Dyan objected to the will, asserting that Thorne had intended to provide for her financial security through a trust. She claimed that he had been prevented from creating this trust by Evelin, who had improperly pressured her father.

Is Dyan entitled to a share of Thorne's estate? It depends. A valid will is one that represents the testator's _____ to transfer and distribute their property. When the decedent's plan of distribution results from improper pressure by another person, the will is _____. Fraud or undue influence may be inferred when a testator ignores a spouse in favor of a third party who was in a position to influence the terms. Here, if Dyan can prove that Thorne _____ to give her a share of his assets in the form of a trust and was prevented from doing so by Evelin, the will is

_____. In that circumstance, Dyan is entitled to a share of Thorne's estate under the _____ laws.

2. Michael and Barbara wanted to set up a \$150,000 trust fund to provide funds for their grandson, Tanner, to attend Eastern State University or a similar accredited institution.

What type of trust would this be, how would it be created, and how would it be administered? A trust created by a grantor to be effective during their lifetime is a _____ trust. The essential elements of a trust are a designated beneficiary, a designated trustee, property sufficiently identified to enable title to pass to the _____, and delivery of the property by the grantor to the _____ with the intent of passing title. The grantor signs a trust deed, and the ownership of the trust property passes to the _____. The trustee administers the property as directed by the grantor for the benefit of the beneficiary and in the beneficiary's interest.



Unit 9

Special Topics

Unit Contents

Chapter 41

Administrative Law

Chapter 42

Antitrust Law

Chapter 43

International and Space Law

41

Administrative Law

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Identify how administrative agencies are created.
- 2 Outline the basic functions of administrative agencies.
- 3 State the controls on agency powers.
- 4 Describe federal laws that make agencies accountable.

administrative agencies

A government agency established to perform a specific function.

administrative law

The body of law created by administrative agencies.

Learning Outcome 1

Identify how administrative agencies are created.

enabling legislation

A statute enacted by Congress creating an agency and specifying its powers and functions.

Conflict Presented

The federal Occupational Safety and Health Administration (OSHA) issues a rule to protect health care workers from viruses that can be transmitted in the blood of patients. Before issuing the rule, OSHA asks whether the restrictions materially reduce a significant workplace risk to human health without causing serious problems for the health care industry. The American Dental Association (ADA) objects to the rule on the ground that OSHA did not prove that dental workers face sufficient risk to benefit from the rule.



Can the proposed OSHA rule be set aside because of the ADA's objection?

In its early years, the United States had a simple, nonindustrial economy with little regulation. As the economy has grown and become more complex, the size of government has also increased, and so has the number of **administrative agencies**.

As the number of agencies has multiplied, so have the rules, orders, and decisions that they issue. Today, there are rules covering almost every aspect of a business's operations. The regulations that administrative agencies issue make up the body of **administrative law**. In this chapter, we explain how these agencies exercise their authority.

41-1 Agency Creation

Congress creates federal administrative agencies. To create an administrative agency, Congress passes **enabling legislation**, which specifies the name, purposes, functions, and powers of the agency being created.

Through similar enabling acts, state legislatures create state administrative agencies. Federal regulations take precedence over conflicting state regulations. There are two basic types of administrative agencies: executive agencies and independent regulatory agencies.

41-1a Executive Agencies

At the national level, executive agencies include the cabinet departments of the executive branch and the subagencies within the cabinet departments. For instance, the Food and Drug Administration is within the U.S. Department of Health and Human Services. Executive agencies are subject to the authority of the president, who has the power to appoint and remove the agencies' officers.

Exhibit 41.1 Selected Independent Regulatory Agencies

Name of Agency and Year Formed	Principal Duties
Federal Trade Commission (FTC)—1914	Prevents businesses from engaging in unfair trade practices; stops the formation of monopolies in the business sector; protects consumer rights.
Securities and Exchange Commission (SEC)—1934	Regulates the nation's stock exchanges, in which shares of stock are bought and sold; enforces the securities laws, which require full disclosure of the financial profiles of companies that wish to sell stock and bonds to the public.
Federal Communications Commission (FCC)—1934	Regulates all communications by telegraph, cable, telephone, radio, satellite, and television.
Equal Employment Opportunity Commission (EEOC)—1964	Works to eliminate discrimination in employment based on religion, gender, race, color, disability, national origin, or age; investigates claims of discrimination.
Environmental Protection Agency (EPA)—1970	Undertakes programs aimed at reducing air and water pollution; works with state and local agencies to help fight environmental hazards.

41–1b Independent Regulatory Agencies

Independent regulatory agencies are outside the federal executive departments. They include the Federal Trade Commission, the Securities and Exchange Commission, and the Federal Communications Commission. The president has somewhat less power over independent regulatory agencies, whose officers serve for fixed terms and cannot be removed without just cause. Exhibit 41.1 lists selected independent agencies and their principal functions.

41–2 The Administrative Process

The basic functions of an administrative agency include making rules, investigating specified activities, and adjudicating disputes between the agency and those who are subject to its rules. These functions make up what is called the **administrative process**.

An integral part of the administrative process is the Administrative Procedure Act (APA). The APA imposes requirements that all federal agencies must follow.

administrative process

The procedure used by agencies in fulfilling their basic functions.

41–2a Rulemaking

The major function of an administrative agency is **rulemaking**. The most common rulemaking procedure is **notice-and-comment rulemaking**. This procedure involves three basic steps: (1) notice of the proposed rulemaking, (2) a comment period, and (3) publication of the final rule.

Notice of the Proposed Rulemaking When a federal agency decides to create a new rule, the agency publishes a notice of the proposed rulemaking proceedings in the *Federal Register*, a daily publication of the executive branch that prints government orders, rules, and regulations. The notice states where and when the proceedings will be held, the agency's authority for making the rule (usually its enabling legislation), and the terms or subject matter of the proposed rule.

Comment Period Following the publication of the notice, the agency allows time for persons to comment on the proposed rule. The comments may be in writing or, if a hearing is held, may be given orally.

Learning Outcome 2

Outline the basic functions of administrative agencies.

rulemaking

The actions by administrative agencies when formally adopting new regulations.

notice-and-comment rulemaking

A procedure in agency rulemaking that requires notice, a comment period, and a published final rule.

The agency need not respond to all comments, but it must respond to significant comments that bear directly on the proposed rule. The agency responds by either modifying its final rule or explaining, in a statement accompanying the final rule, why it did not make any changes.

The Final Rule After the agency reviews the comments, it drafts the final rule and publishes it in the *Federal Register*. The final rule is later compiled with the rules and regulations of other federal agencies in the *Code of Federal Regulations*. Final rules have binding legal effect unless the courts later overturn them. If an agency failed to follow proper rulemaking procedures, for instance, the final rule may not be binding.

41–2b Investigation

Administrative agencies conduct investigations of the entities that they regulate. During the rulemaking process, agencies investigate to obtain information about a particular industry so that any rule they issue is based on a consideration of relevant factors. After final rules are issued, agencies conduct investigations to monitor compliance with the rules.

Inspections and Tests Many agencies gather information through on-site inspections. Sometimes, inspecting an office, a factory, or some other business facility is the only way to obtain the evidence needed to prove a regulatory violation. Administrative inspections and tests cover a wide range of activities, including safety inspections of mines, safety tests of equipment, and environmental monitoring. An agency may also ask a firm or individual to submit certain documents or records to the agency for examination.

If a business firm refuses to comply with an agency request to inspect facilities or business records, the agency may resort to the use of a subpoena or a search warrant.

Subpoenas A subpoena is a writ, or order, compelling a witness to appear at an agency hearing or an individual to hand over certain documents to the agency. There are limits on what an agency can demand in subpoenas. To determine whether an agency is abusing its discretion in its pursuit of information, a court may consider such factors as the following:

1. The purpose of the investigation. An investigation must have a legitimate purpose.
2. The relevance of the information. Information is relevant if it reveals that the law is being violated or if it assures the agency that the law is not being violated.
3. The specificity of the demand for testimony or documents. A subpoena must adequately describe what is being sought.
4. The burden of the demand on the party from whom the information is sought. For instance, in responding to a request for information, a business need not reveal trade secrets.



Highlighting the Point

Natalie is a director of First National Bank when it is declared insolvent (unable to pay debts as they fall due). As part of an investigation into the bank's finances, the Federal Deposit Insurance Corporation (FDIC) issues a subpoena to Natalie for personal financial records relating to gains and losses in her assets. She objects that the subpoena

intrudes on her privacy. The FDIC says that it needs to determine whether she used bank funds for her personal benefit and asks a court to enforce the subpoena.

Will the court enforce the subpoena? Yes. When personal documents of individuals are the subject of an administrative subpoena, privacy concerns must be considered. But there is a significant public interest in promptly resolving the affairs of insolvent banks on behalf of their creditors and depositors. The FDIC has a reasonable need to gain access to some of Natalie's records to determine whether she improperly used bank funds for her personal benefit.

Search Warrants The Fourth Amendment protects against unreasonable searches and seizures. It does this by requiring that, in most instances, a physical search for evidence be conducted under the authority of a search warrant. An agency's search warrant is an order directing law enforcement officials to search a specific place for a specific item and present it to the agency.

Agencies can conduct warrantless searches in several situations. Warrants are not required to conduct searches in highly regulated industries—such as the firearm and liquor industries. Sometimes, certain types of hazardous operations, such as coal mines, may be searched without a warrant. Also, a warrantless search in an emergency situation is normally considered reasonable.

Of course, a warrant is not required if a business has no reasonable expectation of privacy in what is being searched. For instance, a party who puts trash on a curb for pick-up has no reasonable expectation of privacy regarding the trash because any passerby can rummage through it.

41–2c Adjudication

After conducting an investigation, an agency may begin to take administrative action against an individual or organization. Most administrative actions are resolved through negotiated settlements at their initial stages. When no settlement can be reached, the dispute is resolved through a hearing conducted by the agency—a proceeding called **adjudication**.

Negotiated Settlements Depending on the agency, negotiations may take the form of a simple conversation or a series of informal conferences. The purpose is to correct the problem to the agency's satisfaction and eliminate the need for additional proceedings.

Formal Complaints If attempts at a settlement fail, the agency may issue a formal complaint against the suspected violator. In response, the suspected violator will file an answer. After this exchange, if the agency and the suspected violator still cannot agree on a settlement, the case will be heard in a trial-like setting before an **administrative law judge (ALJ)**. The ALJ presides over the hearing and has the power to administer oaths, take testimony, rule on questions of evidence, and make determinations of fact. The law requires ALJs to be unbiased.

Example 41.1 The Environmental Protection Agency (EPA) finds that McAndrews Fish Factory is polluting groundwater in violation of federal pollution laws. The EPA issues a complaint against McAndrews in an effort to bring it into compliance with federal regulations. McAndrews answers, but no settlement is reached, so the matter goes to formal adjudication before an ALJ. ■

Hearing Procedures Hearing procedures vary widely from agency to agency. Often, disputes are resolved through informal proceedings. **Example 41.2** The Federal Trade Commission (FTC) charges Good Foods, Inc., with deceptive advertising. Representatives of Good Foods and the FTC, their counsel, and the ALJ meet at a table in a conference room to resolve the dispute informally. ■

adjudication

A proceeding in which an agency decides cases.

administrative law judge (ALJ)

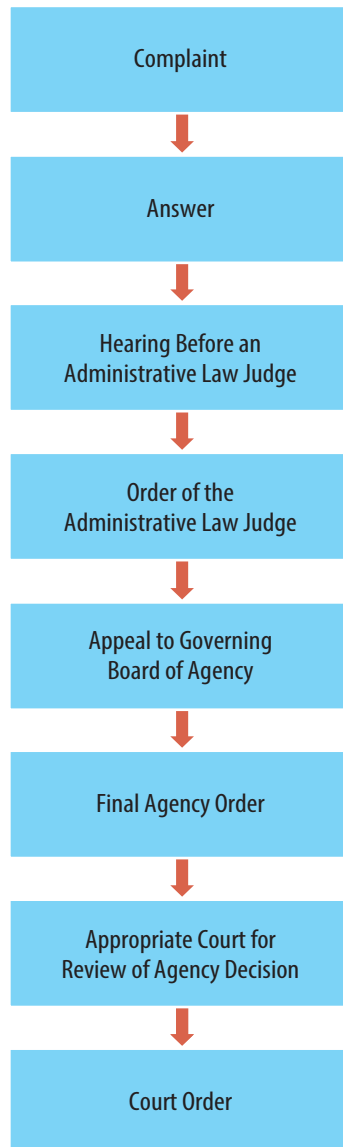
One who presides over an administrative agency hearing.

initial order

An administrative agency's disposition in a matter other than a rulemaking.

final order

The final decision of an administrative agency on an issue.

Exhibit 41.2 The Process of Formal Administrative Agency Adjudication

Learning Outcome 3

State the controls on agency powers.

A formal hearing, in contrast, resembles a trial. Before the hearing, for example, the parties are permitted to undertake extensive discovery. During the hearing, the parties may give testimony, present other evidence, and cross-examine witnesses.

Agency Orders Following a hearing, the ALJ renders an **initial order**, or decision. Either party may appeal the ALJ's decision to the board or commission that governs the agency. If a party does not agree with the commission's initial order, it can appeal to a federal court of appeals.

Example 41.3 If McAndrews Fish Factory is dissatisfied with the ALJ's decision, it may appeal the decision to the commission that governs the EPA. If the factory is dissatisfied with the commission's decision, it may appeal the decision to a federal court of appeals. ■

If no party appeals, the ALJ's decision becomes the **final order** of the agency. If a party appeals and the decision is reviewed, the final order comes from the commission's decision or that of the reviewing court. If a party appeals and the commission and the court decline to review the case, the ALJ's decision also becomes final.

The administrative agency adjudication process is illustrated in Exhibit 41.2.

41-3 Controls on Agency Powers

Administrative agencies are unusual because they exercise powers that normally are divided among the three branches of government. Agencies' powers include functions associated with the legislature (rulemaking), the executive branch (enforcement), and the courts (adjudication). For instance, agencies can make rules that are as legally binding as laws passed by Congress.

An important governmental concern is to prevent agencies from abusing their extensive powers without hindering the agencies as they carry out their prescribed duties. To address this concern, all three branches of the government exercise certain controls over agency powers.

41-3a Executive Controls

The executive branch of government exercises control over agencies through the president's powers to appoint federal officers and through the president's veto powers. For instance, the president may veto enabling legislation presented by Congress or congressional attempts to modify an existing agency's authority.

41-3b Legislative Controls

Congress exercises authority over agency powers in several ways. An agency may not exceed the power that Congress gives to it from enabling legislation. Through later legislation, Congress can take away that power or even abolish an agency altogether. Congressional authority is required to fund an agency, and enabling legislation usually sets time and monetary limits relating to particular programs. Congress can always change these limits. In addition, Congress can investigate the agencies that it creates.

41-3c Judicial Controls

The judicial branch of the government exercises control over agency powers through the courts' review of agency actions. The Administrative Procedures Act (APA) provides for judicial review of most agency decisions.

Requirements for Judicial Review Agency actions are not automatically subject to judicial review. Parties seeking judicial review must meet certain requirements, including the following:

1. The action must be reviewable by the court. The APA provides that unless proven otherwise, agency actions are reviewable, making this requirement easy to satisfy.
2. The party must have standing to sue the agency.
3. The party must have exhausted all other means of resolving a controversy with an agency. Each agency has its “chain of review,” and the party must follow agency appeal procedures before a court will review the case.

Judicial Deference for Agency Decisions Courts generally defer (yield) to an agency’s factual judgment on a subject within the agency’s area of expertise. Courts are also likely to defer to an agency’s interpretation of the law.

When a court does review an agency’s interpretation of law, the court asks whether a statute addresses the issue directly. If it does not, or if the statute is ambiguous, the court considers whether the agency’s interpretation is reasonable.

The Arbitrary and Capricious Test The APA provides that courts should “set aside” agency actions found to be “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.” Under this standard, parties can challenge regulations as contrary to law or so irrational as to be arbitrary and capricious.

In applying the arbitrary and capricious standard, courts typically consider whether the agency has done any of the following:

1. Failed to provide a rational explanation for its decision.
2. Changed its prior policy without justification.
3. Considered legally inappropriate factors.
4. Failed to consider a relevant factor.
5. Rendered a decision plainly contrary to the evidence.

Real Case



The Sikh Cultural Society (SCS) petitioned the United States Citizenship and Immigration Services (USCIS) for a special immigrant religious worker visa for Birender Singh. The USCIS denied the request because there was inadequate evidence as to Singh’s compensation, housing, and employment history. In addition, the SCS did not show that Singh had worked continuously for the previous two years. The SCS filed suit in a federal district court against the USCIS.

The SCS argued that the denial of the visa was arbitrary and capricious. Was it? No. In *Sikh Cultural Society, Inc. v. United States Citizenship and Immigration Services*, the U.S. Court of Appeals for the 2nd Circuit pointed out that the USCIS considered the totality of the evidence submitted and reasonably concluded that SCS’s conflicting assertions and evidence regarding Singh’s employment and compensation undermined SCS’s credibility and called into question whether Singh met the statutory requirements.

—720 F.Appx. 649 (U.S. Ct. App. 2nd Cir.)

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, the federal Occupational Safety and Health Administration (OSHA) issues a rule to protect health care workers from viruses that can be transmitted in the blood of patients. Before issuing the rule, OSHA asks whether the restrictions materially reduce a significant workplace risk to human health without causing serious problems for the health care industry. The American Dental Association (ADA) objects to the rule on the ground that OSHA did not prove that dental workers face sufficient risk to benefit from the rule.

A **Can the proposed OSHA rule be set aside because of the ADA's objection?** No. To be sure, OSHA cannot impose burdensome requirements on an entire industry if the safety or health of its workers is not really at risk. Under the arbitrary and capricious standard, if an agency provides a rational explanation for its rules, the rules will not be set aside.

41-4 Public Accountability

Learning Outcome 4

Describe federal laws that make agencies accountable.

Several laws make agencies more accountable through public scrutiny. Next, we discuss the most significant of these laws.

41-4a Freedom of Information Act

The Freedom of Information Act (FOIA) requires the federal government to disclose certain records to any person on request. For most records, a request need include only a reasonable description of the information sought. An agency's failure to comply with a request may be challenged in a federal district court.

The media, public-interest groups, and even companies seeking information about competitors can obtain information from government agencies under this law. Some records are exempt, however, including those containing confidential business or personal information. **Example 41.4** Juanita, a reporter from *Healthy-Works* magazine, makes an FOIA request to the Centers for Disease Control and Prevention (CDC) for a list of people who have contracted a highly contagious virus. The CDC will not have to comply, because the requested information is confidential and personal. ■

41-4b Government in the Sunshine Act

The Government in the Sunshine Act requires that "every portion of every meeting of an agency" be open to "public observation." Closed meetings are permitted, however, under the following circumstances:

1. The subject of the meeting concerns accusing any person of a crime.
2. Open meetings would frustrate implementation of future agency actions.
3. The meeting involves matters relating to future litigation or rulemaking.

41-4c Regulatory Flexibility Act

Congress passed the Regulatory Flexibility Act in 1980. Under this act, whenever a new regulation will have a "significant impact upon a substantial number" of small businesses, the agency must conduct a regulatory flexibility analysis. The analysis

must measure the cost that the rule would impose on small businesses and must consider less burdensome alternatives. The act also contains provisions to alert small businesses about forthcoming regulations.

41–4d Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act (SBREFA) allows Congress to review new federal regulations for at least sixty days before they take effect. This period gives opponents of the rules time to present their arguments to Congress. The SBREFA also requires federal agencies to prepare guides that explain in “plain English” how small businesses can comply with the regulations. The act set up the Office of the National Ombudsman at the U.S. Small Business Administration to receive comments from small businesses about their dealings with federal agencies.

Chapter Summary—Administrative Law

Learning Outcome 1: Identify how administrative agencies are created.

Administrative agencies are created by enabling legislation, which specifies the name, purposes, functions, and powers of the agency.

Learning Outcome 2: Outline the basic functions of administrative agencies.

- (1) Rulemaking—Agencies are authorized by their enabling legislation to create new regulations. Notice-and-comment rulemaking is the most common rulemaking procedure.
- (2) Investigation—Agencies investigate the entities that they regulate. Investigations are conducted during the rulemaking process to obtain information and after rules are issued to monitor compliance.
- (3) Adjudication—After a preliminary investigation, an agency may initiate an administrative action against an individual or organization. Most such actions are resolved by negotiated settlement at this initial stage. If there is no settlement, the case is presented to an administrative law judge (ALJ) in a proceeding. After a proceeding, the ALJ renders an initial order, which may be appealed.

Learning Outcome 3: State the controls on agency powers.

- (1) Executive controls—The president can control agencies through appointments of federal officers and through vetoes of legislation creating or affecting agency powers.
- (2) Legislative controls—Congress can give power to an agency or take power away, abolish the agency altogether, increase or decrease the agency’s funding, and investigate the agency.
- (3) Judicial controls—Agencies are subject to the judicial review of the courts.

Learning Outcome 4: Describe federal laws that make agencies accountable.

- (1) Freedom of Information Act—Requires that the government disclose certain records to any person on request.
- (2) Government in the Sunshine Act—Requires that every portion of every meeting of an agency be open to “public observation.”
- (3) Regulatory Flexibility Act—Requires a regulatory flexibility analysis whenever a new regulation will have a “significant impact upon a substantial number” of small businesses.
- (4) Small Business Regulatory Enforcement Fairness Act—Allows Congress sixty days to review new regulations and requires federal agencies to explain in “plain English” how small businesses can comply with regulations.

Straight to the Point

1. What is the difference between executive and independent agencies? (See Learning Outcome 1.)
2. What are the three steps to notice-and-comment rulemaking? (See Learning Outcome 2.)
3. What are the most important investigative tools available to an agency? (See Learning Outcome 2.)
4. How are most administrative actions against individuals or organizations resolved? (See Learning Outcome 2.)
5. In applying the arbitrary and capricious standard, what do courts typically consider? (See Learning Outcome 3.)
6. When can an agency hold a closed meeting? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. The Securities and Exchange Commission (SEC) makes rules regarding what must be in a stock prospectus, prosecutes and adjudicates alleged violations, and prescribes punishment. This gives the SEC considerable power. What checks are there against this power? (See Learning Outcome 3.)
2. IteX Corporation would like to know what information federal agencies have about its business operations so that it will know what its competitors may be able to learn about it. Under what federal law can IteX require the agencies to disclose whatever information they may have concerning the company? (See Learning Outcome 4.)

Real Law

41–1. Adjudication—Agency Orders. Edwin Taylor Corporation was retained to construct shells for five three-story condominiums. Paul Barros and Bronson Ostrander were superintendents of the building site. Jay Zimmerman managed them. David Patten, one of the owners of Edwin Taylor, regularly received photos and messages regarding the work. Under this supervisory authority, Edwin Taylor employees were responsible for enforcing safety protocols and correcting potential safety violations at the site. During construction, workers built frames higher than six feet without guardrails. A worker hired by a subcontractor fell 22 feet through an unguarded opening and died. The Occupational Safety and Health Administration (OSHA) opened an investigation. The Department of Labor cited Edwin Taylor for willful violations of OSHA safety regulations and assessed a penalty of \$126,749. Taylor contested the citation to the Occupational Safety and Health Review Commission. The commission’s administrative law judge affirmed the citation but reduced the penalty to \$101,399.20. Edwin Taylor appealed, alleging that it did not willfully violate regulations. During the trial, numerous Edwin Taylor employees testified that they knew that there was not adequate fall protection. Edwin Taylor supervisors also knew that workers would be working on second and third stories and would be exposed to floor openings. Was the penalty assessed Edwin Taylor justified? [*Edwin Taylor Corp. v. U.S. Dept. of Labor*, 814 F.Appx. 498 (U.S. Ct. App. 11th Cir. 2020)] (See Learning Outcome 2.)

41–2. Deference for Agency Decisions. Knox Creek Coal Corp. operates coal mines in West Virginia. The U.S. Department of Labor charged Knox with “significant and substantial” (S&S) violations of the Federal Mine Safety and Health Act. According to the charges, inadequately sealed enclosures of electrical equipment in the mine created the potential for an explosion. The Mine Act designates a violation as S&S when it “could” contribute to a safety hazard. The agency interpreted the word “could” to mean possible—meaning that if there is a violation, the existence of a hazard is assumed. This position was consistent with agency and judicial precedent and the Mine Act’s history and purpose. Knox appealed to a court for review. Knox argued that the word “could” requires actual proof of a hazard. When does a court defer to an agency’s interpretation of law? Do those circumstances exist in this case? Discuss. [*Knox Creek Coal Corp v. Secretary of Labor*, 811 F.3d 148 (4th Cir. 2016)] (See Learning Outcome 3.)

41–3. Adjudication. Mechanics replaced a brake assembly on the landing gear of a CRJ–700 plane operated by GoJet Airlines, LLC. They installed gear pins to lock the assembly in place during the repair but then failed to remove one of the pins. After takeoff on the plane’s next flight, a warning light alerted the pilots that the landing gear would not retract. There was a potential for danger, but the pilots safely flew the CRJ–700 back to the departure airport. No one was injured, and no property was damaged. The Federal Aviation Administration (FAA) cited GoJet for violations of

FAA regulations by “carelessly or recklessly operating an unairworthy airplane.” GoJet objected to the citation. To which court can GoJet appeal for review? On what ground

might that court decline to review the case? [*GoJets Airlines, LLC v. Federal Aviation Administration*, 743 F.3d 1168 (8th Cir. 2014)] (See Learning Outcome 2.)

Ethical Questions

41–4. Judicial Controls. Should an individual or organization sue an agency before the agency takes formal enforcement action? Discuss your answer. (See Learning Outcome 3.)

41–5. The Arbitrary and Capricious Test. The Delaware River Port Authority (DRPA) solicited bids to repaint the Commodore Barry Bridge, a mile-long structure spanning the Delaware River between New Jersey and Pennsylvania. Alpha Painting & Construction Company, an experienced contractor that had previously worked for DRPA, submitted the lowest bid. Under DRPA guidelines, a “responsible”

contractor has the “capacity” and “capability” to do a certain job. A “responsive” contractor includes all required documents with its bid. Alpha’s bid did not include certain required accident and insurance data. For this reason, and without checking further, DRPA declared that Alpha was “not responsible” and awarded the contract to another bidder. Did DRPA act unethically in rejecting Alpha? Explain. [*Alpha Painting & Construction Company, Inc. v. Delaware River Port Authority*, 853 F.3d 671 (3d Cir. 2017)] (See Learning Outcome 3.)

Chapter 41—Work Set

True-False Questions

- _____ 1. Enabling legislation specifies the powers of an agency.
- _____ 2. Federal courts are part of the executive branch of government.
- _____ 3. Congress creates federal administrative agencies.
- _____ 4. After an agency adjudication, the administrative law judge's order must be appealed to become final.
- _____ 5. The Administrative Procedure Act provides for judicial review of most agency actions.
- _____ 6. When a new regulation will have a significant impact on a substantial number of small entities, an analysis must be conducted to measure the costs imposed on small businesses.
- _____ 7. State administrative agency operations prevail over federal agency actions.
- _____ 8. An agency cannot conduct a search without a warrant.
- _____ 9. Agency rules are not as legally binding as the laws that Congress enacts.
- _____ 10. Courts generally defer (yield) to an agency's factual judgment on a subject within the agency's area of expertise.

Multiple-Choice Questions

- _____ 1. Congress has the power to establish administrative agencies to perform which of the following functions?
 - a. Make administrative rules.
 - b. Adjudicate disputes arising from administrative rules.
 - c. Investigate violations of administrative rules.
 - d. All of the above.
- _____ 2. An agency may obtain information concerning activities and organizations that it oversees through
 - a. a subpoena only.
 - b. a search only.
 - c. a subpoena and a search.
 - d. neither a subpoena nor a search.
- _____ 3. The Occupational Safety and Health Administration (OSHA) issues a subpoena for Triplex Corporation to hand over all of its files. Triplex's possible defenses against the subpoena include which of the following?
 - a. OSHA is a federal agency, but Triplex only does business locally.
 - b. An administrative agency cannot issue a subpoena.
 - c. The demand is not specific enough.
 - d. None of the above.
- _____ 4. In making rules, an agency's procedure normally includes
 - a. notice.
 - b. opportunity for comments by interested parties.
 - c. publication of the final draft of the rule.
 - d. all of the above.

- _____ 5. The National Oceanic and Atmospheric Administration (NOAA) is a federal agency. To limit the authority of NOAA, the president can
- abolish the agency.
 - take away the agency's power.
 - veto legislative modifications to the agency's authority.
 - refuse to appropriate funds for the agency.
- _____ 6. The Bureau of Indian Affairs (BIA) wants to close a series of its meetings to the public. To open the meetings, a citizen would sue the BIA under the
- Freedom of Information Act.
 - Government in the Sunshine Act.
 - Regulatory Flexibility Act.
 - Administrative Procedure Act.
- _____ 7. The U.S. Fish and Wildlife Service orders Bill to stop using a certain type of fishing net from his boat. Before a court will hear Bill's appeal of the order, Bill must
- exhaust all other means of resolving the controversy.
 - bypass all administrative remedies and appeal directly to the court.
 - appeal simultaneously to the agency and the court.
 - ignore the agency and continue using the net.
- _____ 8. The Federal Trade Commission (FTC) issues an order relating to the advertising of Midtron Corporation. Midtron appeals the order to a court. The court may review whether the FTC has
- exceeded its authority.
 - taken an action that is arbitrary, capricious, or an abuse of discretion.
 - violated any constitutional provisions.
 - done any of the above.
- _____ 9. The Environmental Protection Agency (EPA) publishes notice of a proposed rule. When comments are received about the rule, the EPA must respond to
- all of the comments.
 - any significant comments that bear directly on the proposed rule.
 - only comments by businesses engaged in interstate commerce.
 - none of the comments.

Answering More Legal Problems

1. OptiWire makes plastic-coated wire. The process generates acidic and alkaline wastewater. OptiWire has a system in its plant to treat the wastewater. The water then flows into an open pit outside the plant and through a pipe that connects with the public sewer system three hundred feet away. Without a search warrant or OptiWire's express consent, agents for the Environmental Protection Agency (EPA) take samples from the pit. Based on the samples, OptiWire is charged with violations of the Clean Water Act.

Does the EPA agents' sampling of the water in the pit constitute a reasonable search? Yes. The U.S. Constitution's Fourth Amendment protects against _____ searches. The EPA agents' "search" was not _____. OptiWire had no _____ expectation of privacy in the wastewater, and therefore, it had no Fourth Amendment _____ with respect to the agents' sampling of it. The water in the pit flows into the public sewer, which is only three hundred

feet away. Once the wastewater reaches that point, any member of the public can take a sample.

2. The Federal Trade Commission (FTC) issued a subpoena to athletic shoemaker Sleek Feet to investigate the company's claims about the benefits of its shoes. Sleek Feet claimed that the shoes helped their wearers lose weight, tone their bodies, and fight heart disease. After a hearing, the FTC decided that the claims were unsubstantiated. Sleek Feet wants to appeal the decision.

What are the requirements for the judicial review of an agency decision? A party seeking the review of an agency decision must meet certain requirements. (1) The action must be _____ by the court. Unless proven otherwise, agency actions are _____. (2) The party seeking review must have _____ to sue the agency. (3) The party must have _____ all possible administrative remedies.

42 | Antitrust Law

Conflict Presented

A group of independent oil producers in Texas and Louisiana are caught between falling demand due to bad economic times and increasing supply from newly discovered oil fields in the region.

A group of major refining companies agrees to buy excess oil supplies from the independents so as to dispose of the excess in an “orderly manner.” It is clear that the purpose is to limit the supply of gasoline on the open market and thereby raise prices. In a lawsuit challenging the agreement, the oil producers claim that under the circumstances, the agreement is reasonable.

Q Does the agreement violate antitrust law?

Antitrust legislation is based on the desire to foster competition. In the United States, we have traditionally believed that competition leads to lower prices, more product information, and a better distribution of wealth between consumers and producers.

Laws that regulate economic competition are referred to as **antitrust laws**. Today’s antitrust laws are the direct descendants of common law actions intended to limit restraints of trade. **Restraints of trade** are agreements between firms that have the effect of reducing competition in the marketplace.

42–1 The Sherman Act

The Sherman Act is the most important antitrust law. Sections 1 and 2 contain its main provisions:

- 1: Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal [and is a crime punishable by fine and/or imprisonment].
- 2: Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony [and is similarly punishable].

Any activity that substantially affects interstate commerce (trade between two or more states) falls under the Sherman Act. The Sherman Act also extends to U.S. nationals abroad who are engaged in activities that affect U.S. foreign commerce.

Learning Outcomes

The four Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 List the activities prohibited by the Sherman Act.
- 2 List the activities prohibited by the Clayton Act.
- 3 State who enforces U.S. antitrust laws.
- 4 Define the extraterritorial reach of U.S. antitrust laws.

antitrust laws

Laws protecting commerce from unlawful restraints.

restraint of trade

Any contract, conspiracy, or combination that unlawfully eliminates competition.

Learning Outcome 1

List the activities prohibited by the Sherman Act.

42–1a Section 1 of the Sherman Act

The underlying assumption of Section 1 of the Sherman Act is that society's welfare is harmed if rival firms are permitted to join in an agreement that consolidates their market power or otherwise restrains competition. In assessing the anticompetitive impact of an alleged restraint of trade, a court considers whether the action is a *per se* violation or whether the rule of reason should be applied.

***per se* violation**

An anticompetitive agreement that is deemed inherently illegal.

price-fixing agreement

An agreement among competitors to set product prices.

Per Se Violations Some agreements are so blatantly and substantially anticompetitive that they are deemed illegal *per se* (inherently) under Section 1. If an agreement is deemed a ***per se* violation**, a court need not determine whether it actually injures competition. Some important types of *per se* violations under Section 1 include the following:

1. Price-fixing agreements—A **price-fixing agreement** is an agreement among competitors to set prices. Any agreement that restricts output or artificially fixes prices is a *per se* violation under Section 1.



Highlighting the Point

The chief executive officers (CEOs) of the largest U.S. book publishers meet four times a year to discuss industry issues, including pricing policies and strategies. When e-books are introduced to the market, the publishers appear to be acting together. The e-books all sell for the same price as the printed versions. Echo Electronics makes and sells e-book readers. Echo's CEO meets with the publishers' CEOs, who agree to sell their e-books through Echo's new online store. The prices of e-books subsequently rise.

Do these circumstances indicate a *per se* violation under Section 1 of the Sherman Act? Yes. The meetings of the CEOs include discussions of pricing policies and strategies. The prices of the printed versions of books and their e-book forms appear to rise in concert, and prices rise again subsequent to the agreement with Echo Electronics. These circumstances meet the requirements of a *per se* price-fixing agreement—that is, concerted action between at least two competitors that constitutes an unreasonable, anticompetitive restraint of trade.

group boycott

A group of competitors' refusal to deal with a particular person or firm.

2. Group boycotts—A **group boycott** is an agreement by two or more sellers to boycott, or refuse to deal with, a particular person or firm. Section 1 has been violated if it can be demonstrated that the boycott or joint refusal to deal was undertaken with the intention of eliminating competition or preventing entry into a given market.
3. Market divisions—It is a *per se* violation of Section 1 for competitors to divide up market territories or customers. **Example 42.1** Alred Office Supplies, Belmont Business Services, and Carlton Biz Network compete against each other in Kansas, Nebraska, and Oklahoma. These three firms agree that Alred will sell office products only in Kansas, Belmont will sell only in Nebraska, and Carlton will sell only in Oklahoma. This concerted action violates Section 1 of the Sherman Act. It reduces marketing costs and allows all three to raise the price of the goods sold in their respective states. (This situation assumes there is no other competition and ignores online competitors.) ■

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, a group of independent oil producers in Texas and Louisiana are caught between falling demand and increasing supply.

A group of major refining companies agrees to buy excess supplies from the independents so as to dispose of the excess in an “orderly manner.” It is clear that the purpose is to limit the supply of gasoline on the market and thereby raise prices. In a lawsuit challenging the agreement, the oil producers claim that under the circumstances, the agreement is reasonable.

A Does the agreement violate antitrust law? Yes. Any agreement among competitors to restrict output or fix prices constitutes a *per se* violation of Section 1 of the Sherman Act. The “reasonableness” of a price-fixing agreement is never a defense.

The Rule of Reason Some agreements, even though they result in enhanced market power, do not unreasonably restrain trade and are therefore lawful. Under the **rule of reason**, the courts analyze anticompetitive agreements that allegedly violate Section 1 of the Sherman Act to determine whether they actually constitute reasonable restraints of trade. When applying this rule, courts consider several factors. These factors include the purpose of the agreement, the parties’ ability to implement the agreement to achieve that purpose, and the effect or potential effect of the agreement on competition. If the court deems that legitimate competitive benefits outweigh the anticompetitive effects of the agreement, it will be held lawful.

The following are examples of business situations in which the rule of reason is applied:

1. Trade associations—Businesses in the same industry or profession frequently organize trade associations to pursue common interests, such as information exchanges, advertising campaigns, and common regulatory standards. If a court finds that a trade association practice or agreement that restrains trade is sufficiently beneficial both to the association and to the public, it may deem the restraint reasonable.
2. Territorial or customer restrictions—In arranging for the distribution of its products, a manufacturer often wishes to protect its dealers from direct competition with one another. To this end, it may institute territorial restrictions or attempt to prohibit wholesalers or retailers from reselling the product to certain classes of customers, such as competing retailers. Territorial and customer restrictions are judged under the rule of reason because there may be legitimate reasons for such restrictions.

rule of reason

A test by which a court balances the reasons for an agreement against its potentially anticompetitive effects.

42–1b Section 2 of the Sherman Act

Section 1 of the Sherman Act prohibits certain concerted, or joint, activities that restrain trade. In contrast, Section 2 condemns “every person who shall monopolize, or attempt to monopolize.” Thus, two distinct types of behavior are subject to sanction under Section 2: monopolization and attempts to monopolize.

One tactic that may be involved in either offense is **predatory pricing**. Predatory pricing involves an attempt by one firm to drive its competitors from the market

predatory pricing

The pricing of a product below cost with the intent to drive competitors out of the market.

by selling its product at prices substantially below the normal costs of production. Once the competitors are eliminated, the firm will attempt to recapture its losses and go on to earn higher profits by driving prices up far above their competitive levels.

monopolization

The possession of monopoly power in the relevant market and the willful acquisition or maintenance of that power.

Monopolization **Monopolization** involves the following two elements:

1. The possession of monopoly power in the relevant market.
2. The willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, good business judgment, or historic accident.

A violation of Section 2 requires that both these elements—monopoly power within a relevant market and an intent to monopolize—be established.

Monopoly Power The Sherman Act does not define monopoly. In theory, monopoly refers to control of a single market by a single entity. A firm may have monopoly power even though it is not the only seller in a market, however. Additionally, size alone does not determine whether a firm is a monopoly.

Example 42.2 Stage Stop Store, a “mom and pop” business located in the isolated town of Happy Camp, Wyoming, is the only grocery store serving that market. Thus, Stage Stop Store is a monopolist. Size in relation to the market is what matters because monopoly involves the power to affect prices. ■

Monopoly power can be proved by direct evidence that the firm used its power to control prices and restrict output. To prove monopoly power indirectly, the plaintiff must show that the firm has a dominant share of the relevant market and that there are significant barriers for new competitors entering that market.

Relevant Market In determining the extent of a firm’s market power, courts often use the **market-share test**, which measures the firm’s percentage share of the relevant market. The relevant market consists of two elements:

1. A relevant product market.
2. A relevant geographic market.

The relevant product market includes all products that have identical attributes, such as tea. Because products that are not identical may sometimes be substituted for one another—coffee may be substituted for tea, for instance—these products are also considered to be part of the same relevant product market.

For products that are sold nationwide, the relevant geographic market encompasses the entire United States. A producer and its competitors may sell in a more limited area, however, in which their customers do not have access to other sources of the product. In that situation, the relevant geographic market is limited to that area.

Establishing the relevant product market is often the key issue in monopolization cases because the way the market is defined may determine whether a firm has monopoly power. When the product market is defined narrowly, the degree of a firm’s market power appears greater.

market-share test

A means of measuring monopoly power by determining a firm’s percentage share of the relevant market.



Highlighting the Point

White Whale Apps acquires Springleaf Apps, its main competitor in nationwide Android-based mobile phone apps. White Whale maintains that the relevant product market consists of online retailers of mobile phone apps. The Federal Trade Commission (FTC), however, argues that the relevant product market consists just of retailers that sell only apps for Android mobile phones.

Does the FTC's view of the relevant product market enhance White Whale's apparent market power? Yes. Under the FTC's narrower definition of the relevant product market, White Whale could be seen to have a dominant share of that market. Thus, the FTC could take appropriate actions against White Whale.

Real Case



Global Distribution Systems (GDSs) are electronic networks that travel agents use to book flights for their clients. Sabre Holding Corporation dominates the GDSs market to the extent that travel agents have little choice but to use its platforms. Taking advantage of this position, Sabre is able to negotiate highly favorable agreements with airlines. US Airways sued Sabre for illegally monopolizing the travel GDSs market in violation of Section 2 of the Sherman Antitrust Act. A federal district court dismissed the lawsuit, noting that it could not wrongfully monopolize a market that was limited to its own customers.

Was the trial court's reasoning correct? No. In *US Airways, Inc. v. Sabre Holding Corporation*, a federal appellate court held that “a single brand of a product or service” can be a relevant market for antitrust purposes when no substitute exists for that product or service. In other words, it was possible that travel agents—and airlines—were unfairly locked into working with Sabre. Therefore, the court ruled that US Airways (later merged with American Airlines) should be given the chance to prove that Sabre was operating as an illegal monopoly in this instance.

—938 F.3d 43 (2nd Cir.)

The Intent Requirement Monopoly power, in and of itself, does not constitute the offense of monopolization under Section 2 of the Sherman Act. The offense also requires an intent to monopolize. In most monopolization cases, intent can be inferred from evidence that the firm had monopoly power and engaged in anticompetitive behavior.

Refusals to Deal Normally, a single seller acting unilaterally is free to deal, or not to deal, with anyone it chooses. Nevertheless, in limited circumstances, a unilateral refusal to deal violates Section 2 of the Sherman Act. This occurs only if (1) the firm refusing to deal has—or is likely to acquire—monopoly power and (2) the refusal is likely to have an anticompetitive effect on a particular market.

Example 42.3 Clark Industries, the owner of three of the four major downhill ski areas in Blue Hills, Idaho, refuses to continue participating in a jointly offered six-day “all Blue Hills” lift ticket. Clark’s refusal to cooperate with its smaller competitor is a violation of Section 2 of the Sherman Act. Because Clark owns three-fourths of the local ski areas, it has monopoly power, and thus its unilateral refusal has an anticompetitive effect on the market. ■

Attempts to Monopolize Cases involving attempts to monopolize are concerned with the following:

1. Actions that are intended to exclude competitors and gain monopoly power.
2. Actions that are likely to succeed.

An action is not likely to succeed unless the alleged offender possesses some degree of market power. In other words, only serious threats of monopolization are condemned as violations.



Highlighting the Point

Big Deal, Inc., owns five rock-format radio stations in Cincinnati and is a major concert promoter in the area. Big Deal's relevant market share in terms of ad revenue is about 90 percent. Big Deal's stations refuse to accept ads for performers who do not contract with Big Deal to promote their concerts. This refusal pressures many artists into contracting exclusively with Big Deal.

Do Big Deal's activities represent an attempt to monopolize the market in violation of Section 2 of the Sherman Act? Yes. Companies enter into exclusive or favored arrangements with other firms every day. Such arrangements are lawful in most cases but may be unlawful when used by a monopolist. Big Deal is a monopolist in its relevant market. How the firm uses its monopoly power and how its actions affect competition make its practices illegal. The effects may include an increase in ticket prices and a decreasing market share for the firm's competitors.

42-2 The Clayton Act

Learning Outcome 2

List the activities prohibited by the Clayton Act.

In 1914, Congress attempted to strengthen federal antitrust laws by enacting the Clayton Act. The Clayton Act is aimed at three specific practices that are not covered by the Sherman Act. These practices are price discrimination, exclusionary practices, and certain mergers. The act makes these practices illegal only if they substantially lessen competition or tend to create monopoly power.

42-2a Price Discrimination

price discrimination

Setting prices so that competing buyers pay different prices for an identical product.

A seller that charges different prices to different buyers for identical goods is practicing **price discrimination**. The Clayton Act prohibits price discrimination that cannot be justified by differences in production or transportation costs.

Under the act, sellers are prohibited from reducing prices to levels substantially below those charged by their competitors unless they can justify the reduction. To do so, they must demonstrate that they charged the lower price "in good faith to meet an equally low price of a competitor."

42-2b Exclusionary Practices

Under the Clayton Act, sellers cannot condition the sale or lease of a product on the buyer's promise not to use or deal in the goods of the seller's competitors. This effectively prohibits two types of agreements: exclusive-dealing contracts and tying arrangements.

exclusive-dealing contract

An agreement under which a producer agrees to sell its goods exclusively through one distributor.

Exclusive-Dealing Contracts A contract under which a seller forbids a buyer to purchase products from the seller's competitors is called an **exclusive-dealing contract**. An exclusive-dealing contract is prohibited if the effect of the contract is to lessen competition substantially or to tend to create a monopoly.

tying arrangement

A sales agreement conditioned on a buyer's promise to buy an additional product.

Tying Arrangements When a seller conditions the sale of a product (the tying product) on the buyer's agreement to purchase another product (the tied product) produced or distributed by the same seller, a **tying arrangement** results. The legality of such an agreement depends on many factors, particularly the purpose of the agreement and the agreement's likely effect on competition in the relevant markets.

42–2c Mergers

A merger occurs when one business firm absorbs the assets and liabilities of another, so that the other ceases to exist. Under the Clayton Act, a business organization cannot merge with another if the effect may be to lessen competition substantially.

A crucial consideration is **market concentration**, which refers to the market shares of the various firms in a market. For instance, if the four largest grocery stores in Chicago account for 80 percent of all retail food sales, that market is concentrated in those four firms. If one of these stores merges with another, the result further concentrates the market and may therefore diminish competition.

Competition is not necessarily diminished solely as a result of market concentration. Other factors will be considered in determining whether a merger violates the Clayton Act. One such factor, for example, is whether the merger will make it more difficult for potential competitors to enter the market.

market concentration

When a small number of firms share the market for a particular good or service.

42–3 Enforcement of Antitrust Laws

The federal agencies that enforce the federal antitrust laws are the U.S. Department of Justice (DOJ) and the Federal Trade Commission (FTC). The FTC was established by the Federal Trade Commission Act in 1914. Section 5 of that act prohibits all forms of anticompetitive behavior that are not covered under other federal antitrust laws.

Learning Outcome 3

State who enforces U.S. antitrust laws.

42–3a Enforcement by Federal Agencies

The DOJ can prosecute violations of the Sherman Act as either criminal or civil violations. Violations of the Clayton Act are not crimes, and the DOJ can enforce that statute only through civil proceedings. The remedies that the DOJ has asked the courts to impose include **divestiture** (making a company give up one or more of its operating functions) and dissolution. For instance, the DOJ might force a meat packer to divest itself of control or ownership of butcher shops.

The FTC also enforces the Clayton Act and has sole authority to enforce violations of the Federal Trade Commission Act. The FTC does not enforce the Sherman Act.

divestiture

The act of selling one or more of a company's parts.

42–3b Enforcement by Private Parties

A private party can sue for treble (triple) damages and attorneys' fees under the Clayton Act if the party is injured as a result of a violation of any of the federal antitrust laws, except the Federal Trade Commission Act. A person wishing to sue under the Sherman Act must prove the following:

1. The antitrust violation either caused or was a substantial factor in causing the injury that was suffered.
2. The unlawful actions of the accused party affected business activities of the plaintiff that were protected by the antitrust laws.

42–3c Exemptions from Antitrust Laws

There are many legislative and constitutional limitations on antitrust enforcement. For example, one exemption covers professional baseball teams. Another permits agricultural cooperatives and fisheries jointly to set prices.

One of the most significant antitrust enforcement exemptions covers joint efforts by businesspersons to obtain government action. For instance, movie producers and video-streaming companies can jointly lobby Congress to extend the period of copyright protection.

42–4 U.S. Antitrust Laws in the Global Context

Learning Outcome 4

Define the extraterritorial reach of U.S. antitrust laws.

Section 1 of the Sherman Act provides for the extraterritorial effect of the U.S. antitrust laws. In other words, these laws may apply outside U.S. territory. Thus, any conspiracy that has a substantial effect on U.S. commerce is within the reach of the Sherman Act. The violation may even occur outside the United States, and foreign governments as well as individuals can be sued for violation of U.S. antitrust laws.

For instance, if a domestic firm joins a foreign cartel to control the production, price, or distribution of goods, and this cartel has a substantial effect on U.S. commerce, a *per se* violation may exist. Hence, both the domestic firm and the foreign cartel could be sued for violation of U.S. antitrust laws. Likewise, if a foreign firm doing business in the United States enters into a price-fixing or other anticompetitive agreement to control a portion of U.S. markets, a *per se* violation may exist.



Highlighting the Point

Ed files a lawsuit against four Chinese manufacturers that collectively control over 60 percent of the world's vitamin C market, alleging a conspiracy to fix prices and manipulate output in the United States in violation of the Sherman Act. The defendants claim that they acted in accordance with Chinese government regulations and that therefore their actions are beyond the reach of the American legal system.

Can the American legal system nonetheless “reach” these Chinese vitamin C importers? Yes. American judges can “carefully consider” a foreign country's laws and views. But American judges should not allow these factors to fully decide the matter. When a court finds that the evidence of the foreign defendants' price fixing is persuasive, they must act accordingly, regardless of the policy goals of the Chinese government.

Chapter Summary—Antitrust Law

Learning Outcome 1: List the activities prohibited by the Sherman Act.

The Sherman Act prohibits contracts, combinations, and conspiracies in restraint of trade, as well as monopolies and attempts to monopolize. The act applies only to activities that have a significant impact on interstate commerce. The *per se* rule applies to restraints of trade that are so inherently anticompetitive that they cannot be justified and are deemed illegal as a matter of law. The rule of reason applies when an anticompetitive agreement may be justified by legitimate benefits.

Learning Outcome 2: List the activities prohibited by the Clayton Act.

The Clayton Act prohibits price discrimination (charging various buyers different prices for identical goods), exclusionary practices (exclusive-dealing contracts and tying arrangements), and mergers that may substantially lessen competition.

Learning Outcome 3: State who enforces U.S. antitrust laws.

Federal agencies that enforce antitrust laws are the Department of Justice and the Federal Trade Commission. Private parties who have been injured as a result of violations of the Sherman Act or Clayton Act may also bring civil suits. If successful, they may be awarded treble damages and attorneys' fees.

Learning Outcome 4: Define the extraterritorial reach of U.S. antitrust laws.

Section 1 of the Sherman Act provides for the global effect of U.S. antitrust laws. A violation may occur outside the United States, and foreign governments as well as individuals can be sued for violations. It must be shown that the violation had a substantial effect on U.S. commerce.

Straight to the Point

1. What is a *per se* violation? (See Learning Outcome 1.)
2. Describe the rule of reason. (See Learning Outcome 1.)
3. Define monopolization. (See Learning Outcome 1.)
4. When does price discrimination violate antitrust laws? (See Learning Outcome 2.)
5. What forms of anticompetitive behavior does the Federal Trade Commission Act prohibit? (See Learning Outcome 3.)
6. How might a foreign firm violate U.S. antitrust law? (See Learning Outcome 4.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Maple Corporation conditions the sale of its syrup on the buyer's agreement to buy Maple's pancake mix. What type of arrangement is this? What factors would a court consider to decide whether this arrangement violates antitrust law? (See Learning Outcome 2.)
2. Under what circumstances would Pop's Market, a small store in an isolated town, be considered a monopolist? If Pop's is a monopolist, is it in violation of Section 2 of the Sherman Act? Discuss your answer. (See Learning Outcome 1.)

Real Law

42–1. The Sherman Act. Private bus companies owned by Luciano Vega-Martínez and others provided busing for students in Caguas, Puerto Rico. That city announced it would hold an auction for a four-year school bus transportation contract. Instead of submitting competing bids, the bus company owners met and agreed to divide up the routes among themselves. When the bid-rigging scheme was revealed, the federal government charged the owners of the bus companies with conspiracy to restrain trade in violation of the Sherman Act. The defendants were convicted in a jury trial, sentenced to prison terms, and ordered to pay restitution. Vega-Martínez appealed, contending that the bid rigging did not fall under the Sherman Act because there was no connection between the scheme and interstate commerce. Did the defendants' conduct substantially affect interstate commerce? [*United States v. Vega-Martínez*, 949 F.3d 43 (U.S. Ct. App. 1st Cir. 2020)] (See Learning Outcome 1.)

42–2. Section 1 of the Sherman Act. Manitou North America, Inc., makes and distributes telehandlers—forklifts with extendable telescopic booms—to dealers throughout

the United States. Manitou agreed to make McCormick International, LLC, its exclusive dealer in the state of Michigan. Later, Manitou entered into an agreement with Gehi Company, which also makes and sells telehandlers, to allocate territories within Michigan among certain dealers for each manufacturer. Under this agreement, McCormick could not buy or sell Gehi telehandlers. What type of trade restraint did the agreement between Manitou and Gehi represent? Is this a violation of antitrust law? If so, who was injured, and how were they injured? Explain. [*Manitou North America, Inc. v. McCormick International, LLC*, 2016 WL 439354 (2016)] (See Learning Outcome 1.)

42–3. Section 1 of the Sherman Act. The National Collegiate Athletic Association (NCAA) and the National Federation of State High School Associations (NFHS) set a standard for nonwood baseball bats. The purpose was to ensure that aluminum and composite bats performed like wood bats in an effort to enhance player safety and reduce technology-driven homeruns and other big hits. Marucci Sports, LLC, makes nonwood bats. Under the new standard, four of Marucci's

eleven products were decertified for use in high school and collegiate games. But many certified bats—including seven of Marucci's products—were available. Marucci's competitors did not drop out of the market, bat prices were not

significantly changed, and bat quality was not affected. Did the new standard violate the Sherman Act? Explain. [*Marucci Sports, LLC v. National Collegiate Athletic Association*, 751 F.3d 368 (5th Cir. 2014)] (See Learning Outcome 1.)

Ethical Questions

42-4. The Rule of Reason. Should all commercial arrangements subject to the antitrust laws be evaluated under the rule of reason? Discuss. (See Learning Outcome 1.)

42-5. Section 2 of the Sherman Act. Apple, Inc., controls which apps—such as ringtones, instant messaging, and video—can run on its iPhone software. Apple's App Store is a website where iPhone users can buy and download the apps. Apple prohibits third-party developers from selling iPhone apps through channels other than the App Store. Apple threatens to cut off sales by any developer who

violates this prohibition. Apple discourages iPhone owners from downloading unapproved apps by threatening to void iPhone warranties if they do. Seven iPhone app buyers filed a complaint in a federal district court against Apple, alleging that the firm monopolized the market for iPhone apps. Is it ethical for Apple to protect iPhone software by setting narrow boundaries on the sales of related apps and aggressively enforcing them? Discuss. [*In re Apple iPhone Antitrust Litigation*, 846 F.3d 313 (9th Cir. 2017)] (See Learning Outcome 1.)

Chapter 42—Work Set

True-False Questions

- _____ 1. Monopoly power is market power sufficient to control prices and exclude competition.
- _____ 2. An exclusive-dealing contract is a contract under which competitors agree to divide up territories or customers.
- _____ 3. Price discrimination occurs when a seller forbids a buyer from buying products from the seller's competitors.
- _____ 4. An agreement between competitors to fix prices is a *per se* violation of antitrust law.
- _____ 5. A merger between firms that compete with each other in the same market is not a violation of antitrust law.
- _____ 6. A relevant product market consists of all products with identical attributes and products that are sufficient substitutes for each other.
- _____ 7. An agreement that is inherently anticompetitive is illegal *per se*.
- _____ 8. Under the rule of reason, conduct is unlawful if its anticompetitive effects outweigh its competitive benefits.
- _____ 9. A unilateral refusal to deal cannot violate antitrust law.

Multiple-Choice Questions

- _____ 1. The National Coal Association (NCA) is a group of independent coal-mining companies. Demand for coal falls, so the price drops. The Coal Refiners Association, a group of coal-refining companies, agrees to buy NCA's coal and sell it according to a schedule that will increase the price. This agreement is
 - a. exempt from the antitrust laws.
 - b. subject to evaluation under the rule of reason.
 - c. a *per se* violation of the Sherman Act.
 - d. none of the above.
- _____ 2. Federated Tools, Inc., charges Jack's Hardware five cents per item and Eve's Home Store ten cents per item for the same product. Jack's Hardware and Eve's Home Store are competitors. If this practice substantially lessens competition, it constitutes
 - a. a market division.
 - b. an exclusionary practice.
 - c. price discrimination.
 - d. none of the above.
- _____ 3. American Goods, Inc., and Consumer Products Corporation are competitors. They merge, and after the merger, Consumer Products is the surviving firm. To assess whether the merger violates the Clayton Act requires a look at
 - a. market division.
 - b. market concentration.
 - c. market power.
 - d. none of the above.
- _____ 4. International Sales, Inc. (ISI), is charged with a violation of antitrust law. ISI's conduct is a *per se* violation
 - a. if the anticompetitive effects outweigh the competitive benefits.
 - b. if the competitive benefits outweigh the anticompetitive effects.
 - c. if the conduct is blatantly anticompetitive.
 - d. only if it qualifies as an exemption.

- _____ 5. Techno, Inc., sells its brand-name computer equipment directly to its franchised retailers. Depending on how existing franchisees do, Techno may limit the number of franchisees in a given area to reduce intrabrand competition. Techno's restrictions on the number of dealers is
- a *per se* violation of the Sherman Act.
 - exempt from the antitrust laws.
 - subject to continuing review by the appropriate federal agency.
 - subject to the rule of reason.
- _____ 6. Gamma Corporation is charged with a violation of antitrust law that requires evaluation under the rule of reason. The court will consider
- only the purpose of the conduct.
 - only the effect of the conduct on trade.
 - only the power of the parties to accomplish what they intend.
 - the purpose of the conduct, the effect of the conduct on trade, and the power of the parties to accomplish what they intend.
- _____ 7. Omega, Inc., controls 80 percent of the market for telecommunications equipment in the southeastern United States. To show that Omega is monopolizing that market in violation of the Sherman Act requires proof of
- only the possession of monopoly power in the relevant market.
 - only the willful acquisition or maintenance of monopoly power.
 - the possession of monopoly power in the relevant market and the willful acquisition or maintenance of that power.
 - none of the above.

Answering More Legal Problems

1. Pharma, Inc., made Cancera, a prescription drug that helped in the treatment of certain forms of cancer. When Cancera's patent was about to expire, Synthetic Chemix Corp. developed a generic version of Cancera and prepared to enter the market. Within weeks of this drug's debut, Pharma offered to pay Synthetic \$50 million per year not to market the generic version. Synthetic accepted the offer.

Was the agreement between Pharma and Synthetic a violation of antitrust law? Yes. One *per se* violation of Section 1 of the Sherman Act is a _____-_____ agreement—an agreement among competitors to set prices. Although the agreement between Pharma and Synthetic included no specific statement as to price, its purpose was to limit the supply of the generic version of Cancera and thus maintain or increase the price of the brand-name drug. This _____-_____ agreement between rival firms also restrained _____ by delaying the entry of the generic version of Cancera into the market. Under these circumstances, the agreement was a *per se* violation of the Sherman Act.

2. Choice Foods Market, Inc., is the largest national chain of supermarkets selling high-end organic food. Choice

Foods wanted to acquire the assets of its main competitor, Naturally Select Markets, Inc. The relevant product market was defined to consist of only premium natural and organic supermarkets rather than all supermarkets. Under this narrow definition, Choice Foods had an 80 percent share of the market, and Naturally Select had a 15 percent share.

Did this proposed acquisition constitute monopolization and thereby violate the Sherman Act? Yes. Monopolization involves two elements: (1) the possession of monopoly _____ in the relevant market and (2) the willful acquisition or maintenance of that _____. In determining the extent of a firm's market _____, the market-share test measures the firm's percentage share of the relevant market. This consists of the relevant product market and the relevant geographic market. The relevant product market can include all products with identical attributes. For products that are sold nationwide, the relevant geographic market is the entire United States. In this problem, the largest chain of high-end organic supermarkets wanted to acquire its main competitor. The merger would have given Choice Foods a 95 percent share of the defined relevant market—a significant increase in monopoly _____ acquired willfully.

43

International and Space Law

Conflict Presented

Café Rojo, a Colombian firm, agrees to sell coffee beans to Black Bear Coffee Company, a U.S. firm. Black Bear accepts the beans but refuses to pay. Café Rojo sues Black Bear in a Colombian court and is awarded damages, but Black Bear's assets are in the United States.

Q Is a U.S. court likely to enforce the Colombian court's judgment?

Commerce has always crossed national borders. The dramatic growth in world trade and the emergence of a global business community, however, is relatively new. Today, exchanges of goods, services, and intellectual property on a global level are routine. In addition, activities in outer space—once the exclusive domain of governments—now are partly conducted by private businesses.

In this chapter, we examine several aspects of international business activities. We also discuss the emerging legal area of space law.

43–1 International Principles and Doctrines

International law is a body of law—formed as a result of international customs, **treaties**, and organizations—that governs relations among or between nations. Courts apply international law in the interest of maintaining harmonious relations among nations. Three important legal principles and doctrines of international law are (1) the principle of comity, (2) the act of state doctrine, and (3) the doctrine of sovereign immunity.

43–1a The Principle of Comity

Under the principle of **comity**, one nation will defer and give effect to the laws and judicial decrees of another country as long as those laws and decrees are consistent with the law and public policy of the accommodating nation.

One way to understand the principle of comity is to consider the relationships among the states in our federal form of government. Each state honors the contracts, property deeds, wills, and additional legal obligations formed in other states. On a worldwide basis, nations similarly attempt to honor judgments rendered in other countries when it is feasible to do so.

Learning Outcomes

The five Learning Outcomes below are designed to help improve your understanding of the chapter. After reading this chapter, you should be able to:

- 1 Identify important international principles and doctrines.
- 2 Discuss how business is done internationally.
- 3 Explain common provisions in international contracts.
- 4 Outline international business regulations.
- 5 List international space law treaties.

Learning Outcome 1

Identify important international principles and doctrines.

treaty

A formal written agreement negotiated between two or more nations.

comity

The principle by which one nation defers to the laws of another.

Conflict Resolved

In the Conflict Presented feature at the beginning of this chapter, Café Rojo, a Colombian firm, sells coffee beans to Black Bear Coffee Company, a U.S. firm. When Black Bear accepts the beans but refuses to pay for them, Café Rojo sues Black Bear in a Colombian court and is awarded damages. Because Black Bear's assets are in the United States, Café Rojo must ask a U.S. court to enforce the Colombian court's judgment.

A **Is a U.S. court likely to grant this request?** Yes. Under the principle of comity, a U.S. court defers and gives effect to foreign laws and judicial decrees that are consistent with U.S. law. The collection of the judgment in this case should not present any problems.

act of state doctrine

A doctrine providing that courts will not review another nation's acts.

expropriation

A government seizure of property for a proper purpose and with just compensation.

confiscation

A government's taking of private property with no legal purpose and no just compensation.

43–1b The Act of State Doctrine

The **act of state doctrine** provides that the judicial branch of one country will not examine the validity of acts committed by a foreign government within its borders. This doctrine can have important consequences for individuals and firms doing business with other countries.

Most often, the act of state doctrine is employed in situations involving expropriation or confiscation. **Expropriation** occurs when a government seizes a privately owned business or privately owned goods for a proper public purpose and awards just compensation. When a government seizes private property for an illegal purpose or without just compensation, the taking is referred to as a **confiscation**. The line between these two forms of taking is sometimes blurred because of differing interpretations of what is illegal and what constitutes just compensation.



Real Case

Under regulations set by the Liquor Control Board of Ontario (LCBO), Brewers Retail, Inc. (BRI) stores are the only establishments in the Province of Ontario, Canada, permitted to sell units of beer larger than a six-pack. BRI stores are controlled by two large beer companies, Anheuser-Busch and Molson Coors. Mountain Crest, an independent brewer based in Wisconsin, filed suit, claiming that the six-pack rule violated U.S. anti-monopoly law.

Was this legal challenge barred by the act of state doctrine? Yes. In *Mountain Crest SRL, LLC v. Anheuser-Busch InBev*, the court held that this legal challenge to the six-pack rule was barred by the act of state doctrine. U.S. courts will not rule on the validity of regulatory decisions made by foreign governments.

—937 F.3d 1067 (7th Cir.)

sovereign immunity

A doctrine that immunizes foreign nations from the jurisdiction of U.S. courts when certain conditions are satisfied.

43–1c The Doctrine of Sovereign Immunity

When certain conditions are satisfied, the doctrine of **sovereign immunity** protects foreign nations from the jurisdiction of U.S. courts. The Foreign Sovereign Immunities Act (FSIA) governs the circumstances in which an action may be brought in the United States against a foreign nation.

According to the FSIA, a foreign state is not immune from the jurisdiction of U.S. courts in the following situations:

1. When the foreign state has waived its immunity either explicitly or by implication.
2. When the foreign state has engaged in commercial activity within the United States or in commercial activity outside the United States that has a direct effect in the United States.
3. When the foreign state has committed a tort in the United States or has violated certain international laws.

Under the FSIA, a foreign state includes both a political subdivision of a foreign state and an instrumentality of a foreign state. An instrumentality may be any department or agency of any branch of the foreign state's government.

43-2 Doing Business Internationally

A U.S. domestic firm can engage in international business transactions in a number of ways. The simplest way is to seek out foreign markets for domestically produced products or services. In other words, U.S. firms can **export** their goods and services to markets in other countries.

Alternatively, a U.S. firm can establish foreign production facilities so as to be closer to the foreign market or markets in which its products are sold. The advantages may include lower labor costs, fewer government regulations, and lower taxes and trade barriers. A domestic firm can also obtain revenues by licensing its technology to an existing foreign company or by expanding abroad by selling franchises to overseas entities.

Learning Outcome 2

Discuss how business is done internationally.

export

To sell products to buyers located in other countries.

43-2a Exporting

Most U.S. companies make their initial foray into international business through exporting. Exporting can take two forms: direct exporting and indirect exporting. Companies that export indirectly can make use of agency relationships or distributorships.

Direct Versus Indirect Exporting In direct exporting, a U.S. company signs a sales contract with a foreign purchaser that provides for the conditions of shipment and payment for the goods. If sufficient business develops in a foreign country, a U.S. corporation may set up a specialized marketing organization in that foreign market by appointing a foreign agent or a foreign distributor. This is called indirect exporting.

Agency Relationships Versus Distributorships When a U.S. firm wishes to limit its involvement in an international market, it normally establishes an agency relationship with a foreign firm. In an agency relationship, one person (the agent) agrees to act on behalf of another (the principal). The foreign agent is thereby empowered to enter into contracts in the agent's country on behalf of the U.S. company.

When a substantial market exists in a foreign country, a U.S. firm may wish to appoint a distributor located in that country. The U.S. firm and the distributor enter into a **distribution agreement**, which is a contract between the seller and the distributor setting out the terms and conditions of the distributorship.

distribution agreement

A contract between a seller and a distributor of the seller's products setting out the terms and conditions of the distributorship.

43-2b Manufacturing Abroad

An alternative to direct or indirect exporting is the establishment of foreign manufacturing facilities. Typically, U.S. firms establish manufacturing plants abroad if they believe that doing so will reduce their costs and enable them to compete more effectively in foreign markets. A U.S. firm can manufacture goods in other countries through licensing, franchising, and subsidiaries.

Licensing A U.S. firm can license a foreign manufacturing company to use its copyrighted, patented, or trademarked intellectual property or trade secrets. Basically, licensing allows a foreign firm to use an established brand name for a fee. A licensing agreement with a foreign-based firm is much the same as any other licensing agreement. The foreign firm obtains the right to make and market the product according to its special formula or process in exchange for payments to the product's U.S. owner.

Example 43.1 The Coca-Cola Bottling Company licenses firms worldwide to use (and keep confidential) its secret formula for the syrup in its soft drink. In return, the company receives a percentage of the income earned from the sale of Coca-Cola by those firms. ■

franchise

Any arrangement in which the owner of intellectual property licenses another to use it under specified conditions in the selling of goods or services.

Franchising A **franchise** is any arrangement in which the owner of a trademark, trade name, or copyright (the franchisor) licenses another (the franchisee) to use it under certain conditions in the selling of goods or services. In return, the franchisee pays a fee, which usually is based on a percentage of gross or net sales. International franchises include Hilton Hotels, Starbucks, and McDonald's.

Subsidiaries Another way to expand into a foreign market is to establish a wholly owned subsidiary firm in a foreign country. When a wholly owned subsidiary is established, the parent company, which remains in the United States, retains complete ownership of all the facilities in the foreign country. The parent company has complete authority and control over all phases of the operation.

43–3 International Contract Provisions

Learning Outcome 3

Explain common provisions in international contracts.

Language and legal differences among nations can create special problems for parties to international contracts when disputes arise. It is possible to avoid these problems by including special provisions in the contracts. Such provisions include choice-of-language, forum-selection, choice-of-law, *force majeure*, and arbitration clauses.

43–3a Choice-of-Language Clause

A deal struck between a U.S. company and a company in another country normally involves two languages. Consequently, the complex contractual terms involved may not be understood equally well by the parties. To make sure that no disputes arise out of this language problem, an international sales contract should have a **choice-of-language clause** designating the official language by which the contract will be interpreted in the event of disagreement.

choice-of-language clause

A clause that designates the official language for a contract's interpretation.

43–3b Forum-Selection Clause

When parties from several countries are involved, litigation may be pursued in courts in different nations. No universally accepted rules govern which court has jurisdiction over particular subject matter or parties to a dispute. Consequently, parties to an international transaction should include a **forum-selection clause** in the contract to indicate what court will decide disputes arising under the contract.

forum-selection clause

A contract provision identifying the court that will decide any disputes.



Highlighting the Point

Garware, Ltd., which is based in India, makes plastics. Intermax Corporation, which is based in New York, is Garware's U.S. agent. The parties execute a written agreement that provides, "The courts of India have jurisdiction to hear suits on all claims relating to this agreement." Intermax buys goods from Garware, warehouses them in the

United States, and resells them. When Intermax fails to pay for the goods, Garware files a suit in a U.S. court to collect.

Does the forum-selection clause require the dismissal of this suit? Yes. The parties' agreement contains a valid and enforceable forum-selection clause, which applies to this suit. The courts of India have jurisdiction.

43–3c Choice-of-Law Clause

A contractual provision designating the applicable law—such as the law of Germany or California—is called a **choice-of-law clause**. An international contract usually includes such a clause. Generally, parties are allowed to choose the law that will govern their contractual relationship, provided that the law chosen is the law of a jurisdiction that has a substantial relationship to the parties and to the international business transaction.

choice-of-law clause

A clause designating the law that will govern the contract.

43–3d Force Majeure Clause

In international business contracts, *force majeure* clauses commonly stipulate that acts of God—such as floods, fires, or catastrophic accidents—may excuse a party from liability for nonperformance. A number of other eventualities, such as government orders or embargoes, may do the same.

43–3e Arbitration Clause

International contracts frequently include arbitration clauses. By means of such clauses, the parties agree in advance to be bound by the decision of a specified third party in the event of a dispute. The third party may be a neutral entity (such as the International Chamber of Commerce), a panel of individuals representing both parties' interests, or some other group or organization.

43–4 Regulation of International Business Activities

International business activities can affect the economies, foreign policies, domestic policies, and other national interests of the countries involved. For this reason, nations impose laws to restrict or facilitate international business. Controls may also be imposed by international agreements.

Learning Outcome 4

Outline international business regulations.

43–4a Investment Protection

Firms that invest in a foreign nation face the risk that the foreign government may take possession of the investment property. Expropriation does not violate generally observed principles of international law. Such principles are normally violated, however, when a government confiscates property without compensation (or without adequate compensation). Few remedies are available for confiscation of property by a foreign government.

To counter the deterrent effect that the possibility of confiscation may have on potential investors, many countries guarantee that foreign investors will be compensated if their property is taken. A guaranty can take the form of national constitutional or statutory laws or provisions in international treaties. As further protection for foreign investments, some countries provide insurance for their citizens' investments abroad.

43–4b Export Controls

Under the U.S. Constitution, Congress cannot impose any export taxes. Congress, however, may set export restrictions on various items, such as grain being sold abroad. Under the Export Administration Act, the flow of technologically advanced products and technical data can be restricted.

Although it restricts certain exports, the United States uses devices such as export incentives and subsidies to stimulate other exports and thereby aid domestic businesses. Under the Export Trading Company Act, U.S. banks are encouraged to invest in export trading companies. These companies are formed when exporting firms join together to export a line of goods.

43–4c Import Controls

All nations have restrictions on imports, and the United States is no exception. Restrictions include strict prohibitions, quotas, and tariffs.

Prohibitions Under the Trading with the Enemy Act, no goods may be imported from nations that have been designated enemies of the United States. Other laws prohibit the importation of illegal drugs, books that urge insurrection against the United States, and agricultural products that pose dangers to domestic crops or animals.

Quotas and Tariffs Limits on the amounts of goods that can be imported are known as **quotas**. At one time, for instance, the United States had legal quotas on the number of automobiles that could be imported from Japan.

Tariffs are taxes on imports. A tariff usually is a percentage of the value of the import, but it can be a flat rate per unit, such as per barrel of oil. Tariffs raise the prices of imported goods, causing some consumers to purchase less expensive, domestically manufactured goods.

Antidumping Duties The United States has specific laws directed at what it sees as unfair international trade practices. One such practice is dumping. **Dumping** is the sale of imported goods at “less than fair value.” Fair value usually is determined by the price of those goods in the exporting country. Foreign firms that engage in dumping in the United States hope to undersell U.S. businesses to obtain a larger share of the U.S. market. To prevent this unfair trade practice, an extra tariff—known as an antidumping duty—may be assessed on the imports.

Minimizing Trade Barriers Restrictions on imports are known as trade barriers. The elimination of trade barriers is sometimes seen as essential to the world’s economic well-being.

Most of the world’s leading trade nations are members of the World Trade Organization (WTO). To minimize trade barriers among nations, each member country of the WTO is required to grant **normal-trade-relations (NTR) status** to other member countries. This means that each member is obligated to treat other members at least as well as it treats the country that receives its most favorable treatment with regard to imports or exports.

Various regional trade agreements and associations also help to minimize trade barriers among nations. Examples include the European Union and the Republic of Korea–United States Free Trade Agreement.

43–5 Space Law

Space law consists of the international and national laws that govern activities in outer space. Until recently, national governments conducted most of these activities, so space law was directed primarily at governments. Now, private companies

quota

A set limit on the amount of goods that can be imported.

tariff

A tax on imported goods.

dumping

The selling of goods in a foreign country at a price below the price charged for the same goods in the domestic market.

normal-trade-relations (NTR) status

A status granted through an international agreement whereby all trade partners are treated equally.

Learning Outcome 5

List international space law treaties.

engage in space-related activities and consequently open outer space to the rest of us. Space law, accordingly, faces new challenges.

43–5a International Space Law

International space law consists of international treaties—primarily negotiated by the United Nations (U.N.)—and U.N. resolutions. These sources recognize that activities conducted in outer space and the benefits derived from those activities should improve the welfare of all nations and humanity.

Exploration and Exploitation The foundation of international space law is the U.N. Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, including the Moon and Other Celestial Bodies. This treaty—referred to as the Outer Space Treaty—set the framework for subsequent international agreements and U.N. resolutions.

The Outer Space Treaty expresses general principles that have been expanded and applied in other treaties. Outer space is declared to be free for the exploration and use of all nations. The moon, the planets, asteroids, and other celestial bodies are not subject to the appropriation of any single nation. Space objects are to be used exclusively for peaceful purposes. No weapons of mass destruction are permitted in outer space.

Each nation is responsible for its activities in outer space, whether they are conducted by the government or by a private entity. In fact, the activities of private entities require authorization and supervision by a government. Each nation retains jurisdiction and control over its space objects and the personnel aboard them. Each nation is liable for the damage caused by its space objects. Finally, space exploration is to be conducted so as to avoid “harmful contamination.”

Astronauts and Space Objects The Agreement on the Rescue of Astronauts, the Return of Astronauts, and the Return of Objects Launched into Outer Space (the Rescue Agreement) provides that each nation will undertake to rescue and assist astronauts in distress and return them to their “launching State.” All nations are to assist in recovering space objects that return to earth outside the territory of the launching state.

The Convention on International Liability for Damage Caused by Space Objects (the Liability Convention) provides further rules concerning these objects. A launching state is absolutely liable for personal injury and property damage caused by its space objects on the surface of the earth or to aircraft in flight.

The Convention on Registration of Objects Launched into Outer Space (the Registration Convention) provides for the mandatory registration of objects launched into outer space. Each launching state is to maintain a registry of the objects that it launches into space. The intent is to assist in identifying the objects.

Space Debris An estimated seven hundred thousand human-made objects are in orbit around the earth. Most of these objects are no longer under any party’s control and are classified as space debris. The U.N. has endorsed guidelines to reduce space debris. The guidelines apply to the planning, design, manufacture, and operational phases of spacecraft. Among other points, systems should be designed not to release debris during normal operations. Objects no longer in operation should be removed from orbit if this can be accomplished in a controlled manner.

43–5b U.S. Space Law

In the United States, each government agency that operates or authorizes spacecraft is responsible for complying with U.S. law and international treaties.

Commercial Spaceflight The Federal Aviation Administration (FAA) regulates private spaceports and the launch and reentry of private spacecraft under the Commercial Space Launch Act. The FAA is working to establish licensing and safety criteria for private spacecraft. Some states limit the liability of space tourism providers under state tort law. State legislatures and, ultimately, courts will need to consider other issues in this context, including insurance requirements and the enforceability of liability waivers.

Exports of Space Technology Under U.S. regulations, all spacecraft are classified as “defense articles.” The defense classification restricts the transfer of space technology and any related information to any foreign person or nation. This restriction makes it difficult for U.S. space companies to compete in global space markets.

Property Rights to Space Resources As mentioned, the Outer Space Treaty bans the national appropriation of territory in space. If the United States cannot appropriate territory in space, then it cannot give U.S. citizens title to property associated with this territory. Under U.S. law, the government must have sovereignty over territory before it can confer title to associated property to its citizens.

The treaty also provides, however, that each nation retains jurisdiction over its objects in space and prohibits interference with space activities. In effect, these provisions confer protections associated with property rights on private space activities.

The Spurring Private Aerospace Competitiveness and Entrepreneurship (SPACE) Act allows U.S. citizens, including private companies, to “engage in the commercial exploration and exploitation of space resources.” This right extends only to inorganic materials, not biological life.

Chapter Summary—International and Space Law

Learning Outcome 1: Identify important international principles and doctrines.

Important international principles and doctrines include:

- (1) The principle of comity—Under this principle, nations give effect to the laws and judicial decrees of other nations as long as those laws and decrees are consistent with the law and public policy of the accommodating nation.
- (2) The act of state doctrine—A doctrine under which U.S. courts avoid passing judgment on the validity of acts committed by a foreign government within its own territory.
- (3) The doctrine of sovereign immunity—When certain conditions are satisfied, foreign nations are immune from U.S. jurisdiction. The doctrine is codified in the Foreign Sovereign Immunities Act.

Learning Outcome 2: Discuss how business is done internationally.

U.S. firms engage in international business transactions through (1) exporting, which may involve foreign agents or distributors, and (2) manufacturing abroad through licensing arrangements, franchising operations, or wholly owned subsidiaries.

Learning Outcome 3: Explain common provisions in international contracts.

International business contracts often include choice-of-language, forum-selection, and choice-of-law clauses to reduce the uncertainties associated with interpreting the language of the agreement and dealing with legal differences. Most domestic and international contracts include *force majeure* clauses. They commonly stipulate that certain events may excuse a party from liability for nonperformance of the contract. Arbitration clauses are also frequently found in international contracts.

Learning Outcome 4: Outline international business regulations.

National laws regulate foreign investments, exporting, and importing. The World Trade Organization attempts to minimize trade barriers among nations, as do regional trade agreements and associations.

Learning Outcome 5: List international space law treaties.

International space law treaties negotiated by the United Nations include the Outer Space Treaty, the Rescue Agreement, the Liability Convention, and the Registration Convention.

Straight to the Point

1. Contrast international and national law. (See Learning Outcome 1.)
2. What is the difference between expropriation and confiscation? (See Learning Outcome 1.)
3. Under the Foreign Sovereign Immunities Act, what comprises a foreign state? (See Learning Outcome 1.)
4. In an international contract, what does an arbitration clause provide? (See Learning Outcome 3.)
5. Why do nations impose laws to restrict or facilitate international transactions? (See Learning Outcome 4.)
6. How do international and U.S. law protect property rights in outer space? (See Learning Outcome 5.)

Issue Spotters

Check your answers to the Issue Spotters against the answers provided in Appendix A at the end of this text.

1. Hi-Cola Corporation, a U.S. firm, markets a popular soft drink. The formula is secret, but with careful chemical analysis, its ingredients could be discovered. What can Hi-Cola do to prevent its product from being pirated abroad? (See Learning Outcome 2.)
2. Gems International, Ltd., is a foreign firm that has a 12 percent share of the U.S. market for diamonds. To capture a larger share, Gems offers its products at a below-cost discount to U.S. buyers (and inflates the prices in its own country to make up the difference). How can this attempt to undersell U.S. businesses be defeated? (See Learning Outcome 4.)

Real Law

43–1. The Principle of Comity. MD Helicopters, Inc., based in Arizona, failed to deliver eight helicopters to the Netherlands National Police Services Agency. The National Police successfully sued MD for breach of contract in Dutch court proceedings. The Netherlands' government represented its police force and then brought suit in Arizona to compel MD to pay the prescribed damages. The Netherlands based its claim on an Arizona statute that recognizes foreign-country judgments if the relevant laws of that country are "similar" to those of Arizona. MD countered that no Netherlands law addressed the issues relating to its dispute with the National Police. Rather, only Dutch court decisions did so. Was MD correct? [*State of the Netherlands v. MD Helicopters, Inc.*, 250 Ariz. 235 (S.Ct. Ariz. 2020)] (See Learning Outcome 1.)

43–2. The Act of State Doctrine. For fifty years, the Soviet Union made and sold Stolichnaya vodka and licensed its trademark for use in the United States. After the Soviet Union collapsed, the state enterprise that had managed the mark was privatized and came under the control of Spirits International B.V. Later, a Russian court held that the enterprise had not been validly privatized and that ownership of the Stolichnaya mark remained with the Soviet Union's successor, the Russian Federation. The Russian Federation assigned the mark to Federal Treasury Enterprise Sojuzplodoimport, OAO (FTE). FTE filed a suit in a U.S. federal district court against Spirits, alleging that its use of the mark violated U.S. trademark law. Spirits challenged the validity of the assignment of the mark to FTE. Is this a

question to be decided by a U.S. court? Why or why not? [*Federal Treasury Enterprise Sojuzplodoimport, OAO v. Spirits International B.V.*, 809 F.3d 737 (2d Cir. 2016)] (See Learning Outcome 1.)

43–3. Import Controls. The Wind Tower Trade Coalition is an association of domestic manufacturers of utility-scale wind towers. The coalition filed a suit in the U.S. Court of International Trade against the U.S. Department of Commerce. It challenged the Commerce Department’s decision

to impose only prospective antidumping duties, rather than retrospective (retroactive) duties, on imports of utility-scale wind towers from China and Vietnam. The Commerce Department had found that the domestic industry had not suffered any “material injury” or “threat of material injury,” and that it would be protected by a prospective assessment. Can an antidumping duty be assessed retrospectively? If so, should it be assessed here? Discuss. [*Wind Tower Trade Coalition v. United States*, 741 F.3d 89 (Fed. Cir. 2014)] (See Learning Outcome 4.)

Ethical Questions

43–4. Choice of Language. Would it be ethical for a U.S. firm to choose not to do business in a foreign country that requires the use of its own language in the legal documents that govern the firm’s business transactions? Discuss. (See Learning Outcome 3.)

43–5. The Doctrine of Sovereign Immunity. A subsidiary of U.S.-based Helmerich & Payne International Drilling Company was incorporated under Venezuelan law. Helmerich supplied oil-drilling rigs to entities that were part of the government of Venezuela. The government fell behind in payment on contracts for its use of the rigs. When the overdue amounts topped \$100 million, the Venezuelan government

nationalized the rigs and took possession. Helmerich filed a lawsuit in a U.S. federal district court against Venezuela, claiming expropriation of property in violation of international law. Helmerich asserted that the U.S. court had jurisdiction under the Foreign Sovereign Immunities Act (FSIA). Venezuela argued that the FSIA did not apply because Helmerich did not have rights in the rigs, which were the property of Helmerich’s Venezuelan subsidiary. Does that fact make Helmerich’s claim frivolous and unethical? Explain. [*Bolivarian Republic of Venezuela v. Helmerich & Payne International Drilling Co.*, __ U.S. __, 137 S.Ct. 1312, 197 L.Ed.2d 663 (2017)] (See Learning Outcome 1.)

Chapter 43—Work Set

True-False Questions

- _____ 1. All nations must give effect to the laws of all other nations.
- _____ 2. Under the act of state doctrine, foreign nations are subject to the jurisdiction of U.S. courts.
- _____ 3. Under the doctrine of sovereign immunity, foreign nations are subject to the jurisdiction of U.S. courts.
- _____ 4. The Foreign Sovereign Immunities Act states the circumstances in which the United States can be sued in foreign courts.
- _____ 5. A member of the World Trade Organization must usually grant other members normal-trade-relations status.
- _____ 6. Congress cannot tax exports.
- _____ 7. The foundation of international space law is the Convention on International Liability for Damage Caused by Space Objects.
- _____ 8. Under a *force majeure* clause, a party may be excused from liability for nonperformance.
- _____ 9. Under U.S. law, U.S. citizens, including private companies, can engage in the commercial exploration and exploitation of space resources.
- _____ 10. Under a license, one party is allowed to use another's patented product.

Multiple-Choice Questions

- _____ 1. Johnston International, a U.S. firm, signs a contract with Irkut, Ltd., a Russian company, to give Irkut the right to sell Johnston's products in Russia. This is
 - a. a distribution agreement.
 - b. a subsidiary.
 - c. direct exporting.
 - d. licensing.
- _____ 2. China, which governs Hong Kong, seizes the property of Mack Enterprises, Inc., a U.S. firm doing business in Hong Kong, without paying the owners just compensation. This is
 - a. a confiscation.
 - b. dumping.
 - c. licensing.
 - d. an expropriation.
- _____ 3. To obtain new computers, Liberia accepts bids from U.S. firms, including Macro Corporation and Micro, Inc. Macro wins the contract. Alleging impropriety, Micro files a suit in a U.S. court against Liberia and Macro. The court may decline to hear the suit under
 - a. the act of state doctrine.
 - b. the doctrine of sovereign immunity.
 - c. the principle of comity.
 - d. the World Trade Organization.
- _____ 4. A South African seller and a U.S. buyer form a contract, which the buyer later breaches. The seller sues in a South African court and wins damages, but the buyer's assets are in the United States. If a U.S. court enforces the judgment, it will be because of the
 - a. act of state doctrine.
 - b. doctrine of sovereign immunity.
 - c. principle of comity.
 - d. World Trade Organization.

- _____ 5. A contract between Moss Energy, a U.S. firm, and Electronique, S.A., a French company, provides that disputes between the parties will be adjudicated in a specific British court. This clause is
- a forum-selection clause.
 - a choice-of-law clause.
 - a force majeure clause.
 - an arbitration clause.
- _____ 6. Kenya issues bonds to finance the construction of an international airport. Kenya sells some of the bonds in the United States to Larry. A terrorist group destroys the airport, and Kenya refuses to pay the interest or principal on the bonds. Larry files a suit in a U.S. court. The court will hear the suit
- if Kenya's acts constitute a confiscation.
 - if Kenya's acts constitute an expropriation.
 - if Kenya's selling bonds is a "commercial activity."
 - under no circumstances.
- _____ 7. Digital, Inc., makes supercomputers that feature advanced technology. To inhibit Digital's export of its products to other countries, Congress can
- confiscate all profits on exported supercomputers.
 - expropriate all profits on exported supercomputers.
 - set quotas on exported supercomputers.
 - tax exported supercomputers.
- _____ 8. Auto Corporation makes cars in the United States. To boost the sales of Auto Corporation and other domestic carmakers, Congress can
- neither set quotas nor tax imports.
 - only set quotas on imports.
 - only tax imports.
 - set quotas and tax imports.

Answering More Legal Problems

1. Hong Electronics, a state-owned factory in the People's Republic of China, made counterfeit parts that were misrepresented as genuine and sold in the United States. Integrated Technology Corp., a U.S. company that made and sold the genuine parts in the U.S. market, filed a suit in a U.S. court against Hong, alleging violations of trademark and patent law.
2. Mobile Processes, Inc., a U.S. company, made network management devices. To test the demand for the devices in Asia, Mobile exported the products to Asian markets. When the test proved successful, Mobile decided to expand its operations to India.

Does the doctrine of sovereign immunity prevent the U.S. court from hearing Integrated's suit? No. The doctrine of sovereign immunity exempts foreign nations from the jurisdiction of U.S. courts, subject to certain conditions. The Foreign Sovereign Immunities Act governs the circumstances in which an action may be brought in a U.S. court against a foreign state, its political _____, or any of its _____ or _____. A foreign state is not immune from the jurisdiction of U.S. courts when it engages in _____ activity that takes place within the United States or that has a _____ effect in the United States. Here, Hong engaged in _____ activity when it sold its counterfeit parts in the United States. Thus, a U.S. court can exercise jurisdiction.

What are Mobile's options for engaging in further international business transactions? Mobile can continue to export its goods to foreign markets. In _____ exporting, a seller signs a contract with a foreign buyer that provides for the conditions of shipment and payment. In _____ exporting, the seller sets up a marketing organization in a foreign market by appointing a foreign agent or distributor. An alternative is to _____ a manufacturing plant abroad. This would likely reduce costs and enable the seller to _____ more effectively in foreign markets. The seller can also obtain business abroad by _____ a foreign company to use copyrighted, patented, or trademarked intellectual property or trade secrets. Another way to expand into a foreign market is to establish a wholly owned _____ in a foreign country and thereby retain complete ownership, authority, and control over the operation.

Appendix A

Answers to the Issue Spotters

Chapter 1

1A: Case law includes courts' interpretations of statutes, constitutional provisions, and administrative rules. Statutes often codify common law rules. For these reasons, a judge might rely on the common law as a guide to the intent and purpose of a statute.

2A: No. The U.S. Constitution is the supreme law of the land and applies to all jurisdictions. A law in violation of the Constitution (in this question, the First Amendment to the Constitution) will be declared unconstitutional.

Chapter 2

1A: Maybe. On the one hand, it is not the company's "fault" when a product is misused. Also, keeping the product on the market is not a violation of the law, and stopping sales would hurt profits. On the other hand, suspending sales could reduce suffering and could stop potential negative publicity that might occur if sales continued.

2A: When a corporation decides to respond to what it sees as a moral obligation to correct for past discrimination by adjusting pay differences among its employees, an ethical conflict is raised between the firm and its employees and between the firm and its shareholders. This dilemma arises directly out of the effect such a decision has on the firm's profits. If satisfying this obligation increases profitability, then the dilemma is easily resolved in favor of "doing the right thing."

Chapter 3

1A: Before a court will hear a case, it must be established that the court has subject-matter and personal jurisdiction and that the matter at issue is justiciable. The party bringing the suit must also have standing to sue.

2A: Yes. Whenever a suit involves citizens of different states, diversity of citizenship exists, and the suit can be brought in a federal court. In diversity-of-citizenship suits, Congress has set an additional requirement—the amount in controversy must be more than \$75,000.

Chapter 4

1A: No. Even if commercial speech is not related to illegal activities and is not misleading, it may be restricted if a state has a substantial interest that cannot be achieved by less restrictive means. In this case, the interest in energy conservation is substantial, but it could be achieved by less restrictive means. That would be the utilities' defense against the enforcement of this state law.

2A: Yes. The tax would limit the liberty of some persons (out-of-state businesses), so it is subject to a review under the equal protection clause. Protecting local businesses from out-of-state competition is not a legitimate government objective. Thus, such a tax would violate the equal protection clause.

Chapter 5

1A: The company might defend against this electrician's wife's claim by asserting that the electrician should have known of the risk and, therefore, the company had no duty to warn. According to the problem, the danger is common knowledge in the electrician's field and should have been apparent to this electrician given his years of training and experience. In other words, the company most likely had no need to warn the electrician of the risk.

The firm could also raise the defense of comparative negligence. Both parties' negligence, if any, could be weighed and the liability distributed proportionately. The defendant could also assert assumption of risk, claiming that the electrician had voluntarily entered into a dangerous situation, knowing the risk involved.

2A: No. As long as competitive behavior is genuine, it is not wrongful, even if it results in the breaking of a contract. The public policy that favors free competition in advertising outweighs any instability that genuine competitive activity causes in contractual or business relations.

To constitute wrongful interference with a contractual relationship, there must be (1) a valid, enforceable contract between two parties; (2) the knowledge of a third party that this contract exists; and (3) the third party's intentionally causing the breach of the contract (and damages) to advance that party's interest.

Chapter 6

1A: Karl may have committed trademark infringement. Search engines compile their results by looking through websites' coding. Meta tags, or keywords, are inserted in the coding to increase the likelihood that a website will be included in search engine results. A site that appropriates the keywords of other sites with more frequent hits will appear in the same search engine results as the more popular sites. But using another's trademark as a keyword without the owner's permission normally constitutes trademark infringement. Of course, some uses of another's trademark as a meta tag may be permissible if the use is reasonably necessary and does not suggest that the owner authorized or sponsored the use.

2A: Yes. Roslyn has committed theft of trade secrets. Lists of suppliers and customers cannot be patented, copyrighted, or trademarked, but such information is protected against appropriation by others as trade secrets. Most likely, Roslyn signed a contract, agreeing not to use this information outside her employment by Organic. But even without this contract, Organic could have made a convincing case against Roslyn for a theft of trade secrets.

Chapter 7

1A: Yes. Forgery is the fraudulent making or altering of any writing that changes the legal liability of another.

2A: Yes. Federal law makes it a crime to use wire (including telegraph, telephone, television, and the internet) to defraud the public. Carl has committed a violation of federal wire fraud statutes.

Chapter 8

1A: No. This contract, although not fully executed, is for an illegal purpose and therefore is void. A void contract gives rise to no legal obligation on the part of any party. A contract that is void is no contract. There is nothing to enforce.

2A: Yes. A person who is unjustly enriched at the expense of another can be required to account for the benefit under the theory of quasi contract. Alison and Jerry did not have a contract, but the law will impose one to avoid the unjust enrichment.

Chapter 9

1A: No. Revocation of an offer may be implied by conduct inconsistent with the offer. When the corporation hired someone else, and the offeree learned of the hiring, the offer was revoked. The acceptance was too late.

2A: Yes. Dani has entered into an enforceable contract to subscribe to *E-Profit*. In this set of facts, the offer to deliver the newsletter via e-mail was presented by Cyber Investments (the offeror) with a statement of how to accept. This statement specified that clicking on the "SUBSCRIBE" button was an acceptance of the offer. Dani (the offeree) had an opportunity to decline the offer by not clicking on the button before making the contract. This is a click-on agreement.

Chapter 10

1A: Yes. The original contract was executory. The parties rescinded it and agreed to a new contract. If Sharon had broken the contract to accept a contract with another employer, she might have been held liable for damages for the breach.

2A: Yes. Under the doctrine of promissory estoppel (or detrimental reliance), Maria, the promisee, is entitled to payment of the promised amount when she graduates. There was a promise, she relied on it, and her reliance was substantial and definite. She went to college for nearly four years, incurring considerable expenses. It would only be fair to enforce the promise.

Chapter 11

1A: No. Joan may disaffirm this contract. Because the apartment was a necessary, however, she remains liable for the reasonable value of her occupancy of the apartment.

2A: A minor may effectively ratify a contract after they reach the age of majority either expressly or impliedly. Failing to disaffirm an otherwise enforceable contract within a reasonable time after reaching the age of majority would also effectively ratify it. Nothing a minor does before attaining majority, however, will ratify a contract.

Chapter 12

1A: No. A contract that calls for something that is prohibited by statute is illegal and thus void and unenforceable.

2A: No. Generally, an exculpatory clause—a clause attempting to absolve parties of negligence or other wrongs—is not enforced if the party seeking its enforcement is involved in a business that is important to the public as a matter of practical necessity, such as an airline. Because of the essential nature of these services, such a party has an advantage in bargaining strength and could insist that anyone contracting for its services agree not to hold it liable.

Chapter 13

1A: No. Brad exerted duress on Dina. Duress involves coercive conduct—forcing a party to enter into a contract by threatening the party with a wrongful act. The threat to break a contract on the eve of the deadline in this problem was sufficiently coercive to constitute duress.

2A: Yes. Rescission may be granted on the basis of fraudulent misrepresentation. The elements of fraudulent misrepresentation include intent to deceive, or *scienter*. *Scienter* exists if a party makes a statement recklessly, without regard to whether it is true or false. *Scienter* also exists if a party says or implies that a statement is made on some basis—such as personal knowledge or investigation—when it is not.

Chapter 14

1A: No. Under the UCC, a contract for a sale of goods priced at \$500 or more must be in writing to be enforceable. In this case, the contract is not enforceable beyond the quantity already delivered and paid for.

2A: The court might conclude that under the doctrine of promissory estoppel, the employer (Next Corporation) is estopped (prevented) from claiming the lack of a written contract as a defense. The oral contract between Next Corporation and Paula may be enforced because Next Corporation made a promise on which Paula justifiably relied in moving to New York. Paula's reliance on the promise was foreseeable and avoiding an injustice can only be accomplished by enforcing the promise. If the court strictly enforces the Statute of Frauds, however, Paula may be without a remedy—such as being reinstated to her position or payment for lost wages and other damages.

Chapter 15

1A: Yes. When one person makes a promise with the intention of benefiting a third person, the third person can sue to enforce it. This is a third-party beneficiary contract. Jeff is an intended beneficiary.

2A: No. Generally, if a contract makes it clear that a right is not assignable, no assignment will be effective. Here, under the lease, Grocers Express (the lessee) cannot assign its rights without the consent of Fleet Trucking (the lessor). Grocers Express failed to obtain Fleet Trucking's consent before attempting to assign its rights to a third party (Harland's Truck Service).

Chapter 16

1A: Ron, the buyer, is entitled to the benefit of the bargain that was made with George, the contractor—that is, Ron is entitled to be put in as good a position as he would have been

in if the contract had been fully performed. The measure of the benefit is the cost to complete the work (\$500). These are compensatory damages.

2A: No. To recover damages that flow from the consequences of a breach but that are caused by circumstances beyond the contract (consequential damages), the breaching party must know, or have reason to know, that special circumstances will cause the nonbreaching party to suffer the additional loss. Amy is the breaching party because she delayed the sale of the ranch. But she is not liable for Bastien's expenses in providing for the cattle because she had no reason to know about them.

Chapter 17

1A: A shipment of nonconforming goods constitutes an acceptance and a breach unless the seller seasonably notifies the buyer that the nonconforming shipment does not constitute an acceptance and is offered only as an accommodation. Without the notification, the shipment is an acceptance and a breach. Thus, here, the shipment was both an acceptance and a breach.

2A: Yes. In a transaction between merchants, the requirement of a writing is satisfied if one of them sends to the other a signed written confirmation that indicates the terms of the agreement, and the merchant receiving it has reason to know of its contents. If the merchant who receives it does not object in writing within ten days after receipt, the writing will be enforceable against the merchant even though they had not signed anything.

Chapter 18

1A: Buyers and sellers can have an insurable interest in identical goods at the same time. If the buyer (Silk & Satin) bore the risk, it must pay and seek reimbursement from its insurance company. If the seller (Adams Textiles) bore the risk, it must seek reimbursement from its insurance company and may still have an obligation to deliver the identified goods (the fabric) to Silk & Satin.

2A: George (the buyer) suffers the loss of the goods (Blaze, the horse). If a bailee—in this case, the stable—holds goods for a seller (Paula), and the goods are to be delivered without being moved, the risk of loss passes when the bailee (the stable) acknowledges the buyer's (George's) right to possess the goods (Blaze). The stable acknowledged George's right to possess the horse when the stable said, "Okay," in response to Paula's call about the sale.

Chapter 19

1A: Yes. Normally, goods must be tendered in a single delivery, but the parties can agree otherwise, or the circumstances may be such that either party can rightfully request delivery

in lots. The seller's (Mike's) proposal to work around the strike seems reasonable.

2A: Yes. In a case of anticipatory repudiation, as in this problem, a buyer (Ace) can resort to any remedy for breach even though the buyer told the seller (Pic)—the repudiating party in this problem—that the buyer would wait for the seller's performance.

Chapter 20

1A: General Construction, the buyer, should argue that Industrial Supplies, the seller, breached an implied warranty of fitness for a particular purpose. An implied warranty of fitness for a particular purpose arises when a seller knows the particular purpose for which a buyer will use goods and that the buyer is relying on the seller's skill and judgment to select suitable goods.

2A: Yes. Anchor, Inc., as the manufacturer of the component part, may be held liable. The strict liability doctrine has been expanded to include suppliers of component parts.

Chapter 21

1A: Yes. The Federal Trade Commission (FTC) has issued rules to govern advertising techniques, including rules designed to prevent bait-and-switch advertising. Under the FTC guidelines, bait-and-switch advertising occurs if the seller refuses to show the advertised item, fails to have in stock a reasonable quantity of the item, fails to promise to deliver the advertised item within a reasonable time, or discourages employees from selling the item.

2A: A number of federal and state laws deal specifically with information given on labels and packages. These laws include the Fair Packaging and Labeling Act and the Nutrition Labeling and Education Act.

Chapter 22

1A: "I promise to pay \$700" would make the instrument negotiable. "I.O.U. \$700" or an instruction to Jim's bank stating, "I wish you would pay \$700 to Sherry," would render the instrument nonnegotiable. To be negotiable, an instrument must contain an express promise to pay. An I.O.U. is only an acknowledgment of indebtedness. An order stating, "I wish you would pay," is not sufficiently precise.

2A: Yes. When Hector signed the back of his check, he converted it to a bearer instrument, which anyone can cash. Because a bearer instrument can be negotiated by delivery alone, the check was negotiated to Paige (the finder). Hector could have avoided this loss by indorsing the check with a restrictive indorsement, such as "For Deposit Only." If he had done that, the check could not have been cashed but

only deposited into his credit union account. In addition, Hector could simply have waited until he reached the credit union's teller counter before indorsing the check.

Chapter 23

1A: Carol is a holder in due course (HDC) to the full extent of the note. One of the requirements for becoming an HDC is taking an instrument for value. A party may attain HDC status to the extent that they give value for the instrument. Paying with cash or with a check is giving value.

2A: No. When a drawer's employee (Roy) provides the drawer (Standard Corporation) with the name of a fictitious payee (U-All Company), a forgery of the payee's name is effective to pass good title to subsequent transferees. Standard Corporation cannot recover funds from First State Bank for Roy's forgery.

Chapter 24

1A: Yes to both questions. In a civil suit, a drawer is liable to a payee or to a holder of a check that is not honored. If intent to defraud can be proved, the drawer can also be subject to criminal prosecution for writing a bad check.

2A: No, the bank cannot refuse to recredit Kay's account nor can it recover the amount it paid to Will. The general rule is that the bank must recredit a customer's account when it pays on a forged signature. In addition, the bank has no right to recover from a holder who, without knowledge, cashes a check bearing a forged drawer's signature. Thus, First State Bank cannot collect from Kay, its customer, nor from Will, who cashed the check. The bank's only recourse is to look for the thief (Hal).

Chapter 25

1A: No. Ofelia, as an agent, is prohibited from taking advantage of the agency relationship to obtain property that the principal (Able Corporation) wants to purchase. This is the duty of loyalty that arises with every agency relationship.

2A: Marie would be liable on the note only if she ratified it when she returned. Remember that ratification is the affirmation of a previously unauthorized contract or act. In this situation, the unauthorized act was Rachel's representing Marie when signing the promissory note.

Chapter 26

1A: Yes. Some courts have held that an implied employment contract exists between employer and employee when an employee handbook states that employees will be dismissed

only for good cause. An employer who fires a worker contrary to this promise can be held liable for breach of contract. Firing Larry because of his looks alone is not for “good cause.” AMC is liable to Larry for breach of contract.

2A: No. Fine Print’s negligence is not a requirement for obtaining benefits under workers’ compensation laws.

Yes. If Erin intentionally self-inflicted her on-the-job injury, workers’ compensation laws would not apply. Workers’ compensation laws establish a procedure for compensating workers who are injured on the job. Instead of suing to collect benefits, an injured worker notifies the employer of the injury and files a claim with the appropriate state agency. The right to recover is normally determined without regard to negligence or fault, but intentionally inflicted injuries are not covered. Unlike the potential for recovery in a lawsuit based on negligence or fault, recovery under a workers’ compensation statute is limited to the specific amount designated in the statute for the employee’s injury.

Chapter 27

1A: Yes. One type of sexual harassment occurs when a request for sexual favors is a condition of employment, and the person making the request is a supervisor or acts with the authority of the employer. A tangible employment action, such as continued employment, may also lead to the employer’s liability for the supervisor’s conduct. That the injured employee is a male and the supervisor a female, instead of the other way around, would not affect the outcome. Same-gender harassment is also actionable.

2A: Yes. Koko could succeed in a discrimination suit if she could show that Lively failed to hire her solely because of her disability. The other elements for a discrimination suit based on a disability are that the plaintiff (1) has a disability and (2) is otherwise qualified for the job. Both of these elements appear to be satisfied in this scenario.

Chapter 28

1A: The most appropriate form for doing business for Sam may be a sole proprietorship. This is because his business is relatively small and is not diversified, employs only a few people, has modest profits, and is not likely to expand significantly or require extensive financing in the immediate future.

2A: No. Hal cannot keep the lease money, and he must account to Gretchen for the profits received from leasing the partnership’s vehicles. Under the partners’ fiduciary duty, a partner must account to the partnership for any personal profits or benefits derived without the consent of all the partners in connection with the use of any partnership property.

Chapter 29

1A: Yes. A shareholder can bring a shareholder’s derivative suit on behalf of a corporation if some wrong is done to the corporation. Normally, any damages recovered go into the corporation’s treasury.

2A: Yes. Broad authority to conduct business can be granted in a corporation’s articles of incorporation. For example, the phrase “any lawful purpose” is often used. This can be important because acts of a corporation that are beyond the authority given to it in its articles or charter (or state statutes) are considered illegal, *ultra vires* acts.

Chapter 30

1A: A director cannot support a business that competes directly with a corporation on the board of which the director sits. Thus, Glen’s fiduciary duty requires him to fully disclose the conflict of interest, and he must abstain from voting on the proposed transaction.

2A: The best defense for Tandin is the business judgment rule. As long as directors or officers act in good faith in what they consider to be the best interests of the corporation, and with the care that ordinarily prudent persons would use in similar circumstances, they are not liable simply because the decision had a negative result.

Chapter 31

1A: The first combination is a merger. DEF Corporation absorbed ABC Corporation, and DEF is the surviving corporation. The second combination is a consolidation. Neither Global nor Hometown continues after the combination, and a new firm (GH, Inc.) continues in their place.

2A: Yes. Shareholders who disapprove of a merger or a consolidation may be entitled to be paid fair value for their shares. The right of a shareholder to be paid fair value in this situation is known as an appraisal right.

Chapter 32

1A: Each of the parties—Larry and Midwest Roofing—can place a mechanic’s lien on the property of Joe (the debtor). If Joe does not pay what is owed, the property can be sold to satisfy the debt.

2A: One alternative is for the creditor or secured party (First National Bank) to dispose of the car. When collateral consists of consumer goods and the debtor (in this case, Gail) has paid less than 60 percent of the debt or the purchase price, the creditor has the option of disposing of the collateral (in this scenario, the car) in a commercially reasonable manner.

Another alternative involves Gail, as the debtor, exercising her right of redemption. Before the creditor's disposal of the collateral, a debtor can exercise the right of redemption. This can be done by tendering performance of all of the obligations secured by the collateral and by paying the creditor's reasonable expenses in retaking and maintaining the collateral.

Chapter 33

1A: The major terms that must be disclosed under the Truth-in-Lending Act include the loan principal, the interest rate at which the loan is made, the annual percentage rate (APR), and all fees and costs associated with the loan. These disclosures must be made on standardized forms and based on uniform formulas of calculation. Certain types of loans have special disclosure requirements.

2A: Foreclosure is a process that allows a lender to repossess and auction off property that is securing a loan. The two most common types of foreclosure are judicial foreclosure and power of sale foreclosure. In the former—available in all states—a court supervises the process. In the latter, which is available in only a few states, a lender forecloses on and sells the property without court supervision.

Chapter 34

1A: The savings and loan association is not eligible to file a bankruptcy petition under Chapter 11. Debtors that can file under Chapter 11 are generally the same as those that can file under Chapter 7—any person, including individuals, partnerships, and corporations, except railroads, insurance companies, banks, savings and loan associations, and credit unions.

2A: No. Besides the claims listed in this problem, the debts that cannot be discharged in bankruptcy include amounts borrowed to pay back taxes, goods obtained by fraud, debts that were not listed in the bankruptcy petition, domestic-support obligations, and others.

Chapter 35

1A: No. An incorrect statement as to the age of an insured is a misrepresentation and would be considered a valid defense for Farm Insurance Company. Under an incontestability clause, however, after a policy has been in force for a certain time (usually two or three years), the insurer cannot cancel the policy or avoid a claim on the basis of statements made in the application.

2A: No. Danilo has no insurable interest in the house because he had already sold it when it was destroyed. To

obtain insurance, one must have a sufficiently substantial interest in whatever is to be insured. Persons have an insurable interest in property if they would suffer a financial loss from its destruction. This interest in property must exist when the loss occurs.

No. Danilo cannot receive insurance proceeds for Bea's death. To obtain insurance on another's life, a person must have a reasonable expectation of benefit from the continued life of the other. The benefit may be founded on a relationship, but an "ex-spouse" alone is not such a relationship. An interest in someone's life must exist when the policy is obtained.

Chapter 36

1A: Dave and Caleb are joint tenants. The main distinguishing feature between a tenancy in common and a joint tenancy is that a joint tenancy includes a right of survivorship. Dave and Caleb included such a right in their written contract when they acquired their multimedia computer.

2A: No. The finder of the property cannot keep it. Property that is involuntarily left is lost property. A finder can claim title to the property against the whole world, except the true owner. Many states require a finder to make a reasonably diligent search to find the true owner. When the finder knows the true owner and fails to return the property to that party, the finder is guilty of conversion. Here, Evelyn can reasonably assume that Geo Properties is the true owner. Keeping the cash in this circumstance could easily constitute conversion.

Chapter 37

1A: Yes. A bailment agreement expressly or impliedly provides for the return of the bailed property to the bailor (or a third person), or it provides for the disposal of the goods. This agreement assumes that the bailee will return the identical goods given by the bailor and that the goods will be in acceptable condition. An ordinary bailee owes a duty to take proper care of the items left in its charge.

2A: Rosa de la Mar Corporation, the shipper, suffers the loss. A common carrier is liable for damage caused by the willful acts of third persons or by an accident. Other losses must be borne by the shipper (or the recipient, depending on the terms of their contract). This shipment was lost due to an act of God.

Chapter 38

1A: The most important factor in determining whether an item is a fixture is the intent of the owners. Other factors include whether the item can be removed without damaging the real property and whether the item is sufficiently adapted

so as to have become a part of the real property. If removal would irreparably damage the property, the item may also be considered a fixture.

2A: Yes. The government can take private property for public use (a taking), but it cannot do so, under the Fifth Amendment to the U.S. Constitution, without paying the property owner just compensation. In some cases, to obtain title, a condemnation proceeding is brought before the property is taken. In a separate proceeding, a court determines the property's fair value (usually market value) to be paid to the owner.

Chapter 39

1A: The tenant's heirs inherit the lease and can fulfill its term. (A lease passes to a tenant's heirs as personal property.) This rule protects the landlord's interest, which is to realize the full benefits of the lease, and the tenant's interest, which is also to realize the benefits of the lease. Of course, both parties must continue to abide by the terms of the lease.

2A: Yes. A lease may be oral. In most states, however, some leases must be in writing (such as those that cannot be completed within a year, which must be in writing under the Statute of Frauds). As with other oral agreements, a party who wants to enforce an oral lease may have a hard time proving its existence.

Chapter 40

1A: No. At the time that a will is made, the testator must comprehend the kind and character of the property being distributed and understand and formulate a plan for disposing of the property. Here, Sheila, the testator, passes the test. Mental incompetency did not occur until after the will had been made.

2A: The will may name an executor to administer the estate. If the will does not name an executor, or if there is no will, the court must appoint an administrator. The term personal representative refers to either an executor or an administrator.

Chapter 41

1A: All three branches of government exercise controls over agency powers. The courts have the power to review agency actions. Among other things, Congress can create, restrict,

or abolish an agency. Congress can also limit the funds that it gives to an agency. The president can exercise control over an agency through the appointment of its officers.

2A: IteX Corporation can use the Freedom of Information Act (FOIA), which requires the federal government to reveal certain "records" to "any person" on request. Under the FOIA, a business firm can learn what information federal agencies possess about it.

Chapter 42

1A: This agreement is a tying arrangement. The legality of a tying arrangement depends on the purpose of the agreement, the agreement's likely effect on competition in the relevant markets (the market for the tying product and the market for the tied product), and other factors. Tying arrangements for commodities are subject to Section 3 of the Clayton Act. Tying arrangements for services can be agreements in restraint of trade in violation of Section 1 of the Sherman Act.

2A: Size alone does not determine whether a firm is a monopoly—size in relation to the market is what matters. A small store in a small, isolated town is a monopolist if it is the only store serving that market. Monopoly involves the power to affect prices and output. If a firm has sufficient market power to control prices and exclude competition, that firm has monopoly power. Monopoly power in itself is not a violation of Section 2 of the Sherman Act. The offense also requires an intent to acquire or maintain that power through anticompetitive means.

Chapter 43

1A: A U.S. firm (here, Hi-Cola Corporation) can license its formula, product, or process to a foreign concern to prevent the formula from being pirated abroad. In such an arrangement, the foreign firm obtains the right to make and market the product according to the formula and agrees to keep the necessary information secret and to pay royalties to the licensor.

2A: The practice described in this scenario is known as dumping, which is regarded as an unfair international trade practice. Dumping is the sale of imported goods at "less than fair value." Based on the price of those goods in the exporting country, an extra tariff can be imposed on the imports. This is known as an antidumping duty.

Glossary

A

abandoned property Property that has been discarded by the owner, who has no intention of recovering it.

acceleration clause This clause in a loan document allows the lender to call the entire loan due, with interest, under certain circumstances such as when a payment has been missed.

acceptance In contract law, the offeree's willing consent to the terms of an offer. In negotiable instrument law, a drawee's signed agreement to pay a draft when it comes due.

acceptor A drawee who accepts an instrument when it is presented.

accession An addition that increases the value of property (such as the addition of a diamond to a ring).

accord and satisfaction Settling a claim by the debtor offering to pay less than the creditor claims to be owed.

action A court proceeding to enforce or protect a right, or redress or prevent a wrong.

act of state doctrine A doctrine providing that courts will not review another nation's acts.

adhesion contract A contract in which the stronger party dictates the terms.

adjudication A proceeding in which an agency decides cases.

adjustable-rate mortgage (ARM) A mortgage in which the rate of interest changes periodically.

administrative agency A government agency established to perform a specific function.

administrative law The rules, orders, and decisions created by administrative agencies.

administrative law judge (ALJ) One who presides over an administrative agency hearing.

administrative process The procedure used by agencies in fulfilling their basic functions.

administrator A person appointed by a court to dispose of an estate.

adverse possession Acquiring real property by openly occupying it without the owner's consent.

after-acquired property Debtor property that is acquired after a secured creditor's interest in the debtor's property has been created.

agency relationship A relationship in which one party (the agent) acts for another (the principal).

agent A person authorized to act for another.

age of majority The age when a person is no longer a minor.

agreement When two or more parties consent to a contract's terms.

alien corporation A corporation formed in another country but doing business in the United States.

alternative dispute resolution (ADR) The resolution of disputes outside the traditional judicial process.

annual percentage rate (APR) The cost of credit on a yearly basis, typically expressed as an annual percentage.

answer A defendant's response to a complaint.

antitrust law Laws protecting commerce from unlawful restraints.

apparent authority Authority that arises when a principal causes a third party to believe an agent has authority to act on the principal's behalf.

appellant The party who takes an appeal from one court to another.

appellee The party against whom an appeal is taken.

appraisal right Shareholder's right to be paid fair value for shares.

arbitration Dispute resolution made by a neutral third party.

ARM margin The amount of interest a borrower pays on an adjustable-rate mortgage above the so-called index rate.

articles of incorporation The document filed with the appropriate governmental agency when a business is incorporated.

articles of partnership A written agreement that sets forth partner rights and obligations.

artisan's lien As security for payment for services performed, a lien given to a person who has added value to another's personal property.

assault Any word or action intended to make another person fearful of immediate physical harm.

assignment Transferring one's rights under a contract.

assumption of risk Voluntarily assuming the risk of injury from a danger.

attachment In a secured transaction, the process to an enforceable security interest.

authorization card A card permitting a union to act for an employee.

automatic stay A suspension of all judicial proceedings on the occurrence of an independent event.

B

bailee One to whom goods are entrusted by a bailor.

bailment An agreement in which the personal property of a bailor is entrusted to a bailee.

bailor One who entrusts goods to a bailee.

bait-and-switch advertising Advertising low-priced products to entice customers into a store to buy higher-priced products.

bankruptcy trustee A person appointed by the court to sell the debtor's assets and distribute the proceeds to creditors.

battery The intentional touching of another that is harmful or offensive.

bearer A person in possession of an instrument that does not specify a payee.

bearer instrument A negotiable instrument payable to the bearer.

benefit corporation A corporation that seeks to have a materially positive impact on its surroundings.

bilateral contract A contract that includes the exchange of a promise for a promise.

bilateral mistake A mistake that occurs when both parties are mistaken about a material fact.

Bill of Rights The first ten amendments to the U.S. Constitution.

binder A written, temporary insurance policy.

bond A security that evidences a corporate long-term debt.

breach of contract Failure to perform the obligations of a contract.

brief A written summary by a party to explain its case.

business ethics A consensus of what constitutes right or wrong behavior in the world of business.

business invitee A person invited onto business premises by the owner.

business judgment rule A rule that immunizes management from liability for actions undertaken in good faith.

business necessity A defense against discrimination based on genuine requirements of the business.

business torts A tort occurring only within the business context.

bylaws A set of governing rules or regulations adopted by a corporation.

C

case law Rules of law announced in court decisions.

categorical imperative An evaluation based on the effect if everyone acted in the same way.

causation in fact An act without which an event would not have occurred.

cease-and-desist order An order prohibiting specified activities.

certificate of deposit (CD) A bank note in which a bank acknowledges a receipt of money from a party and promises to repay it.

check A signed written draft ordering the drawee to pay a fixed sum of money on demand.

checks and balances Divisions of power among the branches of government.

choice-of-language clause A clause that designates the official language for a contract's interpretation.

choice-of-law clause A clause designating the law that will govern the contract.

civil law Law that defines and enforces all private and public rights, as opposed to criminal matters.

civil law system A legal system based on a statutory code.

click-on agreement An agreement entered into online when a buyer indicates his or her acceptance of an offer by clicking on a button that reads "I agree."

close corporation A corporation whose shareholders are limited to a small group.

closed shop A firm that requires union membership as a condition of employment.

codicil A formal written supplement or modification to a will.

collateral promise A secondary promise made by one person to pay the debts of another if that second party fails to perform.

collecting bank Any bank handling an item for collection, except the payor bank.

collective bargaining The process by which labor and management negotiate the terms and conditions of employment.

comity The principle by which one nation defers to the laws of another.

commerce clause Constitutional provision that gives Congress the power to regulate commerce.

commercial impracticability A situation in which the duty to perform becomes too difficult or costly due to unforeseen factors.

common law A body of law developed from court decisions.

common stock A security that evidences ownership in a corporation.

community property Concurrent ownership in which each spouse owns an undivided one-half interest in most property acquired during a marriage.

comparative negligence Liability for injuries based on proportionate negligence.

compensatory damages A monetary award equivalent to the actual value of injuries or damages sustained by the aggrieved party.

complaint A pleading alleging wrongdoing on the part of the defendant.

computer crime Crime that involves knowledge of computer technology for its perpetration, investigation, or prosecution.

concurrent jurisdiction When two different courts have the power to hear a case.

confiscation A government's taking of private property with no legal purpose and no just compensation.

conforming goods Goods that conform to contract specifications.

confusion The mixing together of goods so that they are indistinguishable.

consequential damages Special damages to compensate for a loss that goes beyond the contract itself.

consideration The value given in return for a promise or performance.

consolidation When two or more corporations join to become a new corporation.

constructive delivery An act equivalent to the physical delivery of property that cannot be physically delivered.

constructive discharge When working conditions compel an employee to leave.

constructive eviction Depriving a lessee of the possession of property by rendering the premises unfit for occupancy.

constructive trust A trust that is imposed by a court to promote fairness.

contract An agreement that can be enforced in court.

contractual capacity The legal ability to enter into a contractual relationship.

conversion The wrongful taking, using, or retaining possession of personal property that belongs to another.

copyright The exclusive right to publish, print, or sell an intellectual production.

corporate social responsibility The idea that corporations should act ethically and be accountable for their actions.

corporation A business recognized by law as a single entity.

cost-benefit analysis Weighing the costs of a given action against the benefits.

co-surety One who assumes liability jointly with another surety for the payment of an obligation.

counteradvertising New advertising that corrects earlier false claims.

counteroffer An offeree's rejection of the original offer and simultaneous making of a new offer.

course of dealing Previous conduct between the parties to a transaction that establishes a common basis for their understanding.

course of performance The conduct that occurs under the terms of a particular agreement.

covenant of quiet enjoyment A promise not to disturb a buyer's possession of land.

covenant not to compete A promise to refrain from competing in business with another.

cover A buyer's purchase of substitute goods on a seller's breach.

crime A wrong against society punishable by fines, imprisonment, or death.

criminal law Law that defines crimes and subjects criminals to punishment.

cross-examination Questioning an opposing party's witness during a trial.

crowdfunding A cooperative online activity in which people network and pool funds to assist a cause or invest in a business venture.

cure The right of a party to correct nonconforming performance.

cybercrime A crime that occurs online.

cyber fraud Any misrepresentation knowingly made online with the intention of deceiving another for gain.

cybersquatting Registering a domain name similar to the trademark of another and then offering to sell that domain name to the trademark owner.

cyberterrorist A hacker whose purpose is to create a serious negative impact.

D

damages Money sought as a remedy for a harm suffered.

deceptive advertising Advertising that misleads consumers.

deed A document by which title to property is passed.

defamation Anything published or publicly spoken that causes injury to another's reputation.

default judgment A judgment against a defendant who has not appeared in court.

defendant A person against whom a lawsuit is brought.

deficiency judgment A judgment against a debtor for the amount of a debt remaining unpaid after the collateral has been repossessed and sold.

delegation The transfer of a contractual duty to a third party.

depository bank The first bank to receive a check for payment.

deposition Any evidence verified by oath.

destination contract A contract requiring the seller to tender delivery of the goods at a certain destination, at which time title passes to the buyer.

devise A gift of real property by a will.

devisee A person who inherits real property under a will.

direct examination Examination of a witness by the attorney who calls the witness to testify.

disaffirmance The repudiation (avoidance) of a contractual obligation.

discharge In contract law, the termination of one's obligation under a contract. In bankruptcy law, the termination of a debtor's obligation to a creditor.

disclosed principal A principal whose identity is known by a third party when a contract is made by an agent.

discovery Method by which parties obtain information to prepare for trial.

dishonor To refuse to pay or accept a negotiable instrument.

disparagement of property Economically injurious falsehoods about another's product or property.

disparate-impact discrimination Discrimination resulting from certain employer practices or procedures that, although not overtly discriminatory, have a discriminatory effect.

disparate-treatment discrimination Intentional discrimination against individuals on the basis of color, gender, sexual orientation, national origin, race, or religion.

dissociation The severance of the relationship between a partner and a partnership.

dissolution The formal disbanding of a corporation or a partnership.

distribution agreement A contract between a seller and a distributor of the seller's products setting out the terms and conditions of the distributorship.

diversity of citizenship Situation in which parties to a lawsuit are citizens of different states or countries.

divestiture The act of selling one or more of a company's parts.

dividend A distribution of profits to shareholders.

document of title A document that evidences the right to possession of goods.

domain name An internet address.

domestic corporation In a given state, a corporation that does business in and is organized under the laws of that state.

dominion The right to own, use, and possess property.

double jeopardy A situation occurring when a person is tried twice for the same criminal offense.

draft Any instrument that orders the drawee to pay a certain sum of money.

drawee A person who is ordered to pay a draft.

drawer A person who initiates a draft.

due process clause Constitutional provision that guarantees due process of law.

dumping The selling of goods in a foreign country at a price below the price charged for the same goods in the domestic market.

duress Threats made to force a party to enter into a contract.

duty of care The duty to exercise a reasonable amount of care in dealings with others.

E

easement A nonpossessory right to use another's property.

eBill An electronic version of a paper bill for goods or services that is issued online and can be paid online.

e-contract A contract entered into online.

electronic fund transfer (EFT) A transfer of funds through the use of an electronic terminal, a phone, a computer, or magnetic tape.

emancipation The release of a minor from parental control.

embezzlement The fraudulent taking of money or other property by a person to whom it has been entrusted.

eminent domain The government's power to take private land for public use for just compensation.

employment-at-will doctrine A doctrine under which an employment contract may be terminated at any time and for any reason.

employment discrimination Treating employees or job applicants unequally on the basis of race, color, sexual orientation, gender, national origin, religion, age, or disability.

enabling legislation A statute enacted by Congress creating an agency and specifying its powers and functions.

entrapment An act by which a public official induces someone to commit a crime.

entrustment rule A rule stating the merchant's power to transfer entrusted goods to certain buyers.

equal dignity rule A rule requiring that an agent's authority be in writing if the contract to be made on the principal's behalf must be in writing.

equal protection clause Constitutional provision that guarantees equal protection of the laws.

equitable right of redemption The right of borrowers to redeem or purchase their property before foreclosure proceedings.

equity Equity here means fairness. Within the law, it refers to types of relief, such as injunctions (as opposed to legal remedies).

e-signature An electronic sound, symbol, or process used as a signature.

establishment clause Constitutional provision that prohibits any law "respecting an establishment of religion."

estate in property All of the property owned by a person, including real estate and personal property.

estrays statute A statute defining finders' rights in property when the true owners are unknown.

ethics A set of moral principles and values applied to social behavior.

eviction Depriving a lessee of the possession of property.

exclusionary rule Rule preventing the government from using evidence gathered in violation of the U.S. Constitution.

exclusive-dealing contract An agreement under which a producer agrees to sell its goods exclusively through one distributor.

exclusive jurisdiction When only one court has the power to hear a case.

exculpatory clause A contract clause that releases a party from liability for wrongful acts.

executed contract A contract that has been fully performed by both parties.

executor A person appointed by a testator to administer a will.

executory contract A contract that has not yet been fully performed.

export To sell products to buyers located in other countries.

express contract A contract that is stated in words, oral or written.

express warranty A warranty that assures the quality, description, or performance of the goods.

expropriation A government seizure of property for a proper purpose and with just compensation.

F

federal form of government Government in which power is divided between a central government and member states.

federal question An issue based on federal law.

Federal Reserve System The central banking system of the United States.

fee simple A form of property ownership entitling the owner to the entire bundle of property rights.

fee simple absolute An interest in land with no limitations.

felony A crime that carries the most severe sanctions.

fictitious payee A payee on a negotiable instrument who is not intended to have an interest in the instrument.

fiduciary relationship A relationship founded on trust and loyalty.

final order The final decision of an administrative agency on an issue.

firm offer An offer (by a merchant) that is irrevocable for a period of time.

fixed-rate mortgage A mortgage with a fixed, or unchanging, rate of interest.

fixed-term tenancy A tenancy for a specified period of time.

fixture An item of personal property that is attached to real property.

forbearance An agreement between a lender and a borrower to postpone, for a limited time, payments on the loan. In contract law, it is the refraining from an action that one has a legal right to undertake.

foreclosure A proceeding in which a lender either takes title to or forces the sale of the borrower's property in satisfaction of a debt.

foreign corporation In a given state, a corporation that does business in the state but is not incorporated there.

forgery The fraudulent making or altering of any writing.

form The manner observed in creating a legal agreement, as opposed to the substance of the agreement.

formal contract A contract requiring a specific form to be valid.

forum-selection clause A contract provision identifying the court that will decide any disputes.

franchise Any arrangement in which the owner of intellectual property licenses another to use it under specified conditions in the selling of goods or services.

fraud Any misrepresentation made with the intention of deceiving another.

free exercise clause Constitutional provision that prohibits any law “prohibiting the free exercise” of religion.

fungible goods Goods that are alike by physical nature, by agreement, or by trade usage.

G

garnishment A legal process whereby a creditor appropriates a debtor’s property or wages that are in the hands of a third party.

general partner A partner responsible for the partnership’s management and debts.

gift A voluntary transfer of property ownership made without consideration.

good faith purchaser One who buys without notice of invalidity of title.

group boycott A group of competitors’ refusal to deal with a particular person or firm.

guarantor A third party who agrees to be secondarily liable for the debt of another.

H

hacker A person who uses one computer to break into another.

holder The person who is legally entitled to payment on an instrument.

holder in due course (HDC) A holder who takes a negotiable instrument free of most defenses and all claims.

holographic will A will entirely in the testator’s handwriting.

I

identification The express designation of the goods provided for in a contract.

identity theft The act of stealing another’s identifying information and using it to access the victim’s financial resources.

implied contract A contract formed from the conduct of the parties.

implied warranty A warranty implied by law.

implied warranty of fitness for a particular purpose An implied warranty by a merchant that goods are fit for a particular purpose specified by a buyer.

implied warranty of habitability A presumed promise that a rented residence is fit for human habitation.

implied warranty of merchantability An implied warranty that goods are reasonably fit for the general purpose for which they are sold or leased.

impossibility of performance A situation in which performance is impossible or totally impracticable in an objective sense.

imposter A person who, with the intent to deceive, pretends to be somebody else.

incidental beneficiary A third party who incidentally benefits from a contract but has no rights in it.

incidental damages Damages for reasonable expenses incurred because of a contract’s breach.

independent contractor A person whose working conditions are not controlled by an employer.

indorsement A signature on an instrument transferring ownership rights in the instrument.

informal contract A contract not requiring a specific form to be valid.

initial order An administrative agency’s disposition in a matter other than a rulemaking.

injunction A court order to do or not do a certain act.

innocent misrepresentation A misrepresentation that occurs when a person makes a false statement of fact that they believe is true. They are guilty of an innocent misrepresentation but not fraud.

insider trading The purchase or sale of securities based on information not available to the public.

insolvent A condition in which a person’s liabilities exceed the value of their assets, or being unable to pay debts.

installment contract A contract in which payments due are made periodically.

insurable interest A property interest in goods that permits a party to obtain insurance. In addition, a financial interest in a person’s life.

insurance A contract in which the insurer promises to reimburse the insured or a beneficiary in the event of a specified loss.

intangible property Property that exists only conceptually.

integrated contract A written contract that constitutes the final expression of the parties' agreement.

intellectual property Property resulting from intellectual, creative processes.

intended beneficiary A third party for whose benefit a contract is formed and who can sue the promisor if it is breached.

intentional tort A wrongful act knowingly committed.

intermediary bank Any collecting bank, except the depository or payor bank.

international law The law that governs relations among nations.

internet service provider (ISP) A business that offers users internet access.

interrogatory Written questions and answers prepared and signed under oath.

intestacy laws State laws determining the distribution of the property of one who dies intestate.

intestate As a noun, one who has died without a valid will. As an adjective, without a will.

issue The first transfer, or delivery, of a negotiable instrument to a holder.

J

joint and several liability A doctrine under which a plaintiff may sue the partners together or individually.

joint tenancy Co-ownership of property in which each party owns an undivided interest that, on the owner's death, automatically passes to the surviving owners.

judicial foreclosure A court-supervised foreclosure.

jurisdiction The authority of a court to decide a specific dispute.

L

larceny The wrongful taking and carrying away of another person's personal property.

law Enforceable rules governing individuals and their society.

lawsuit A judicial proceeding for the resolution of a dispute.

lease An agreement to transfer the right to possess and use goods for a period of time in exchange for payment.

lease agreement A contract whereby a landlord transfers the right to possession and use of property to a tenant for rent.

legacy A gift of personal property by a will.

legatee A person who inherits personal property under a will.

lessee One who acquires the right to the possession and use of goods under a lease.

lessor One who transfers the right to the possession and use of goods under a lease.

liability Legal responsibility for a debt or an obligation.

libel Defamation in written form.

license An agreement permitting the use of intellectual property. In property law, a revocable privilege to enter onto another's land.

lien A claim against specific property to satisfy a debt.

life estate An interest in land that exists only for the duration of someone's life.

limited liability company (LLC) A business form that offers the limited liability of a corporation and the tax advantages of a partnership.

limited liability partnership (LLP) A form of partnership that limits a partner's liability for other partners' malpractice.

limited partner A partner who contributes capital to the partnership but does not participate in its daily operations.

limited partnership (LP) A partnership consisting of general partners and limited partners.

liquidated damages A reasonable estimate of the damages that will occur in the event of a breach.

liquidation The sale and distribution of the assets of a business.

living trust A trust created by and effective during the grantor's lifetime.

long arm statute A state statute that permits jurisdiction over nonresident defendants.

lost property Property that the owner has involuntarily parted with and then cannot find or recover.

M

mailbox rule A rule providing that an acceptance of an offer becomes effective on dispatch.

maker One who issues a promissory note or certificate of deposit.

malware Malicious software programs designed to disrupt or harm computers.

market concentration When a small number of firms share the market for a particular good or service.

market-share test A means of measuring monopoly power by determining a firm's percentage share of the relevant market.

mechanic's lien A lien on real property to ensure priority of payment for work performed.

mediation The use of a neutral third party to facilitate a settlement.

merchant A person engaged in the purchase and sale of goods.

merger When one corporation acquires the assets and liabilities of another corporation, which then ceases to exist.

meta tag A keyword used in online coding.

minimum wage The lowest hourly wage that an employer can legally pay an employee.

mirror image rule A rule requiring that the terms of the offeree's acceptance exactly match the terms of the offeror's offer.

misdemeanor A lesser crime than a felony.

mislaid property Property that the owner has voluntarily parted with and then cannot find or recover.

mitigation of damages A rule requiring a plaintiff to reasonably minimize the damages caused by the defendant.

mobile banking A version of online banking that is carried out with apps on smartphones or tablets.

monopolization The possession of monopoly power in the relevant market and the willful acquisition or maintenance of that power.

moral minimum The minimum degree of ethical behavior expected of a firm.

mortgage A security interest in a debtor's real property.

mortgage insurance Insurance that compensates a lender for losses due to a borrower's default on a mortgage loan.

motion for a directed verdict A motion for the judge to direct a verdict on the ground of insufficient evidence.

motion for summary judgment A request by one of the parties asserting that there are no disputed issues of fact that would necessitate a trial.

motion to dismiss A pleading that asserts the plaintiff's claim has no basis in law.

N

necessaries Necessities required for a standard of living, such as food and shelter.

negligence Failure to exercise the standard of care that a reasonable person would exercise.

negotiable instrument A signed writing that contains an unconditional promise or order to pay an exact amount.

negotiation An attempt to settle a dispute without going to court. Or, the transfer of a negotiable instrument to a holder.

neobanks Banks that operate exclusively online without traditional physical branch networks.

normal-trade-relations (NTR) status A status granted through an international agreement whereby all trade partners are treated equally.

notice-and-comment rulemaking A procedure in agency rulemaking that requires notice, a comment period, and a published final rule.

notice of default A formal notice to borrowers that they are in default on mortgage payments and may face foreclosure.

notice of sale A formal notice to a borrower who is in default that the mortgaged property will be sold in a foreclosure proceeding.

novation The substitution, by agreement, of a new contract for an old one.

O

objective theory of contracts The view that the intent to contract should be determined by outward, objective facts.

offer A promise to perform some specified act in the future.

offeree A person to whom an offer is made.

offeror A person who makes an offer.

online banking Traditional banking services, such as account management and transfers, that are provided on the financial institution's website.

online dispute resolution (ODR) The resolution of a dispute via the internet.

operating agreement A limited liability company's management agreement.

order for relief A court's grant of assistance to a debtor.

order instrument A negotiable instrument payable to the order of an identified person.

overdraft An extension of credit from a bank to a customer with insufficient funds.

owner in common An owner with an undivided share of the whole.

P

parol evidence rule A rule governing the admissibility of oral evidence in court.

partially disclosed principal A principal whose identity is unknown by a third party, but that party knows the agent is acting for a principal when the contract is made.

partnership An association of two or more persons to carry on, as co-owners, a business for profit.

partnership by estoppel Partnership liability imposed by a court on nonpartners.

pass-through entity A business entity whose income tax liability is passed through to the owners.

past consideration A past act that cannot be consideration for a later promise.

patent A government grant of the exclusive right to make, use, or sell an invention for a limited time period.

payee A person to whom an instrument is made payable.

payor bank The bank on which a check is drawn.

penalty A sum named in a contract as punishment for a default.

per capita A method of distributing the property of an intestate's estate by which all the heirs receive equal shares.

perfection The method by which a secured party obtains a priority interest in the debtor's collateral.

perfect tender rule A rule requiring that goods conform exactly to a contract's terms or the seller is in breach.

performance The fulfillment of one's duties arising under a contract.

periodic tenancy A tenancy for an indefinite period of time with payment at fixed intervals.

per se violation An anticompetitive agreement that is deemed inherently illegal.

personal defense A defense effective only against ordinary holders.

personal property Property that is movable.

per stirpes A method of distributing an intestate's estate in which a group takes the share to which their deceased ancestor would have been entitled.

phishing Sending an electronic message purportedly from a legitimate business to induce the recipient to reveal personal information.

pierce the corporate veil To disregard the corporate entity and hold the shareholders personally liable for a corporate obligation.

plaintiff A person who initiates a lawsuit.

pleadings Statements of facts, charges, and defenses in a case.

police powers Powers possessed by states as part of their inherent sovereignty.

policy A contract between an insurer and the insured.

power of attorney A document authorizing another to act as one's agent.

power of sale foreclosure A foreclosure procedure that is not court supervised.

precedent A court decision that guides subsequent decisions.

predatory lending Lending procedures that are excessive, deceptive, or not properly disclosed.

predatory pricing The pricing of a product below cost with the intent to drive competitors out of the market.

predominant-factor test A test to determine whether a contract is primarily for the sale of goods or services.

preemption A doctrine under which federal laws preempt state laws.

preemptive right A shareholder's right to purchase a prorated share of a new stock issue before the stock is offered to others.

preferred stock Classes of stock that have priority over common stock.

premium The price for insurance protection for a specified period of time.

prenuptial agreements An agreement entered into in contemplation of marriage, specifying the rights and ownership of the parties' property.

prepayment penalty clause A clause assessing a penalty if a loan is repaid early.

presentment Presenting an instrument for acceptance or payment.

presentment warranty A warranty made by any person who presents an instrument.

price discrimination Setting prices so that competing buyers pay different prices for an identical product.

price-fixing agreement An agreement among competitors to set product prices.

prima facie case A case in which plaintiffs produce sufficient evidence to prove their conclusion if no evidence rebuts it.

principal A person who authorizes an agent to act on their behalf.

principle of rights The principle that human beings have certain fundamental rights.

privity of contract The relationship that exists between contracting parties.

probable cause Reasonable grounds for believing a search will reveal a specific illegality.

probate court A court having jurisdiction over the settlement of a person's estate.

proceeds Whatever is received when collateral is sold, exchanged, collected, or disposed of.

product liability Liability for injuries or damages suffered because of defects in goods.

profit The right to remove things from another's property.

promise A declaration that binds the person who makes it to do or not to do a certain act.

promisee A person to whom a promise is made.

promisor A person who makes a promise.

promissory estoppel A doctrine used to enforce promises when the promisee justifiably relied on them to their detriment.

promissory note A written promise signed by a maker to pay another party a certain amount on a specified date.

prospectus A disclosure document for investors that is required when selling securities.

protected class A group of persons protected by specific laws because of its defining characteristics.

proximate cause Connection between an act and an injury strong enough to impose liability.

proxy A written agreement authorizing one shareholder to vote for another's shares in a certain manner.

puffery A salesperson's opinion about property, products, or services.

punitive damages Damages that are awarded to punish the wrongdoer.

Q

quasi contract A fictional contract imposed by law to prevent unjust enrichment.

quitclaim deed A deed conveying a grantor's interest with no other promises.

quorum The number of decision-makers who must be present before business can be conducted.

quota A set limit on the amount of goods that can be imported.

R

ratification Accepting and giving legal force to an obligation that previously was not enforceable. Also, the confirmation of an act or contract performed by another.

real property Land and everything attached to it.

reformation A court-ordered correction of a written contract to reflect the parties' true intentions.

Regulation Z A set of rules that implements the Truth-in-Lending Act.

release An agreement in which one party gives up the right to pursue a legal claim against another party.

remedy The means to enforce a right or compensate for a wrong.

reorganization A bankruptcy plan for the readjustment of a corporation's debts.

rescission A remedy whereby a contract is terminated, and the parties are returned to the positions they had before the contract was made.

respondeat superior A principle of law whereby a principal or an employer is held liable for the wrongful acts committed by agents or employees acting within the scope of their agency or employment.

restitution A remedy that restores a person to the position held before a contract, including the restoration of goods, property, or funds previously conveyed.

restraint of trade Any contract, conspiracy, or combination that unlawfully eliminates competition.

resulting trust A trust implied in law.

revocation The withdrawal of an offer by an offeror.

right of contribution The right to recover from co-sureties the excess paid on a debt.

right of reimbursement The right to be repaid for expenses incurred on another's behalf.

right of subrogation The right to stand in the place of another.

right-to-work law State law prohibiting union membership as a job requirement.

risk A prediction concerning potential loss based on certain factors.

risk management A contractual transfer of risk from the insured to the insurer.

robbery The act of forcefully and unlawfully taking personal property from another.

royalties Payments made by a licensee to a licensor as part of an agreement for the ongoing use of the licensor's trademarked asset.

rulemaking The actions by administrative agencies when formally adopting new regulations.

rule of reason A test by which a court balances the reasons for an agreement against its potentially anticompetitive effects.

S

sale The passing of title to property for a price.

sale on approval Buyer takes goods on a trial basis.

sale or return A conditional sale that can be rescinded by the buyer during a specified time.

sales contract A contract to sell goods.

scienter A party's knowledge that material facts have been falsely represented with an intent to deceive.

search warrant An order from a judge authorizing the search or seizure of private property.

seasonably Within a specified time period or within a reasonable time.

secured creditor A lender or seller who has a security interest in collateral that secures a debt.

secured transaction Any transaction in which debt payment is guaranteed by personal property.

securities Items that represent an ownership interest in a corporation or a promise of repayment of debt by a corporation.

seniority system A system in which those who have worked longest are first in line for promotions, salary increases, and other benefits, and are last to be laid off.

service mark A mark that distinguishes business services.

sexual harassment Language or conduct that creates a hostile working environment.

share exchange An exchange of one corporation's shares for those of another.

shareholder's derivative suit A suit brought by a shareholder to enforce a corporate cause of action against a third person.

shipment contract A contract requiring the seller to deliver the goods to a carrier, at which time title passes to the buyer.

short-form merger A merger that can be accomplished without shareholder approval.

signature Any name, word, or mark used to authenticate a writing.

slander Defamation in oral form.

slander of quality Publication of false information about another's product.

slander of title The publication of a statement that casts doubt on another's legal ownership of any property.

small claims court A trial court for small claims, usually involving \$2,500 or less.

sole proprietorship The form of business in which the owner is the business.

sovereign immunity A doctrine that immunizes foreign nations from the jurisdiction of U.S. courts when certain conditions are satisfied.

specific performance An equitable remedy requiring exactly the performance that was specified in a contract.

stale check A check that is presented for payment more than six months after its date.

standing to sue A stake in a controversy sufficient to entitle an individual to bring a lawsuit.

stare decisis A doctrine under which judges follow established precedents.

Statute of Frauds A statute under which certain contracts must be in writing to be enforceable.

statute of limitations A statute limiting the time period a certain action can be brought.

statutory law Laws enacted by a legislative body.

stock An equity or ownership interest in a corporation.

stock certificate A certificate evidencing the ownership of corporate shares.

stop-payment order A customer's order telling a bank not to pay a certain check.

strict liability Liability regardless of fault.

strike Unionized workers' refusal to work when collective bargaining fails.

sublease A tenant's transfer of leased premises to a third person for a period shorter than the lease term.

substantial government interest A significant connection or concern that justifies a government restriction on commercial speech.

substitute check A negotiable instrument that is a paper reproduction of an original check.

supremacy clause Provision that declares the Constitution "the supreme Law of the Land."

surety A third party who agrees to be primarily responsible for the debt of another.

suretyship A third party's contractual promise to be primarily responsible for a debtor's obligation.

symbolic speech Nonverbal expressive conduct.

T

takeover The acquisition of control over a corporation through a purchase of a stock.

taking The taking of private property by the government for public use and for just compensation.

tangible employment action A significant change in employment status or benefits.

tangible property Property that has physical existence.

tariff A tax on imported goods.

tenancy at sufferance A tenant's possession of premises after a lease has terminated.

tenancy at will A tenancy that either party can terminate without notice.

tenancy in common Co-ownership of property in which each party owns an undivided interest that passes to their heirs at death.

tender A timely offer to pay a debt or perform an obligation.

tender of delivery The seller's act of giving the buyer reasonable notice that conforming goods are available.

tender offer An offer to buy shareholders' voting shares.

testamentary trust A trust that is created by a will.

testator One who makes and executes a will.

third party beneficiary One who is not a party to a contract but who benefits from the contract.

tort A civil wrong not arising from a breach of contract.

tortfeasor One who commits a tort.

trade acceptance A draft drawn by a seller of goods ordering the buyer to pay a specified sum.

trademark A word, symbol, sound, or design associated with a good.

trade name A name used in commercial activity to designate a business.

trade secret Information giving a business an advantage over competitors.

transfer warranty A guaranty made by a person who transfers a negotiable instrument for consideration to subsequent transferees and holders who take the instrument in good faith.

treaty A formal written agreement negotiated between two or more nations.

trespass to land Entry without the owner's permission.

trespass to personal property Unlawfully taking or harming another's personal property.

trust An arrangement to administer property for the benefit of another.

tying arrangement A sales agreement conditioned on a buyer's promise to buy an additional product.

U

ultra vires acts Acts of a corporation that are beyond its express and implied powers to undertake.

unconscionable contract or clause A contract or clause that is so unfair that it is rendered void.

underwriter The one assuming a risk in return for the payment of a premium.

undisclosed principal A principal whose identity is unknown by a third party, and that party has no knowledge the agent is acting in an agency capacity when the contract is made.

undue influence Persuasion that induces a person to act according to the will of the dominating party.

unenforceable contract A valid contract that cannot be enforced by a court.

unilateral contract A contract exchanging a promise for an act.

unilateral mistake A mistake that occurs when one party to a contract is mistaken about a material fact.

union shop A firm in which all workers must become union members within a specified period of time.

universal defense A defense effective against all holders of a negotiable instrument.

unreasonably dangerous Defective to the point of threatening a consumer's health or safety.

unsecured creditor A creditor whose debt is not backed by any collateral.

usage of trade A practice or method of dealing observed regularly in a place, vocation, or trade.

usury Charging an illegal rate of interest.

utilitarianism An evaluation of an action based on its "good" consequences.

V

validation notice Notice from a collection agency informing debtors they have thirty days to challenge a debt and request verification.

valid contract A contract having legal strength or force.

venture capital Financing provided by outside investors to new business ventures.

vested The condition in which rights have taken effect.

voidable contract A contract that can be legally avoided.

void contract A contract having no legal force.

voluntary consent Knowledge of and genuine assent to the terms of a contract.

W

warranty deed A deed under which the grantor provides guarantees to the grantee concerning title.

warranty disclaimer A statement limiting the seller's liability for any product defects.

waste The abuse or destructive use of real property.

whistleblower An employee who publicly reveals an employer's unsafe or illegal activity.

white-collar crime Nonviolent crime committed in the business world.

will An instrument made by a person directing what is to be done with their property after death.

winding up The stage of dissolution in which the firm collects and distributes assets and discharges liabilities.

workers' compensation laws State statutes to compensate workers for on-the-job injuries, regardless of fault.

Table of Cases

For your convenience and reference, here is a list of all the cases mentioned in this text. The cases in the *Real Case* features for each chapter are given special emphasis by having their titles appear in **boldface**.

A

Absolute Trading Corp. v. Bariven S.A., 256
Accettura v. Vacationland, Inc., 236
 Accredited Aides Plus, Inc. v. Program Risk Management, Inc., 186
 A2 Creative Group, LLC v. Anderson, 496
 Akhtar v. Dairkee, 473
 Albarran v. Amba II, Inc., 298
 Alcoa World Alumina, LLC v. Glencore, Ltd., 411
 Alexander v. Stibal, 158
Allen v. Charlevoix Abstract & Engineering Company, 153
 Alpha Painting & Construction Company, Inc. v. Delaware River Port Authority, 535
Altercare of Canal Winchester Post-Acute Rehabilitation Center, Inc., v. Turner, 424
American Legend Coop. v. Top Lot Farms, 224
 American Multi-Cinema, Inc. v. Hegar, 473
 American National Property and Casualty Co. v. Sykes, 461
 Apple iPhone Antitrust Litigation, *In re*, 548
 Ardito v. Woodbridge Animal Control, 484

B

Bakhshi v. Baarlaer, 121
 Banco Bilbao Vizcaya Argentaria v. Easy Luck Co., 298
Banc of California v. Madhok, 435
 Barclays Bank PLC v. Poynter, 427
 Beach Community Bank v. First Brownsville Co., 438
 Bell v. Oneighty C Technologies Corp., 411
 Blackwell v. Sky High Sports Nashville Operations, LLC, 136
 Bolivarian Republic of Venezuela v. Helmerich & Payne International Drilling Co., 560

Bostock v. Clayton County, 350
 Bowen v. Gardner, 214
 BRC Rubber and Plastics, Inc. v. Continental Carbon Co., 241
Brown v. Papa Murphy's Holding Incorporated, et al., 405
Bylan v. Mouradjian, 470

C

Cadence Bank v. Elizondo, 302
 Call Center Technologies, Inc. v. Grand Adventures Tour & Travel Publishing Corp., 411
 Cannon v. Farm Bureau Insurance Company, 460
Carson v. Makin, 6
 Castellotti v. Free, 173
 Cayer v. Cox Rhode Island Telecom, LLC, 329
Chen v. Chase Bank USA, N.A., 264
 Citibank, N.A. v. Village of Tarrytown, 496
 Citizens United v. Federal Election Committee, 47
Classy Cycles, Inc. v. Panama City Beach, 44
 Collins Asset Group, LLC v. Alialy, 284
 Constellation-F, LLC v. World Trading 23, Inc., 508
Coppage Construction Company, Inc. v. Sanitation District No. 1 and DCI Properties, 364
 Cosmopolitan Condominium Owners Association v. Class A Investors Post Oak, 497
 Country Contractors, Inc. v. A Westside Storage of Indianapolis Inc., 400
 Czyzewski v. Jevic Holding Corp., 450

D

David Knigge v. B&L Food Stores, Inc., 174
 Davis v. Harmony Development, LLC, 199
Deny v. Breawick, 380
 Desgro v. Pack, 147

Deutsche Bank National Trust Co. v. Brock, 284
 Deutsche Bank National Trust Co. v. Pardo, 284
 Dewey, Ann H. McMaster, Estate of, *In re*, 525
 Dickman v. University of Connecticut Health Center, 24
 Doe v. Epic Games, Inc., 136
Dr. Seuss Enterprises, L.P. v. ComicMix, LLC, 72
 Ducote v. Whitney National Bank, 313
 Dweck v. Nasser, 400
 Dykes, *In re*, 450

E

Ecocards v. Tekstir, Inc., 113
 Edmonds v. U.S. Bank National Association, 438
 Edwin Taylor Corp. v. U.S. Dept. of Labor, 534
Envision Printing, LLC v. Evans, 290
 Erb Poultry, Inc. v. CEME, 241
 Espinoza v. Arkansas Valley Adventures, LLC, 147
 Estate of Jimmy Smith v. Graham, 77
 Expansion Capital Group, LLC v. Patterson, 400

F

F.A. Investment Group, Inc. v. City of Philadelphia, 508
 Family Winemakers of California v. Jenkins, 10
 Federal Treasury Enterprise Sojuzplodoimport, OAO v. Spirits International B.V., 560
Fee v. Cheatham, 493
 Fulmer v. Hurt, 389

G

Gianelli, *In re*, 77
 Glass, *In re*, 24
 Gobran Auto Sales, Inc. v. Bell, 256
 GoJets Airlines, LLC v. Federal Aviation Administration, 535

Goldstein v. Orensanz Events, LLC, 200
Good v. Harry's Dairy, LLC, 247
Goonewardene v. ADP, LLC, 182
 Gould v. North Kitsap Business Park Management, LLC, 64
 Grand Harbour Condominium Owners Association, Inc. v. Grogg, 427
 Gregory v. Connecticut Shotgun Manufacturing Co., 256
Guth v. Loft, Inc., 397

H

Heal v. Brian Anderson, 485
 Hemsley, Estate of, *In re*, 521
H&J Ditching & Excavating, Inc.
 v. Cornerstone Community Bank, 199
 Hoffman v. Verizon Wireless, Inc., 389
 Horn v. Knight Facilities Management-GM, Inc., 357
 Humble v. Wyant, 199

I

Investment Group, Inc. v. City of Philadelphia, 508

J

Jennifer Mitchell v. Turbine Resources Unlimited, Inc., 373

K

Kadiyala v. Bank of America, 313
 Kassa v. Synovus Financial Corporation, 356
 Kemper v. Brown, 115
 Kiewitz v. My Custom Shop, Inc., 256
 Kimble v. Marvel Entertainment, LLC, 9
 Kincaid v. Dess, 186
 Kindred Nursing Centers East, LLC v. Jones, 329
 Knox Creek Coal Corp v. Secretary of Labor, 534
 Krueger, *In re*, 450
 Kutite, LLC v. Excell Petroleum, LLC, 115

L

Leaf Invenergy Co. v. Invenergy Renewables LLC, 97
 Legato Vapors, LLC v. David Cook, 228
Leonard v. HSBC Bank USA, N.A., 447
L.F. v. Lake Washington School District, 34
 Lucas Contracting, Inc. v. Altisource Portfolio Solutions, Inc., 115
Lynwood Place, LLC v. Sandy Hook Hydro, LLC, 505

M

Magic Carpet Ride, LLC, et al. v. Rugger Investment Group L.L.C., 191
 Manitou North America, Inc. v. McCormick International, LLC, 547
 Manual v. Merchants and Professional Bureau, Inc., 268
 Marriage of Tuttle, *In re*, 173
 Marucci Sports, LLC v. National Collegiate Athletic Association, 548
 Mashiri v. Epsten Grinnell & Howell, 269
 May v. Chrysler Group, LLC, 9
 McCoolidge v. Oyvetsky, 228
 McLane Co. v. Equal Employment Opportunity Commission, 357
McNelly v. Conde, 169
 McWilliam v. McWilliam, 136
 Merriman v. American Guarantee & Liability Insurance Co., 461
Miller v. House of Boom Kentucky, LLC, 142
 Morris v. Inside Outside, Inc., 241
Mountain Crest SRL, LLC v. Anheuser-Busch InBev, 552
 Mrs. Ressler's Food Products v. KZY Logistics, LLC, 485
 Murray v. Farmers Insurance Company of Arizona, 186

N

National Football League Players Association v. National Football League Management Council, 39
 New England Precision Grinding, Inc. v. Simply Surgical, LLC, 214
 Newman v. Plains All American Pipeline, L.P., 186
 Nichols v. Tri-National Logistics, Inc., 39
 Norcia v. Samsung Telecommunications America, LLC, 241
Norred v. Cotton Patch Café, LLC, 130
 Northbrook Bank & Trust Co. v. Matthew O'Malley, 427

O

Odigie v. Nation Star Mortgage, LLC, 438
 Ortégón v. Giddens, 104
 Oxford Tower Apartments, LP v. Frenchie's Hair Boutique, 39
Ozburn-Hessey Logistics, LLC v. NLRB, 341

P

Packers Sanitation Services, Inc., v. Occupational Safety and Health Review Commission, 343
 Paper City Brewery Co., Inc. v. La Resistance, Inc., 214
 Patterson v. Suntrust Bank, 313
 Perfect 10, Inc. v. Giganews, Inc., 78
 Pervis, *In re*, 158
 Philadelphia Indemnity Insurance Co. v. Farrington, 461
 Philadelphia Indemnity Insurance Co. v. White, 125
 Prager University v. Google LLC, 52
 810 Properties VII, L.L.P., et al. v. Sukenik, et al., 372

R

Ramirez v. Reemployment Assistance Appeals Commission, 344
 Ramsey v. Allstate Insurance Co., 104
 Rawls v. Progressive Northern Insurance Co., 64
 Reed v. Thurman, 372
 Regency Transportation, Inc. v. Commissioner of Revenue, 52
Reidel v. Akron General Health System, 320
 Retail Wholesale and Department Store Union Local 338 Retirement Fund v. Hewlett-Packard Co., 400
Revell v. Burlison Law Group, 519
 Richman v. Hartley, 497
 Roberts v. Ocean Prime, LLC, 508
 Robinson v. Langenbach, 389
 Royal & Sun Alliance Insurance, PLC v. International Management Services Co., 228
 RR Maloan Investments, Inc. v. New HGE, Inc., 298

S

Sacco v. Paxton, 372
 Saribekyan v. Bank of America, 146
 Savant Homes, Inc. v. Collins, 77
Scaife v. Perkins, 57
 Shankle, *In re*, 450
 Shannon v. Fischer, 158
 Sharabianlou v. Karp, 125
 Sharon Hershkowitz v. Harold Levy, Jr., 173
Sikh Cultural Society, Inc. v. United States Citizenship and Immigration Services, 531
 Simon v. Farm Bureau Insurance Co., et al., 329
 Snapp v. Castlebrook Builders, Inc., 389

Snizek v. Kansas City Chiefs Football Club, 125

Split Rail Fence Co. v. United States, 344

Stanley v. ExpressJet Airlines, Inc., 355

State of Kansas v. Lawrence, 473

State of North Carolina v. Devin Way Fink, 330

State of the Netherlands v. MD Helicopters, Inc., 559

State of Washington v. Arlene's Flowers, Inc., 269

Sullivan v. Christie's Fine Art Storage Services, Inc., 485

T

Terry v. Robin Drive Auto, 214

The People v. Edward Robert Starski, 52

Thompson v. Jefferson Partners, 344

Toll Processing Services v. Kastalon, 481

Total Quality Logistics, LLC v. Balance Transportation, LLC, 228

Trade Commission v. Ross, Inc., 269

TransUnion Risk and Alternative Data Solutions, Inc. v. Surya Challa, 147

TreeHouse Foods, Inc. v. SunOpta Grains and Foods, Inc., 210

Tri-Lin Holdings, LLC v. Flawlace, LLC, 508

U

United Specialty Insurance Company v. Cole's Place, Inc., 457

United States v. Berry, 426

United States v. Davis, 91

United States v. Gagarin, 88

United States v. Heesham Broussard, 92

United States v. Johnson, 438

United States v. Norman, 91

United States v. Simpson, 91

United States v. Vega-Martínez, 547

US Airways, Inc. v. Sabre Holding Corporation, 543

U.S. Bank National Association v. Gaitan, 284

U.S. v. Napout, 15

U.S. v. Pritchard, 63

V

Verble v. Morgan Stanley Smith Barney, LLC, 39

Vilarinho v. Palmetto Sports Cars, Inc., 298

Vizant Technologies, LLC v. Julie Whitchurch, 64

Volkswagen "Cleaned Diesel" Marketing, Sales Practices, and Product Liability Litigation, *In re*, 24

W

Walker, Estate of, *In re*, 521

Wallace v. County of Stanislaus, 357

Wells Fargo Bank, N.A. v. Bricourt, 277

Weston Medsur Center v. Blackwood, 159

Wilson v. Parker, 104

Wind Tower Trade Coalition v. United States, 560

Workers Local No. 46 Annuity Fund v. USA DeBusk, LLC, 411

Z

Zephier v. Agate, 472

Zigler v. Featherstone Foods, Inc., et al., 125

Zurenda v. Zurenda, 136

Index

A

- Abandoned property, 468, 471
- Abnormally dangerous activities, 62
- Acceleration clause, 280, 436
- Acceptance. *See also* Contract(s); Lease contract; Sales contract
 - by bailee, 478
 - of bribe, 86
 - of contract, 97
 - defined, 111
 - of draft, 275
 - of offer, 111–112
 - authorized means of, 112
 - communication of, 111–112
 - unequivocal, 111
 - of gift, 468
 - mode and timeliness of, 112
 - for mutual rescission, 192
 - online, 112–113
 - of reorganization plan (bankruptcy), 446
 - revocation of, 236
 - silence as, 111
 - substitute method of, 112
 - trade, 275
 - UCC on, 208–209
- Acceptor, liability of, 496–497
- Accession, acquisition of personal property by, 469
- Accommodation, 208. *See also* Reasonable accommodation
- Accord and satisfaction
 - discharge by, 192–193
 - settlement of claims through, 123
- Accountability, of administrative agencies, laws for, 532–533
- Accounting
 - agent's duty of, 322
 - inspection of corporate books and, 386
 - inspection of partnership books and, 365
 - of partnership assets/profits, 369
 - Public Company Accounting Oversight Board and, 16
- ACPA. *See* Anticybersquatting Consumer Protection Act
- Acquiring corporation, 406
- Acquisition, of personal property, 467–469
- Action
 - defined, 4
 - FTC, against deceptive advertising, 261
 - tangible employment, 351
- Action of the parties, termination by, 109–110
- Act of commission, 82
- Act of omission, 82
- Act of state
 - corporate dissolution by, 408
 - doctrine of, 552
- Act of the parties, agency termination by, 326
- Acts of God, liability for nonperformance and, 555
- Acts of the partners, partnership termination by, 368
- Actual authority, of agent, 322–323
- Actual knowledge, of security interest, 246
- Actual malice, 57
- ADA. *See* Americans with Disabilities Act
- ADEA. *See* Age Discrimination in Employment Act
- Adequacy of consideration, 120
- Adhesion contract, 143
- Adjudication, by administrative agencies, 529–530
- Adjustable-rate mortgage (ARM), 431
- Adjustment, of debts by individuals (Chapter 13 bankruptcy), 442, 447–448
- Adjustment plan, for Chapter 13 bankruptcy, 447–448
- Administrative agency. *See also* Regulation(s)
 - adjudication by, 529–530
 - appeals from, 30
 - controls on powers of, 530–531
 - defined, 526
 - executive agencies, 526
 - functions of, 527–530
 - independent regulatory agencies, 527
 - investigations by, 528–529
 - public accountability laws for, 532–533
- Administrative law, 526–533
 - defined, 7, 526
- Administrative law judge (ALJ), 529, 530
- Administrative Procedure Act (APA), 1946, 527
 - arbitrary and capricious test of, 531
 - judicial review of agency decisions and, 530–531
- Administrative process, 526–532
- Administrator, 512
- Admissible evidence, 34, 84, 170, 171
- Admissions
 - for oral contracts, 167–168, 211
 - requests for, 34
- Adopted children, intestacy laws and, 516
- ADR. *See* Alternative dispute resolution (ADR)
- Adverse possession, 494–495
- Advertising, advertisement. *See also* Deceptive advertising
 - bait-and-switch, 260
 - as commercial speech, 47
 - fraud, e-mail, and, 261
 - as invitation to negotiate, 108
 - of online business, 68, 76
 - online deceptive advertising, 261
- Advice of counsel. *See* Attorney
- Affidavit, 33
- Affirmation or promise of fact, 246
- Affirmative indication, in agency relationship, 320
- Affordable Care Act (ACA), 339
- After-acquired property, 418
- Age. *See also* Minor
 - disaffirmance and misrepresentation of, 131
 - discrimination based on, 351–352
 - of majority, 129
 - of testator, 512
- Age Discrimination in Employment Act (ADEA, 1967), 351–352
- Agencies (government). *See also* Administrative law; specific agencies
 - administrative, 526–532
 - executive, 526
 - independent regulatory, 527
 - state and local, 527
 - antitrust law enforcement by, 545
- Agency
 - by agreement, 320
 - coupled with an interest, 326
 - by estoppel, 320
 - exclusive, 322
 - formation of, 319–321
 - by operation of law, 320–321
 - by ratification, 320, 324
 - relationships (*See* Agency relationships)
 - termination of, 326–327
- Agency law
 - liability for agent's contracts, 324–325
 - partnership and, 363, 366
- Agency relationships, 318
 - agents of insurance companies and, 454
 - bank-customer relationship as, 302–303
 - vs. distributorships, in international business, 553
 - employer–employee, 318
 - employer–independent contractor, 319
 - with foreign firm, 553
 - formation of, 319–321
 - termination of, 326–327

- Agent. *See also* Agency relationships
 authority (*See* Agent's authority)
 crimes of, 381
 defined, 318
 dishonest employee or, 293
 duties to principal, 321–322
 loyalty as, 321–322
 fictitious payee rule and, 293
 foreign, 553
 insurance, 453–455
 liability of, 322, 324–325
 partner as, 367
 principal's duties to, 322
 tort liability of, 325
 unauthorized acts of, 292
 Agent's authority, 322–324
 scope of, 325
 Aggregate, entity vs., 363
 Agreement(s). *See also* Contract
 agency by, 320
 bailment, 477, 479
 click-on, 113
 contractual, 97, 99, 107
 corporate dissolution by, 408
 defined, 107
 discharge by, 192–193
 distribution (international business), 553
 to exceptions to perfect tender rule, 233–235
 forbearance, 119, 434
 lacking consideration, 121–123
 lease (*See* Lease contracts)
 mutual, agency termination by, 326
 noncompete, 122
 operating (LLC), 370
 partnership, 364
 prenuptial, 166
 price-fixing, 540
 security, 416, 417
 settlement, 123
 withdrawal from illegal, 145
 workout, 435
 Airspace rights, 490
 Alien corporation, 380
 ALJ. *See* Administrative law judge
 All rights, assignment of, 181
 Alteration, material, 295
 Alternative dispute resolution (ADR), 36–37
 arbitration as, 36–37
 defined, 36
 differences in, 37
 mediation as, 36
 negotiation as, 36
 online (ODR), 37
 Ambiguity, in contracts, 102, 170
 Amendments, to U.S. Constitution.
 See Bill of Rights; specific amendments
 American Law Institute (ALI), 6
 Americans with Disabilities Act (ADA 1990), 352–353
 reasonable accommodation under, 353
 Annual percentage rate (APR), 433
 Answer
 to administrative agency's complaint, 529
 in pleadings, 33
 Anticipatory repudiation, 236–237
 Anti-Counterfeiting Trade Agreement (ACTA, 2011), 75
 Anticybersquatting Consumer Protection Act (ACPA, 1999), 70
 Antidiscrimination laws. *See* Discrimination; Employment discrimination
 Antidumping duty, 556
 Antilapse clause, 456
 Antitrust law, 539–546. *See also* specific acts
 enforcement of, 545
 exemptions from, 545
 in global context, 546
 APA. *See* Administrative Procedure Act (APA, 1946)
 Apparent authority
 of agent, 324
 estoppel and, 320
 Appeal
 of ALJ's decision, 530
 appellate review, 29
 to higher appellate court, 29
 to Supreme Court, 30–31
 Appearance, of agency, 320
 Appellant, 35
 Appellate (reviewing) courts
 federal (*See* Federal court system, appellate courts of)
 state (*See* State court system, appellate courts of)
 Appellate jurisdiction, 29
 Appellee, 35
 Application, for insurance, 455
 Appraisal clause, 456
 Appraisal right, 405–406
 Appraiser, 434
 Approval, sale on, 224
 Arbitrary and capricious test, for agency decisions, 531
 Arbitrary trademarks, 68
 Arbitration
 online, 70
 as type of ADR, 36–37
 Arbitration clause
 in contract, insurance, 456
 in international contracts, 551
 Arbitrator, 37
 Argument, closing, 35
 Arrangement, tying, 540
 Arrest, 83, 84
 Arsonist, 61, 62
 Articles
 of consolidation, 404
 of incorporation, 388, 393
 filing with state, 378
 of merger, 403
 of organization, of LLC, 370
 of partnership, 364
 Articles of Constitution. *See* Constitution (U.S.)
 Artificial intelligence (AI), 311
 Artisan's lien, 421
 Assault and battery, tort law and, 56
 Assault, defined, 56
 Assets
 in Chapter 13 bankruptcy, 447
 in consolidation, 404
 direct purchase of, 406
 successor liability after, 406
 liquidation of corporate, 409
 in merger, 403
 sales of corporate, 406
 Assignee, 178, 281
 rights subject to defenses, 178
 transfer of interest in leased property to, 505
 Assignment, 184–185
 of “all rights,” 181
 of lease, 505
 notice of, 179–180
 personal services contract and, 179
 prohibited by contract, 179
 prohibited by statute, 179
 of rights, 177–181
 risk or duties of obligor and, 179
 transfer of negotiable instrument by, 281
 Assignor, 178
 extinguishing rights of, 178
 Associations. *See* Trade associations
 Assumption of risk, 62
 product liability and, 253
 Assurance, of performance, 235
 Astronauts, agreements on, 557
 At common law. *See* Common law
 Attachment
 to collateral, 417
 defined, 417
 writ of, 422
 Attempted monopolization, 542, 543
 Attorney
 locating, 8
 power of, 319, 323
 Attorney fees, Clayton Act and, 541
 At-will employees, 333
 At will, tenancy, 502
 Auctions
 foreclosure, 436
 live and online, 108
 offers, intent, and, 108
 Audit reports, Public Company Accounting Oversight Board and, 16
 Authority
 of agent, 322–324
 apparent, 320, 324
 binding, 318
 implied, 323
 Authorization card, 341
 Authorized actions, contract liability and, 325
 Authorized means, of acceptance, 112
 Automated teller machines (ATMs), 309
 Automatic stay, 443
 Automobile insurance, 454, 457
 Automobiles
 information labels for, 262
 quotas and, 556

Avoidance, of foreclosure, 434–435
 Award. *See also* Damages
 in arbitration, 37

B

Bad faith
 in arbitration, 37
 tort actions, against insurers, 459
 Bailee
 bailment for sole benefit of, 480
 defined, 222–223, 477
 duties of, 480–482
 of care, 480–481, 483
 goods held by, 223
 liability of, 480, 482
 property transferred to, 477, 478
 rights of, 479–480
 Bailment. *See also* Bailee
 defined, 477
 elements of, 477–479
 involuntary, 478
 for mutual benefits, 480
 ordinary, 479
 for sole benefit of bailee, 480
 for sole benefit of bailor, 480
 special (extraordinary) types of, 479, 483
 Bailment agreement, 477, 479
 Bailor, 482
 bailment for sole benefit of, 480
 defined, 477
 duties of, 482
 Bait-and-switch advertising, 260
 Bank(s)
 collecting, 306
 collection process of, 306–308
 depository, 306
 duty to accept deposits, 306
 duty to honor checks, 303–306
 EFTA and, 309
 intermediary, 306
 liability of, 304, 310
 negligence of, 305
 payor, 306
 recovery by, 305
 UCC definition of, 301
 Bank customer
 artificial intelligence, 311
 check collection between, 307
 death or incompetence of, 304
 forged indorsements and, 305–306
 forged signatures and, 305
 liability of, 310
 mobile, 310
 negligence of, 305
 online, 310
 relationship with bank, 302
 Banking
 artificial intelligence, 311
 electronic, 309
 mobile, 310
 online, 310
 Bank note. *See* Certificate of deposit
 Bankruptcy. *See also* Bankruptcy Code
 comparison of types of, 448
 creditors' committees and, 446

 creditors' meeting and, 443–444
 crime in, 442
 discharge in, 295, 441, 444–446, 448
 dismissal of petition, 442, 444
 estate in property in, 444
 exceptions in, 442, 443, 445
 fraud and, 445, 446, 448
 involuntary, 441–443
 partner's dissociation and, 367
 petition in, 442–444, 447
 property distribution in, 444–445
 relief in, 442, 444, 446
 reorganization in, 442, 446
 repayment plan in, 442, 447–448
 sole proprietorship and, 447
 termination of agency relationship by,
 327
 voluntary, 441, 442
 Bankruptcy Code. *See also* Bankruptcy
 Chapter 7 of (liquidation proceedings),
 441, 443–446
 Chapter 11 of (reorganization), 442,
 446–447
 Chapter 13 of (adjustment of debts by
 individuals), 442, 447–448
 cram-down provision of, 446
 exemptions in, 442–445
 goals of, 441
 types of relief under, 441–442
 Bankruptcy courts, 442
 Bankruptcy trustee, 443, 444
 Bank statements, timely examination by
 customer, 305
 Bargained-for exchange, 120
 Bargaining
 collective, 341–342
 freedom of contract and, 120
 Bargaining unit, for union, 341
 Basis of the bargain, 247
 Battery
 assault and, tort law and, 56
 defined, 56
 Bearer, defined, 276
 Bearer instruments, 280–281
 Beneficiary
 creditor, 182
 donee, 182
 incidental, 183–184
 of insurance policy, 453
 intended, 182–183
 third party, 181–184
 of trust, 517
 of will, 513
 Benefit corporation, 380
 Benefits
 for FMLA leave, 335
 for Social Security, 338
 Bequest, 512
 Berne Convention (1886), 75
 Beyond a reasonable doubt, 81
 BFOQ. *See* Bona fide occupational
 qualification
 Bids, as offers, 108
 Bilateral contracts, 98, 111
 Bilateral mistakes of fact, 152
 Bill of lading, 219

Bill of Rights. *See also* Constitution (U.S.);
 individual amendments
 business and, 46–49
 protections in, 46
 Binder, insurance, 455–456
 Blank indorsement, 282
 Board of directors. *See* Directors,
 corporate
 Bona fide occupational qualification
 (BFOQ), 354
 Bond(s), as securities, 382
 Books. *See* Accounting
 Borrower, of mortgage loans
 lender protections and, 432–433
 protections for, 433–434
 Boycotts, group, 540
 Breach of contract. *See also* Damages;
 Lease contracts; Sales contracts
 anticipatory repudiation and, 236–237
 bailee's failure to return bailed property
 as, 481
 by buyer or lessee, 225
 damages for
 compensatory, 195
 consequential, 195
 liquidated, 196
 punitive, 196
 defined, 189
 lease contract, 225, 503, 506
 material, 191
 performance, compromise and, 198
 as personal defense, 295
 remedies for, 194–197
 risk of loss and, 225, 226
 sales contract, 208, 225
 by seller or lessor, 225
 Breach of duty
 of care, 60, 396
 fiduciary, 387
 Breach of loyalty. *See* Duty of loyalty
 Breach of warranty, 239, 245
 as personal defense, 295
 Bribery, 86
 Foreign Corrupt Practices Act and,
 21–22
 Brief, 35
 Britain. *See* England (Britain)
 Broker, insurance, 453, 455
 Burden of proof, 81
 Burden-shifting procedure, 348
 Burden, substantial, free exercise clause
 and, 49
 Business(es). *See also* Antitrust law;
 Corporation; Small business
 Bill of Rights and, 46–49
 crimes affecting, 84–86
 international (*See* International
 business; International contract)
 legal requirements for, 2–3
 regulation of (*See* Regulation(s))
 sole proprietor, 371
 Business contracts. *See* Contract(s)
 Business ethics. *See also* Ethics
 business decisions and, 14
 business law and, 16–17
 conflicts and trade-offs and, 15–16

- Business ethics (*continued*)
 - corporate compliance programs and, 15
 - defined, 14
 - ethical leadership and, 14
 - global, 21–22
 - importance of, 13–14
 - law and, 16–17
 - principles and philosophies of, 18–20
 - principle of rights in, 19
 - social media and, 20
- Business invitees, 60
- Business judgment rule, 398, 407
- Business necessity, as employment discrimination defense, 354
- Business organization. *See also* specific forms
 - sole proprietorship as, 362–363
- Business relationship, wrongful interference with, 58
- Business torts, 55–64. *See also* Tort(s)
 - defined, 55
 - wrongful interference and, 58
- Business trust. *See* Antitrust law; Trust
- But for test, 61
- Buyer
 - contract breached by, 225
 - entrustment rule and, 220
 - examination or refusal to inspect, 250
 - insolvency of, 237
 - insurable interest of, 225
 - obligations of, 235–237
 - in ordinary course of business, 220, 419
 - passage of title to, 218–220
 - rejection of goods by, 233
 - remedies of, 238–240
 - right to recover damages for
 - nonacceptance by, 237
 - risk of loss and, 223, 224
- Bylaws, corporate, adopting, 378
- C**
- Canceled checks, 305
- Cancellation. *See also* Rescission
 - of insurance policy, 457–458
- Capacity
 - contractual, 97, 129–135, 319
 - testamentary, 512
- Capital
 - for corporation, 382
 - for sole proprietorship, 363
 - venture, 382
- Care. *See* Duty of care
- Carrier cases, 221–222, 232–233
- Carriers, substitution of, 234
- Case(s). *See also* Lawsuit
 - diversity-of-citizenship, 31
 - prima facie*, 348, 349, 352
- Case law
 - common law doctrines and, 4
 - defined, 4
- Cashier's checks, 275, 302
- Cash, negotiable instrument as, 274
- Categorical imperative, 18
- Causation
 - in fact, 61
 - in negligence action, 61–62
- Cause
 - of action, 33
 - of injury, negligence and, 61
 - proximate, 61, 252
- CD. *See* Certificate of deposit
- Cease-and-desist order, 261
- Celebrity endorsements, in deceptive advertising, 260
- Certificate
 - of limited partnership, 369
 - stock, 386
- Certificate of deposit (CD), 277
- Certified check, 302
- Changed circumstances, termination of agency relationship by, 327
- Chapter 7 bankruptcy (liquidation proceedings), 441, 443–446
 - exceptions and, 443, 445
- Chapter 11 bankruptcy (reorganization), 442, 446–447
- Chapter 13 bankruptcy (adjustment of debts by individuals), 442, 447–448
- Charitable institutions, involuntary bankruptcy and, 442
- Check(s), 274–276, 279, 301. *See also* Negotiable instrument(s)
 - bank's duty to honor, 303–306
 - canceled, 305
 - cashier's, 275, 302
 - certified, 302
 - clearing of, 307, 308
 - collection process for, 306–308
 - death or incompetence of bank
 - customer and, 304
 - defined, 301–302
 - as demand instrument, 274
 - dishonor of, 303
 - electronic presentment of, 307
 - forged signature on, 305
 - overdrafts and, 303–304
 - stale, 304
 - stop-payment order and, 304
 - substitute, 308, 309
- Check Clearing in the 21st Century Act (Check 21), 308
- Check collection
 - deferred posting, 307
 - electronic processing, 307
 - process of, 306–308
- Checks and balances system, 44
- Chief executive officer (CEO). *See* Officers, corporate
- Child labor, restrictions on, 336
- Children. *See also* Minor
 - intestacy laws and, 516
 - revocation of will by birth of, 515
- Choice-of-language clause, 554
- Choice-of-law clause, in international contracts, 555
- C.I.F. (C.&F.), defined, 221
- Circuits, federal judicial, 29
- Circumvention, DMCA and, 74
- Citizenship
 - corporate, 20
 - diversity of, 31
- Civil law
 - criminal law vs., 7, 81–82
 - defined, 7, 81
- Civil lawsuit(s), procedural rules in, 32–36
- Civil (codified) law systems, 7
- Civil Rights Act (1964). *See* Title VII
- Claim(s)
 - under ADA, 353
 - under ADEA, 353
 - creditors', 444
 - settlement of, 123
 - subordinate, 445
 - under Title VII, 347–348
- Classes
 - in bankruptcy, 445–447
 - protected, 144, 347–353
- Classifications
 - of crimes, 82
 - of insurance, 454
 - of law, 7
- Clause
 - acceleration, 280, 436
 - exculpatory, 144, 480
 - insurance, 456–457, 459
 - international contract, 554–555
 - arbitration, 555
 - choice-of-language, 554
 - choice-of-law, 555
 - force majeure*, 555
 - forum-selection, 554
 - option-to-cancel, 122
 - prepayment penalty, 432–433
 - unconscionable, 142–143
- Clayton Act (1914), 544
 - enforcement of, 545
 - exclusionary practices under, 544
 - mergers under, 545
 - price discrimination under, 544
- "Clear and conspicuous" disclosure, 261
- Clearinghouse, 307
- Click-on agreements, 113
- Clients. *See* Attorney
- Close corporation, 380
 - oppressive conduct in, 387
- Closed shop, 341
- Closing argument, 35
- Codes. *See also* United States Code
 - codes of ethics and, 14–15
 - of ethics, 14
- Codicil, 514
- Codified law, defined, 7
- Collateral
 - attachment to, 417
 - debtor rights in, 417
 - description of, 418
 - disposition after default, 420
 - priority of claims to debtor's, 419, 445
 - secured party and, 417, 420
 - security interest and, 417, 418, 444
 - surrender of, 424
- Collateral heirs, 516
- Collateral (secondary) promise, 165–166
- Collecting bank, 306, 307
- Collection agencies, FDCPA and, 266
- Collection, of checks. *See* Check collection
- Collective bargaining, 341–342
 - agreement, employee drug testing protection in, 337
- Color, discrimination based on, 349
- Comity, principle of, 551

- Comment period, in agency rulemaking, 527–528
- Commerce clause, 44–45
dormant, 45
- Commercial bribery, 86
- Commercial impracticability, 194, 234
- Commercially reasonable disposition, 420
- Commercial reasonableness, 90, 231
- Commercial spaceflight, regulation of, 558
- Commercial Space Launch Act, 558
- Commercial speech, 47
- Commercial transactions. *See* Lease contracts; Sales contracts
- Commission, act of, 82
- Committee(s), creditors', 446
- Common carriers, bailment relationship with, 483
- Common law
antitrust law and, 539
case law and, 4
contracts and, 113
defined, 3–4
employment at will doctrine and, 333
as source of law, 3–5, 27
systems of, 7
tradition of, 3
vs. UCC, 208
- Commonly known danger defense, 254
- Common stock, 382
- Common, tenancy in, 467, 469
- Communication
of acceptance, 111–112
of effective offer, 109
monitoring of employee, 337
- Community property, 467
- Company. *See also* Business(es); Corporation(s); specific types of companies
export trading, 556
- Comparative negligence (fault), 62, 254
- Compassion, in ethical standards based on religion, 18
- Compelling government interest test, 50
- Compensation. *See also* Income; Payment; Wages
bailee's right of, 479
confiscation and expropriation by foreign government and, 552, 555
for eminent domain action, 495
partnership and, 365
principal's duty of, 322
workers' (*See* Workers' compensation)
- Compensatory damages, for breach of contract, 195
- Competition. *See* Antitrust law; Covenant, not to compete; Sherman Antitrust Act
- Complaint
administrative agency issuance of, 529
in pleadings, 32–33
- Completely integrated contract, 171.
See also Fully (completely)
integrated contract
- Complete performance, 190
- Compliance programs, corporate, 15
- Computer crime, 87. *See also* Cyber crime
- Computer Fraud and Abuse Act (CFAA, 1984), 89
- Computer Software Copyright Act (1980), 73
- Concentration, market, 545
- Concurrent jurisdiction, 31
- Concurrent ownership, 467
- Concurrent powers, of federal and state governments, 45
- Condemnation, eminent domain and, 495
- Condition
discharge by failure of, 189–190
orally agreed-on, 171
- Conditional sales, 224
- Conduct
agency agreement implied from, 320
contracts and, 113
of debtor, in bankruptcy, 445–446
ethical codes of, 14–15
implied contract and, 99–100
misrepresentation by, 154
partnership implied by, 364
of principal, agency by estoppel and, 320
- Confirmation, of reorganization plan, 448
- Confiscation, of private property, 552
- Conflicting perfected security interests, 419
- Conflicting unperfected security interests, 419
- Conflicts of interest, 397–398
- Conforming goods, 208, 231, 246
- Confusion, acquisition of personal property by, 469
- Congress, federal court jurisdiction and, 31
- Consent
for assignment of lease, 505
modifications made in, 209
terms subject to, 209
voluntary, 319
- Consequential (special) damages, 195, 239
- Consideration
adequacy of, 120
agreements lacking, 121–123
bargained-for exchange and, 120
contractual, 97
defined, 119
instrument transferred for, 293
lack of, 121–123
lack or failure of, as defense, 295
legally sufficient value and, 119–120
for mutual rescission, 192
past, 122
preexisting duty rule and, 121–122
premium as, 453
under UCC, 209
value vs., 288
- Consolidation
defined, 404
merger vs., 403
- Constitution (U.S.). *See also* Bill of Rights; individual amendments
Article I, 44, 45
Article VI, 45
commerce clause of, 44, 45
control of federal courts in, 31
due process clause of (*See* Due process clause)
regulation of businesses in interstate commerce and, 6
safeguards in, 82–84
on separation of powers, 43–44
state powers in, 44
supremacy clause of, 45
as supreme law, 5, 43–44
taxing and spending powers and, 45
- Constitutional law, 5–7, 43–52. *See also* Constitution (U.S.)
- Constructive bailment, 478
- Constructive delivery, 468, 478
- Constructive discharge, 350
- Constructive eviction, 503
- Constructive trust, 518
- Consultation, of legal expert, 8
- Consumer Credit Protection Act, Title 1 of (TILA), 263–265
- Consumer credit reporting agencies, FCRA on, 265
- Consumer fund transfers, 309–310
- Consumer goods. *See also* Goods
as collateral in default, 420
- Consumer law, 259
selected areas regulated by statutes in, 263
- Consumer Product Safety Act, 267
- Consumer protection
credit protection, 263–266
deceptive advertising and, 259–262
health and safety protection, 267
labeling and packaging laws, 262
in sales transactions, 262
- Consumer Protect Safety Commission (CPSC), 267
- Continuity, sole proprietorship and, 363
- Contract(s). *See also* Breach of contract; Discharge; Illegality; Performance; Sales contracts; Statute of Frauds
acceptance of, 97, 111–112
adhesion, 143
agency agreement, 320
agreement in, 97, 107
ambiguity in, 102
with ambiguous terms, 170
assignment of, 177–181
assignment prohibited by, 179, 185
bailments and, 477
bilateral, 98, 111
cancellation of (*See* Cancellation)
capacity and, 97, 129–135, 319
to commit a crime, 139
consideration and, 97, 119–123
contrary to public policy, 142–144
contrary to statute, 139–142
defined, 58, 96–98
delegation prohibited by, 181
destination, 218–219, 221, 233
disaffirmance by minor and, 131–132
discharge of, 189–194
distribution agreement, 553
electronic (*See* e-contract)
e-mail, 172
employment, 334
enforceability of, 98
enforceable, 58, 101, 133, 172

- Contract(s) (*continued*)
- exclusive-dealing, 544
 - executed, 101
 - executory, 101
 - express, 99–100, 334, 501
 - formal, 100
 - formation of, 163
 - guaranty, 424
 - illegality of, 139–145
 - through duress or undue influence, 156–157
 - implied, 99–100
 - incomplete, 170
 - informal, 100
 - installment, 234
 - insurance (*See* Insurance contract)
 - integrated, 171
 - international, 554–555
 - interpretation of, 102
 - by intoxicated persons, 133
 - legality of, 97, 139–145
 - mental incompetence and, 129, 133–134
 - by minors, 101, 129–135
 - mistakes in, 151–153
 - objective theory of, 97
 - offeree/offor and, 98
 - offers for, 97, 107–109
 - option-to-cancel clauses in, 122
 - oral (*See* Oral contracts)
 - parol evidence rule in, 169–171
 - personal, 191
 - for personal services, 179
 - privity of, 177, 251
 - quasi, 100
 - ratification of (*See* Ratification)
 - reformation of, 141
 - requirements of, 97
 - requiring a writing, 163–168
 - rescission and, 122, 196
 - in restraint of trade, 140–141
 - review of, 185
 - for sale of goods, 167
 - for sale of land, 164
 - sale-or-return, 224
 - to settle legal claims, 123
 - shipment, 218, 221, 232–233
 - Statute of Frauds and, 163–168
 - of suretyship, 422
 - termination, 189–194
 - types of, 98–102
 - unconscionability of (*See* Unconscionability)
 - unenforceable, 101–103
 - unilateral, 99, 111
 - valid, 101–102, 134
 - void, 102, 134, 170
 - voidable, 101–102, 129, 133, 134, 170
 - voluntary consent to, 98, 151
 - factors indicating lack of, 151–156
- Contract law, 81, 206. *See also* Parol evidence rule; Remedies; Statute of Frauds
- employment (*See* Employment contract)
- international (*See* International contract)
- overview of, 96–102
- ratification in, 132
- statutory law and, 206
- Contractor. *See* Independent contractor
- Contractual capacity, 97, 129–135, 319
- Contractual relationship
- bank-customer relationship as, 303
 - wrongful interference with, 58
- Contribution, right of, 425
- Control(s)
- on agency powers, 530–531
 - export, 556
 - import, 556
- Conversion, 59
- failure to return bailed property and, 481
 - of lost property, 470
- Cooperation
- performance and parties, 235
 - principal's duty of, 322
- Copyright
- defined, 71
 - in digital information, 73–74
 - exclusions in, 72
 - fair use exception and, 72, 74
 - file-sharing technology and, 74
 - infringement of, 72–73
 - and protected expression, 71–72
 - software protection and, 73, 75
- Copyright Act (1976), 71, 72
- Corporate citizenship, 20
- Corporate compliance programs, 15
- Corporate officers. *See* Officers, corporate
- Corporate political speech, 47
- Corporate securities, trading of, 383–384
- Corporate social responsibility (CSR), 20
- corporate aspects of, 20
 - social aspects of, 20
 - stakeholders and, 20
- Corporate veil, piercing of, 379, 380
- Corporation(s). *See also* Business ethics; specific forms
- benefit, 380
 - board of directors of (*See* Directors, corporate)
 - bylaws of, 378
 - classifications of, 380
 - close, 380
 - consolidations of, 404
 - criminal acts and, 381
 - de facto*, 379
 - directors of (*See* Directors, corporate)
 - domestic, foreign, and alien, 380
 - by estoppel, 379
 - financing of, 381–382
 - formation of, 377–379
 - incorporation procedures for, 377–378
 - issuing, 382
 - legal jurisdiction over, 28
 - liability for criminal acts and, 381
 - mergers of, 403
 - nonprofit, 380
 - officers of (*See* Officers, corporate)
 - parent corporation, 404, 405
 - as person, 46, 377
 - powers of, 381
 - public and private, 380
 - publicly held, 384
 - purchase of assets by, 406
 - successor liability after, 406
 - reorganization of (Chapter 11 bankruptcy), 442, 446–447
 - reputations of, 22
 - requirements for combination of, 404
 - sales of assets by, 406
 - S corporation, 380
 - share exchange and, 404
 - shareholders of (*See* Shareholders)
 - subsidiary corporation, 404, 405
 - short-form merger of, 405
 - surviving, 403
 - takeovers of, 406
 - responses to, 407
 - target, 406, 407
 - termination phases, 382
 - dissolution, 408–409
 - liquidation, 409
- Cost-benefit analysis, 19
- Costs, of starting sole proprietorship, 362
- Co-sureties, 425
- Counsel. *See* Attorney
- Counteradvertising, 261
- Counterfeit Access Device and Computer Fraud and Abuse Act. *See* Computer Fraud and Abuse Act
- Counterfeit goods, 69
- Counterfeiting, international agreement combating, 75
- Counteroffer, 110
- Course of dealing, 211–212
- implied warranty from, 249
- Course of performance
- contracts and, 170, 212
 - implied warranty from, 249
- Court(s). *See also* Case(s); Federal court system; Supreme Court
- of appeals (appellate) (*See* Federal court system, appellate courts of; State court system, appellate courts of)
 - in England, 3
 - of equity, 5
 - federal (*See* Federal court system)
 - function of, 27
 - of general jurisdiction, 28
 - of law, 5
 - of limited jurisdiction, 28–29
 - piercing the corporate veil by, 379, 380
 - probate, 511
 - reviewing (*See* Federal court system, appellate courts of; State court system, appellate courts of)
 - state (*See* State court system)
 - Supreme (*See* Supreme Court)
 - trial (*See* Trial courts)
 - unconscionability and, 142
- Court order, corporate dissolution by, 408
- Court systems. *See* Federal court system; State court system
- Covenant. *See also* Promise
- not to compete, 141
 - employment contracts involving (restrictive covenants), 141
 - reformation for, 141
 - sale of ongoing business and, 141
 - of quiet enjoyment, 494, 503

- Cover, right to obtain, 239
 - Cram-down provision, of Bankruptcy Code, 446
 - Credit
 - consumer, 263–266
 - continuing line of, 418
 - discrimination, 264
 - negotiable instrument as, 274
 - provisional, 307
 - sale made on, 235, 237
 - Credit cardholder, protection under TILA, 264–265
 - Credit cards, 310
 - Credit counseling, voluntary bankruptcy and, 442
 - Creditor(s)
 - artisan's liens' priority and, 421
 - in bankruptcy (*See also* Bankruptcy)
 - claims of, 444
 - committee of, 446
 - equitable treatment of, 441
 - involuntary bankruptcy forced by, 442–443
 - meetings of, 443–444
 - main purpose rule and, 166
 - of partners and partnership, 366, 369
 - protections for, when granting mortgages, 432–433
 - rights and remedies, 420–425
 - secured, 416, 417, 442, 444, 448 (*See also* Secured party)
 - surety and guaranty, 422–423
 - TILA and, 264, 433–434
 - unsecured, 418, 432, 442, 445, 446
 - Creditor beneficiary, 182
 - Creditor–debtor relationship, bank–customer relationship as, 302
 - Credit protection, 263
 - Fair and Accurate Credit Transactions Act, 265–266
 - Fair Credit Reporting Act, 265
 - Fair Debt Collection Practices Act, 266
 - Truth-in-Lending Act, 263–265
 - Crime. *See also* Criminal acts; specific types
 - affecting business, 84–86
 - agent's, liability for, 381
 - classification of, 82
 - computer, 87
 - contracts to commit, 139
 - cyber, 87–89
 - defined, 55, 81
 - employee's, liability for, 398
 - property, 84–86
 - under RICO, 86
 - white-collar, 84–86
 - Criminal acts. *See also* Crime
 - corporations and, 381
 - tort lawsuit and criminal prosecution for same act, 56
 - Criminal code, state, 409
 - Criminal law
 - civil law vs., 7, 81–82
 - constitutional safeguards in, 82–84
 - defined, 7, 81
 - Criminal liability, 82, 389. *See also* Crime
 - defenses to, 86–87
 - Crops, sale of, 490
 - Cross-examination, 35
 - Crowdfunding, 382
 - CSR. *See* Corporate social responsibility
 - Cumulative voting, by shareholders, 385
 - Cure
 - defined, 225, 233
 - right to, 233–234
 - Customary practices, 170–171
 - Customer restrictions, in distribution, 541
 - Cyber crime, 87–89
 - cyber fraud as, 87–88
 - cyber theft and, 88
 - hacking and, 89
 - identity theft, 88
 - prosecution of, 89
 - Cyberinsurance policies, 459
 - Cyber security, 90
 - Cyberspace. *See also* Internet
 - jurisdiction in, 28
 - risk management in, 459
 - Cybersquatting, domain names and, 70
 - Cyberterrorist/cyberterrorism, 89
- D**
- Damage, caused by space objects, 557
 - Damaged property, bailed, 482
 - Damages
 - for breach of contract, 194–196
 - for breach of fiduciary duty, 387
 - for buyer's nonacceptance of goods, 237
 - under Clayton Act, 546
 - compensatory, 195
 - consequential, 195, 239
 - defined, 5
 - incidental, 237
 - injury requirement and, 156
 - liquidated, 196
 - mitigation of, 197
 - monetary, 265
 - punitive, 156, 196
 - right to recover, 238, 239
 - for wrongful possession of land, 502
 - Dangerous activities, abnormally, 62
 - Dangers, commonly known, 254
 - Data collection, pretexting and, 51
 - Dealers, of securities, 384
 - Dealings, course of, 211–212
 - implied warranty from, 249
 - Deal, refusal to, 543
 - Death
 - of bank customer, 304
 - impossibility of performance by, 193
 - intestate, 516–517
 - of partner, 366
 - termination by
 - of agency relationship, 326
 - of offer, 110
 - Debit cards, 301
 - lost or stolen, 310
 - Debt
 - bonds as, 382
 - collateral promise and, 165
 - discharge of, in bankruptcy, 441–442
 - FDCPA and collection of, 266
 - garnishment and, 422
 - laws assisting creditors and, 420–425
 - payment on dissolution of partnership, 369
 - secured transaction and, 416–420
 - Debtor. *See also* Bankruptcy; Borrower
 - conduct of, in bankruptcy, 445–446
 - default by, 417–418, 420, 423, 434
 - defenses of principal, 424
 - estate in bankruptcy, 444
 - financing statement filing and, 418
 - involuntary bankruptcy and, 442–443
 - main purpose rule and, 166
 - means test applied to, in bankruptcy, 443
 - priority of claims to collateral of, 419, 445
 - rights of, in collateral, 417
 - role at creditors' meeting, 443–444
 - in secured transaction, 416, 417
 - TILA and, 264, 433–434
 - voluntary bankruptcy and, 442
 - Debtor–creditor relationship, in secured transactions, 417
 - Decedent, 511
 - intestacy laws and, 516–517
 - with will, 511–515
 - Deceit, intentional, 57
 - Deceive, intent to, 155
 - Deceptive advertising
 - bait-and-switch advertising, 260
 - defined, 259
 - forms of, 259–260
 - FTC actions against, 261
 - Lanham Act and, 261
 - online, 261
 - Decision(s)
 - ethical business, 14
 - laws and, 2, 3, 17
 - Decision making
 - ethics and, 14
 - laws and, 17
 - Declaration, of revocation of will, 515
 - Deed(s)
 - in lieu of foreclosure, 435
 - real property transfer and, 494
 - De facto* corporations, 379
 - Defamation, 57
 - Default
 - basic remedies to, 420
 - collateral disposition after, 420
 - by debtor, 417–418, 420, 434
 - notice of, 436
 - Default judgment, 33
 - Defect(s)
 - implied warranty and goods with, 248
 - latent, 250
 - of leased property, 504
 - product, 250, 252–253
 - of title, deeds and, 494
 - Defective condition, in strict product liability, 252
 - Defective goods, 233, 482
 - liability for, 251–254
 - warranty liability for, 251
 - for warranties, 250

- Defective instruments, HDC status and lack of notice, 289
- Defendant
 answer of, 33
 defined, 32
 motion to dismiss and, 33
 summons for, 33
- Defense(s)
 against assignor, 178
 to contract enforceability, 98, 151
 to criminal liability, 86–87
 to employment discrimination, 354
 FTC Rule 433, 296
 against insurance payment, 458–459
 to negligence, 62
 personal (limited), 295
 of principal debtor, 424
 to product liability, 253–254
 of surety and guarantor, 424
 takeover, 407–408
 universal (real), 294–295
 to wrongful interference, 58
- Defense classification, of space technology, 558
- Deference, judicial, for agency decisions, 531
- Deferred posting, 307
- Deficiency judgment, 420, 436
- Definiteness of terms, in offer, 108–109
- Delayed effective date, of insurance policy, 456
- Delegatee, 180, 181
- Delegation, 180, 184–185
 of duties, 177, 180–181
 duties that cannot be delegated, 180–181
 effect of, 181
 prohibited by contract, 181
 relationships of, 180
- Delegator, 180
- Delivery
 constructive, 468, 478
 of gift, 468
 with movement of goods (carrier cases), 221–222
 of nonconforming goods, 233
 physical, 468, 478
 place of, 232–233
 of possession, 478
 right to withhold, 237
 seller or lessor withholding of, 237
 by substitute carrier, 234
 tender of, 218, 231–232
 terms of, 226
 without movement of goods, 219, 222–223
- Delivery ex-ship, defined, 221
- Demand instrument, 274. *See also* Negotiable instrument(s)
 HDC status and overdue, 289
- Denial, as misrepresentation by conduct, 154
- Departments of government. *See* specific departments
- Deposit
 bank's duty to accept, 306–308
 direct, 309
 of contract, 139, 189–194
 defined, 189
 by failure of a condition, 189–190
 from liability on negotiable instrument, 296
 notice of assignment and, 180
 by operation of law, 193–194
 by performance, 190–192
- Disclaimer, of warranty, 249–250
- Disclosed principal, 324
- Disclosure
 “clear and conspicuous” (FTC), 261
 of confidential medical information, 339
 conflicts of interest, 397–398
 by director or officer, 397–398
 in TILA, 264, 433–434
- Disclosure law, TILA as, 263
- Discovery
 defined, 34
 depositions in, 34
 interrogatories in, 34
- Discrimination
 age-based, 351–352
 based on sexual orientation, 347
 credit, 264
 disability, 352–353
 disparate-impact, 348–349, 352
 disparate-treatment, 348, 352
 employment (*See* Employment discrimination)
 gender-based, 349–350
 hiring (*See* Hiring, discrimination in)
 laws on, 50, 347–355
 pregnancy, 349
 price, 544
 for race, color, and national origin, 349
 religion-based, 349
 transgender persons, 350
- Dishonor, of instrument, 289, 291–292, 303, 307
- Disinheritance, 513
- Dismissals, of debtor's voluntary petition, 442, 444
- Dismiss, motion to, 33, 35
- Disparagement of property, 59–60
- Disparate-impact discrimination, 348–349, 352
- Disparate-treatment discrimination, 348, 352
- Disposal, of goods, 237
- Disposition, of collateral after default, 420
- Dispute-resolution services. *See* Alternative dispute resolution
- Dissociation, of partner, 367–368
- Dissolution
 of corporation, 408–409
 voluntary and involuntary, 408–409
 of partnership, 368
 as remedy for Sherman Act violation, 545
- Distributed network, 74
- Distribution
 agreement, 553
 intestacy laws and, 516, 517
 of partnership assets, 369
- Depository bank, 306
- Deposition, 34
- Derivative actions, 387, 398
- Description
 of collateral, 418
 goods conforming to, 246
- Design defects, 252
- Design patent, 70
- Destination contracts, 218–219, 221, 233
- Destruction
 of identified goods, 235
 of subject matter
 and impossibility of performance, 193
 termination of offer by, 110
- Detrimental reliance, 124
- Devise, defined, 512
- Devisee, defined, 512
- Digital age, 310–311
- Digital assets, 513
 digital executor, 514
 heirs, 514
 password manager, 514
 passwords galore, 514
- Digital information, copyrights in, 73–74
- Digital lending, 311
- Digital Millennium Copyright Act (DMCA, 1998), 74
- Dilution, of trademarks, 68
- Direct deposits and withdrawals, 309
- Directed verdict, motion for, 35
- Direct examination, 35
- Direct exporting, 553
- Directors, corporate
 bylaws and, 378
 duties of, 396–398
 election of, 378, 393–394
 fiduciary duties of, 396–398
 in takeover, 407
 liability of, 398
 management responsibilities of, 377, 394–395
 meetings of, 394
 removal of, 385, 393
 rights of, 395–396
 as trustees in liquidation, 409
 voluntary dissolution and, 408
 voting by, 394
- Disability
 defined, 353
 discrimination based on, 352–353
 Medicare and, 338
- Disability insurance, 454. *See also* Social Security
- Disaffirmance
 defined, 130
 exceptions to obligations on, 131–132
 mental incompetence and, 134
 minor's obligations on, 130–131
 minor's right to, 129–131, 134–135
 within reasonable time, 130
- Discharge
 by accord and satisfaction, 192–193
 by agreement, 192–193
 in bankruptcy, 295, 441–443, 445–446, 448
 constructive, 350

- of property, 444–445
 - territorial or customer restrictions in, 541
 - Distributorship, in foreign country, 553
 - District courts, federal, 29–30
 - Diversity-of-citizenship, 31
 - Divestiture, as remedy for Sherman Act violation, 545
 - Dividends, 382, 386
 - Division of markets, as *per se* violation, 540
 - Divorce, revocation of will by, 515
 - DMCA. *See* Digital Millennium Copyright Act
 - Doctrine(s)
 - act of state, 552
 - of commercial impracticability, 194
 - of comparative negligence, 62
 - corporation by estoppel, 379
 - employment-at-will, 333–334
 - fair use, 72
 - first sale, 73
 - freedom of contract, 120
 - promissory estoppel, 124
 - respondeat superior*, 325, 381
 - of sovereign immunity, 552–553
 - stare decisis*, 4
 - of strict liability, 252–254
 - ultra vires*, 381
 - Document(s)
 - requests for, 34
 - of title, 219
 - Documentation, of employment, 340
 - “Doing Business As” (DBA) effect, 371
 - Domain name
 - cybersquatting and, 70
 - defined, 69–70
 - ODR and, 37
 - Domestic (in-state) corporation, 380, 404
 - Domestic relations courts, 29
 - Domestic-support obligations, bankruptcy and, 445
 - Dominion, gift delivery and, 468
 - Donative intent, 468
 - Donee beneficiary, 182
 - Donor, donee, 468
 - Dormant commerce clause, 45
 - Double jeopardy, 83
 - Down payment, 432
 - Draft
 - defined, 274
 - time and sight, 275
 - trade acceptance, 275
 - Drawee, 274, 275, 301
 - Drawer, 274, 275, 301
 - forged signature of, 305
 - liability of, 290, 291
 - signature of, 278
 - Drugs
 - safety regulation of, 267
 - testing employees for, 337
 - Due care
 - product liability and, 251
 - standard (*See* Duty of care)
 - Due course, holder in, 281
 - Due process clause, 46, 49–50, 83
 - Duration, of fee simple, 492
 - Duress
 - contract illegal through, 157
 - as defense to liability on negotiable instrument, 295
 - Duties, antidumping, 556
 - Duty. *See also* Breach of duty; Duty of care; Taxation
 - of agents, 321–322
 - assignment and alteration of, 179
 - of bailee, 480–482
 - of bailor, 482
 - of bank, 303–306
 - of bankruptcy trustee, 444
 - cannot be delegated, 180–181
 - delegation of, 177, 180–181
 - of directors and officers, 396–398
 - fiduciary (*See* Fiduciary duty)
 - of landlords and tenants, 503–505
 - of majority shareholders, 387
 - of merchant buyers and lessees, 238–239
 - of partners, 366
 - preexisting, 121–122
 - of principals, 322
 - of restitution, 131
 - Duty-based ethics, 18–19
 - Duty of care. *See also* Reasonable person standard
 - of bailee, 480, 481, 483
 - director’s and officer’s, 396, 407
 - in dissociation, 367
 - negligence and, 60–61, 305
 - partner’s, 366
 - Duty of loyalty
 - agent’s, 321–322
 - directors and officers and, 397, 407
 - partner’s, 366
 - Duty to reveal defects, 482
- E**
- Easement, defined, 492
 - e-commerce, UETA and, 113–114
 - e-contract, 102
 - acceptances of, 112–113
 - offers in, 112
 - UETA and, 113–114
 - ECPA. *See* Electronic Communications Privacy Act
 - EDGAR (Electronic Data Gathering, Analysis and Retrieval) system (SEC), 383
 - e-documents, 169
 - EEOC. *See* Equal Employment Opportunity Commission
 - Effective date, of insurance contract, 455–456
 - Eighth Amendment, criminal protections in, 83
 - Elderly. *See* Age
 - Election
 - of corporate directors, 378, 393–394
 - labor union, 341
 - Electronic bill (eBill), 310
 - Electronic bill payment and presentment (EBPP), 310
 - Electronic check presentment, 307
 - Electronic check processing, substitute check for, 308
 - Electronic Communications Privacy Act (ECPA, 1986), 50, 337
 - Electronic evidence. *See* e-evidence
 - Electronic fund transfer (EFT)
 - defined, 309
 - EFTA on, 309–310
 - systems of, 309
 - Electronic Fund Transfer Act (EFTA), 309–310
 - Electronic monitoring, of employees, 337
 - Electronic payment systems, 309, 310
 - Electronic records
 - as negotiable instrument, 274
 - UCC and, 167, 210
 - Electronic signature. *See* e-signature
 - Electronic sites. *See* Internet
 - Electronic transactions. *See* e-contract; Uniform Electronic Transactions Act (UETA)
 - Electronic warehouses, hacking and, 89
 - Eleventh Amendment, 352
 - e-mail
 - ads, fraud and, 85
 - mailbox rule and, 112
 - UCC and, 167, 210
 - UETA on, 169
 - e-mail contracts, enforceable, 172
 - Emancipation, of minor, 129, 132–133
 - Embezzlement, 85
 - Eminent domain, 495
 - Employee(s). *See also* Labor unions
 - at-will, 333
 - constructive discharge and, 350
 - disability of, reasonable accommodation for, 353
 - family and medical leave for, 335
 - fictitious payee rule and, 293
 - foreign workers as, 21, 340
 - garnishment and, 422
 - health and safety of, 334–335
 - health-insurance coverage and, 338–339
 - hiring of, 355
 - income security and, 337–338
 - liability
 - for misconduct of, 382
 - for torts of, 398
 - noncompete agreement and, 122
 - privacy rights of, 336–337
 - protections for, 334–339
 - retirement income and, 337–338
 - termination of, 355
 - unemployment insurance for, 338
 - wages and hours for, 336
 - workplace safety and, 335
 - wrongful termination of, 197
 - Employee Polygraph Protection Act, 336–337
 - Employee Retirement Income Security Act (ERISA), 338
 - Employer(s)
 - discrimination laws and, 347–354
 - group health plans of, 338–339
 - immigration laws and, 339–340
 - liability under Title VII, 351

- Employer(s) (*continued*)
 monitoring by, 337
 reasonable accommodation by, for
 employees with disabilities, 353
 retaliation by, 333, 351
 undue hardship vs. reasonable
 accommodation by, 353
 unfair labor practices of, 340, 342
 union elections and, 341
 use of independent contractors by, 319
 Employer-employee relationships, 318, 333
 Employer-independent contractor
 relationships, 319, 327
 Employment
 discrimination in (*See* Employment
 discrimination)
 foreign supplier practices and, 21
 I-9 verification and, 340
 laws of (*See* Employment law)
 Employment at will, 333
 exceptions to, 333–334
 Employment contract(s)
 covenants not to compete in, 141
 express, 334
 implied, 334
 Employment discrimination
 age-based, 351–352
 defenses to, 354
 defined, 347
 disability and, 352–353
 gender and, 349–350
 intentional (disparate-treatment), 348
 online harassment and, 351
 for pregnancy, 349
 race, color, national origin, and, 349
 religion and, 349
 sexual harassment and, 351, 355
 Title VII and, 347–351
 unintentional (disparate-impact),
 348–349
 union membership and, 342
 in wages, 350
 Employment Eligibility Verification, Form
 1-9, 340
 Employment law
 employment at will, 333–334
 family and medical leave, 335
 wages, hours and, 336, 350
 worker health and safety, 334–337
 Enabling legislation, 526, 530
 Enforceability
 of contracts, 98, 151–156, 183
 of e-mail contracts, 172
 Enforceable contract, 58, 101–102, 133,
 172
 Enforcement
 of antitrust laws, 545
 of employment verification, 340
 of exculpatory clauses, 144
 of FDCPA, 266
 of immigration laws, 340
 of Sarbanes-Oxley Act, 16
 of signature, 169
 England (Britain)
 common law heritage from, 3
 early courts in, 3–4
 Entity, partnership as independent, 363
 Entrapment, 87
 Entrepreneur, 558
 Entrustment rule, 220
 Entry upon land, requests for, 34
 Environmental Protection Agency (EPA,
 1970), 527
 Equal Credit Opportunity Act, 264
 Equal dignity rule, 319, 323
 Equal Employment Opportunity
 Commission (EEOC, 1964), 527
 ADA claims and, 353
 Title VII claims and, 347–348
 Equal Pay Act (1963), 350
 Equal protection, clause, 49–50
 Equitable right of redemption, 436
 Equity
 courts of, 5
 defined, 5
 Equity securities. *See* Stock(s)
 ERISA. *See* Employee Retirement Income
 Security Act
 Errors. *See also* Mistakes
 clerical, 171
 e-signature. *See also* Signature
 UETA definition of, 169
 Establishment clause, 48
 Estate
 life, 492
 in property, 444
 Estop, defined, 124, 168
 Estoppel
 agency by, 320, 324
 apparent authority and, 320, 324
 corporation by, 379
 partnership by, 364
 promissory, 124, 168
 Estray statute(s), 470
 Ethical codes of conduct, 14
 Ethical leadership, importance of, 14
 Ethical reasoning, 18–20
 Ethics. *See also* Business ethics
 defined, 13
 duty-based, 18–19
 gray areas of, 17
 law and, 16–17
 outcome-based (utilitarianism), 19
 principles and philosophies of, 18–20
 setting ethical tone, 14–16
 European Union (EU), 556
 Event, occurrence of
 agency termination and, 327
 dissociation and, 367
 Eviction, 503
 Evidence. *See also* Discovery; Parol
 evidence rule
 admissible, 34, 84, 170, 171
 in advertising, 260
 contract ambiguity and outside, 102
 exclusion of, 83
 preponderance of the, 81
 Examination
 by buyer or lessee, 250
 requests for, 34
 in trial, 35
 Examination (medical), for life insurance,
 456
 Exceptions
 in bankruptcy, 442–444, 448
 to employment-at-will doctrine,
 333–334
 fair use, 72
 to general priority rules, 419
 “main purpose” rule as, 166
 to minor’s right to disaffirm, 131–132
 to parol evidence rule, 169–171
 to perfect tender rule, 233–235
 to preexisting duty rule, 122
 to privity of contract rule, 177
 to writing requirements of Statute of
 Frauds, 211
 Exchange, bargained-for, 120
 Exclusionary practices, under Clayton
 Act, 544
 Exclusionary rule, 83
 Exclusions
 from COBRA, 339
 from Copyright Act, 72
 Exclusive agency, 322
 Exclusive-dealing contract, 544
 Exclusive jurisdiction, 31
 Exclusive possession, of property, 492
 Exculpatory clauses, 144, 480
 Executed contract, 101
 Execution
 fraud in, 294
 writ of, 422
 Executive agencies, 526
 Executive branch
 checks and balances for, 44
 control over agencies by, 530
 Executive committee, of board of
 directors, 395
 Executive(s). *See* Officers, corporate
 Executor, 512
 Executory contract, 101, 144
 Exemption(s). *See also* Exceptions
 from antitrust laws, 545
 to Freedom of Information Act, 532
 property, in Chapter 7 bankruptcy, 444
 from securities registration
 requirements, 383
 Existing goods, 217
 Exploration and exploitation of outer
 space, laws governing, 557
 Export(s)
 controls of, 556
 defined, 553
 direct vs. indirect, 553
 of space technology, 558
 Export Administration Act, 556
 Export Trading Company Act, 556
 Express authority, of agent, 323
 Express (or implied) bailment agreement,
 479
 Express contracts, 99–100
 employment, 334
 fixed-term tenancy and, 501
 Expression(s)
 of ideas, copyright exclusions and, 72
 of opinion, 107–108
 protected, 71–72
 Express powers, corporate, 381
 Express ratification, 132

Express trusts, 517–518
 Express warranty, 246–247, 249
 Expropriation, of private property, 552, 555
 Extraterritorial application, of antitrust laws, 546
 Extreme duress, as defense, 295

F

Facebook, forum-selection clause of, 113
 Face of the instrument, 275, 280
 Fact(s)
 affirmation or promise of, 246
 causation in, 61
 justifiable ignorance of, 144
 justifiable reliance on misrepresentation of, 155
 material, 151, 252
 mistakes of, 87, 151–152
 objective, 97
 statement of, 247
 in pleadings, 32
 FACT Act. *See* Fair and Accurate Credit Transactions Act
 Failure of a condition, discharge by, 189–190
 Failure of consideration, as defense, 295
 Fair and Accurate Credit Transactions (FACT) Act, 265–266
 Fair Credit Reporting Act (FCRA), 265
 consumer requests under, 265
 Fair Debt Collection Practices Act (FDCPA), 266
 validation notice under, 266
 Fair Labor Standards Act (FLSA), 336
 Fair Packaging and Labeling Act, 262
 “Fair use” doctrine, 72, 74
 Fair value
 antidumping and, 556
 appraisal right and, 405–406
 False advertising. *See* Deceptive advertising
 False imprisonment, 56–57
 Family and Medical Leave Act (FMLA), 1993, 335
 Family relationships, agency by operation of law and, 320–321
 Fanciful trademarks, 68
 Farmers, involuntary bankruptcy and, 442
 F.A.S., defined, 221
 Fault. *See* Comparative negligence (fault); Strict liability
 FCC. *See* Federal Communications Commission
 FCPA. *See* Foreign Corrupt Practices Act
 FCRA. *See* Fair Credit Reporting Act
 FDCA. *See* Federal Food, Drug, and Cosmetic Act
 Federal agencies. *See* Agencies (government); specific agencies
 Federal Aviation Administration (FAA), commercial spaceflight regulation by, 558
 Federal Communications Commission (FCC, 1934), 527

Federal court system, 27. *See also* Court(s); Supreme Court
 appellate courts of, 30
 bankruptcy proceedings in, 442
 boundaries of appellate and district courts, 30
 district courts in, 29–30
 jurisdiction of, 30, 31
 Federal crimes. *See also* Crime under RICO, 86
 Federal Food, Drug, and Cosmetic Act (FDCA), 267
 Federal government
 courts of (*See* Federal court system)
 employees of, 337, 347, 352
 powers of, 43–45
 concurrent with states, 45
 substantial-interest requirement and, 47
 Federal Insurance Contributions Act (FICA), 338
 Federal law. *See also* specific laws
 consumer protection, 259–268
 on garnishment, 422
 labor, 340–341
 Federal question, 31
 Federal Register, rulemaking notice in, 527
 Federal regulations. *See* Regulation(s)
 Federal Reserve System (the Fed), check clearing by, 307, 308
 Federal statutes. *See* Statute(s); specific statutes
 Federal Trade Commission (FTC), 527
 actions against deceptive advertising, 261
 antitrust law enforcement by, 545
 deceptive advertising and, 259
 FDCPA enforcement under, 266
 “Guides against Bait Advertising” of, 260
 Mail or Telephone Order Merchandise Rule, 262
 Federal Trade Commission Act (1914), 545, 546
 Federal Trade Commission (FTC) Rule 433, 296
 Federal Unemployment Tax Act (FUTA, 1935), 338
 Feedback quality control, 254
 Fee simple absolute, 491
 Fee simple, ownership in, 467, 491
 Felonies, 82
 cyber crime as, 89
 Fictitious business names (FBNs), 371
 Fictitious payee, 293
 Fiduciary duty, 366–367
 breach of, 387
 of corporate officers and directors, 396–398
 in takeover attempts, 407
 of majority shareholders, 387
 of partners, 366
 Fifth Amendment, 49, 50
 criminal protections in, 83
 on double jeopardy, 83
 on due process, 49, 83
 on self-incrimination, 87
 takings clause of, 495

File-sharing technology, DMCA and, 74
 Filing
 of articles of incorporation, 378
 of bankruptcy petitions, 442, 446, 447
 of financing statement, 418
 perfection of security interest by, 418
 of reorganization plan (bankruptcy), 446
 Final order, ALJ’s decision as, 530
 Final rule, in agency rulemaking, 528
 Finance, corporate financing and, 381–382
 Financing statement, 417
 collateral description on, 521
 debtor’s name on, 418
 perfection by filing, 418
 Fingerprint access, 310
 Fire insurance, 454
 Firm offer, merchant’s, 207
 First Amendment, 49. *See also* Freedom(s)
 commercial speech and, 46–48
 corporate political speech and, 47
 establishment clause and, 48
 on freedom of religion, 48–49
 on freedom of speech, 46–48
 free exercise clause and, 48–49
 obscene speech and, 48
 symbolic speech and, 46
 unprotected speech and, 48
 First-in-time rule, 419
 First sale doctrine, 73
 Fitness for a particular purpose, implied warranty of, 248–249
 Fixed amount, of money in negotiable instruments, 279
 Fixed-rate mortgage, 431
 Fixed-term tenancy, 506
 Fixture (personal property), 164, 490
 Floating lien, 418–419
 in financing of inventories, 419
 FLSA. *See* Fair Labor Standards Act
 FMLA. *See* Family and Medical Leave Act
 F.O.B., defined, 221
 Food
 FDCA and, 267
 product labels for, 262
 Forbearance, 119, 434–435
 For cause, corporate director’s removal and, 385, 393
 Force majeure clause, 555
 “For deposit only” indorsement, 283
 Foreclosure, 434
 avoiding, 434–435
 procedure in, 435–436
 redemption rights and, 436
 Foreign agent, 553
 Foreign commerce, Sherman Act and, 539
 Foreign companies. *See also* International business
 employment practices of suppliers, 21
 Foreign (out-of-state) corporation, 380, 404
 Foreign Corrupt Practices Act (FCPA, 1977), 21–22, 86
 Foreign governments
 act of state doctrine and, 552
 sovereign immunity and, 552–553
 U.S. antitrust laws and, 546

Foreign investment. *See* International business

Foreign officials, bribery of, 21–22, 86

Foreign Sovereign Immunities Act (FSIA, 1976), 552–553

Foreign state, FSIA on, 553

Foreign workers, authorization for hiring, 340

Foreseeability, proximate cause and, 62

Forgery, 84
on check, 305
as defense against liability on negotiable instrument, 294
failing to detect, 306
on negotiable instrument, 292, 293

Formal complaints, by administrative agencies, 529

Formal contracts, 100

Formation. *See also* specific types of organizations
agency, 319–321
partnership, 364

Form(s), of contract, 98, 163

Forum-selection clause, 554

Fourteenth Amendment
on due process, 46, 49
equal protection clause of, 49–50

Fourth Amendment, 50
criminal protections in, 83
drug testing and, 337
on search and seizure, 83, 529

Franchise(s)
defined, 554
in foreign countries, 554

Franchisee, franchisor, 554

Fraud. *See also* Statute of Frauds
bankruptcy discharge and, 445, 446, 448
cyber, 87–88
defined, 57–58
in the execution, 294
in inducement (ordinary fraud), 295
as insurance company defense, 458
Internet, 263
invalidation of will by, 512
mail, 85
securities, 86, 384
voidable contracts and, 101
wire, 85

Fraud alert system, identity theft and, 265

Fraudulent misrepresentation. *See also* Fraud; Misrepresentation

Fraudulent misrepresentation (fraud), 251–252
elements of, 153–156

Freedom(s). *See also* Bill of Rights; Right(s)
of religion, 48–49
of speech (*See* Free speech)

Freedom Act. *See* USA Freedom Act

Freedom of contract doctrine, 120

Freedom of Information Act (FOIA, 1966), 50, 532

Free exercise clause, 48–49

Free speech, 46–48
commercial speech, 47
corporate political speech, 47

defamation and, 57
restrictions on, 46–47
symbolic speech, 46
unprotected speech and, 48

Free trade agreements, 556

Free will, undue influence and, 156

Friendly foreclosure, 435

Fruit of the poisonous tree, 83

FTC. *See* Federal Trade Commission

Full disclosure, by director or officer, 397–398

Fundamental rights, 49

Funds
electronic transfer of, 309–310
insufficient, 303

Fungible goods, 218, 469
bailment of, 479

Future advances, against lines of credit, 418

Future goods, 218

G

Gambling, contract contrary to statute and, 140

Garnishee, 422

Garnishment, 422

Gays. *See* Sexual orientation

Gender, employment discrimination based on, 349–350, 354

General devise, 512

General jurisdiction
of federal courts, 29
state courts of, 28

General partner, in LP, 369

General partnership, 363–370. *See also* Partnership
limited partnerships compared with, 369

General power of attorney, 323

Geographic market, relevant, 542

Gift
of personal property, 468
by will, 512

Global business ethics, 21–22

Global context, U.S. laws in, antitrust laws, 546

Globalization. *See* Global business ethics; International business

Good faith
in bankruptcy, 448
compliance with law and, 8
insurance industry and, 459
in labor bargaining, 342
purchaser, 220
in substantial performance, 190
taking in, 288
in UCC, 231

Goods. *See also* Contract(s); Delivery; Product; Product liability; Sales contracts
associated with real estate, 205
buyer's nonacceptance of, 237
conforming, 208, 231, 246
consumer, 420
contracts for sale of (*See* Sales contracts)
counterfeit, 69
defective, 233, 249, 251
defined, 205
delivery with movement of, 221–222
delivery without movement of, 219, 221–223
existing, 217
fungible, 218, 469
future, 218
held by bailee, 223
held by seller or lessor, 223
identification of, 217–218
identified, 225
leases of, 204–206, 217
merchtable, 248
nonconforming, 208, 225, 233
nonmerchtable, 248
part of larger mass, 218
rare or unique, 197
readily available, 197
refusal to examine, 250
right
to obtain upon insolvency, 237
to reclaim, 237
to reject, 234, 238–239
to resell or dispose of, 237
to withhold delivery of, 237
sale of, 204–206, 224, 275
services combined with, 205
specially manufactured, 211
substitute, 239

Good title (title warranty), 245

Government. *See also* specific types
branches of U.S., 45
eminent domain power of, 495
federal form of (*See* Federal government)
judiciary's role in (*See* Court(s))
national (*See* Federal government)
regulation by (*See* Regulation(s))
state (*See* State(s))

Government in the Sunshine Act, 532

Government regulation. *See* Regulation(s)
antitrust (*See* Antitrust law)
by states (*See* State(s))

Gramm-Leach-Bliley Act, 51

Grandchildren, intestacy laws and, 516–517

Grantee, of real property, 494

Grantor
of real property, 494
of trust, 517

Gray areas, in law, 17

Group boycott, 540

Group health plans, employer-sponsored, 338–339

Group insurance, 454

Guarantor
actions releasing, 424
defenses of, 424
defined, 423
rights of, 424–425

Guaranty, 423–424
parties to, 423

Guardian, of mentally incompetent person, contracts and, 133

Guidelines (UN), to reduce space debris, 557

“Guides against Bait Advertising” (FTC), 260

H

Habitability, implied warranty of, 504
 Hackers/hacking, 89
 cyberterrorism and, 89
 protection against, 90
 Half-truths, in advertising, 259
 Handwritten (holographic) will, 513
 Harassment
 online, 351
 sexual, 350–351, 355
 Harm. *See also* Injury
 negligence and, 60
 strict product liability and, 251, 252
 “Harmful contamination,” avoidance in
 space exploration, 557
 Hazardous products, protection against,
 267
 Health
 of employees, 334–335
 and safety protections (consumer), 267
 Health insurance
 cancellation of, 457–458
 COBRA and, 339
 employer-sponsored, 338
 Medicare, 338
 Health Insurance Portability and
 Accountability Act (HIPAA, 1996),
 50, 338–339
 Hearing, administrative agency, 529–530
 Heirs, collateral and lineal, 516
 Hiring
 discrimination in, 355 (*See also*
 Employment discrimination)
 procedures, social media, ethics, and, 20
 Holder
 ordinary, 287, 288
 UCC definition of, 281
 Holder in due course (HDC), 281, 287
 defined, 281
 good faith and, 288
 requirements for status of, 287–289
 unauthorized signatures and, 292
 Holding company, 404
 Holographic will, 513
 Homeowners’ insurance, 433, 454
 Homosexuals. *See* Sexual orientation
 Hostile work environment harassment,
 351
 Hotel operators, liability of, 483
 Hours, laws on work, 336
 Human resources management (HRM),
 355
 Hyperlinks, for long disclosure, 261

I

Idea, copyrighting of, 72
 Identification
 of cyber criminals, 89
 of goods in contract, 217–218
 Identified goods, 225, 235
 Identity theft, 51
 as cyber theft, 88
 FACT Act and, 265
 I-9 employment verifications, 340
 Illegal actions, as insurance company
 defense, 458–459

Illegal agreement, withdrawal from, 145
 Illegal immigrants. *See* Undocumented
 immigrants
 Illegality
 of contracts, 139–145
 as defense to liability on negotiable
 instrument, 295
 of performance, discharge by, 193
 termination of offer by, 110
 Illusory promises, 122–123
 Immigration Act (1990), 340
 Immigration, documentation for, 340
 Immigration law, 339–340
 Immigration Reform and Control Act
 (IRCA), 340
 Immunity
 self-incrimination privilege and, 87
 state, 352
 Impairment, of collateral, 424
 Impersonated payee, 293
 Implied authority, of agent, 323
 Implied (or express) bailment agreement,
 479
 Implied contracts, 99–100
 employment, 334
 Implied powers, corporate, 381
 Implied ratification, 132
 Implied trusts, 518–519
 Implied warranty, 248–249
 from course of
 dealing, 249
 performance, 249
 disclaimer of, 249–250
 of fitness for a particular purpose,
 248–249
 of habitability, 504, 508
 of merchantability, 248
 usage of trade, 249
 Important government objectives,
 intermediate scrutiny and, 50
 Import(s), controls of, 556
 Impossibility of performance
 discharge by operation of law, 193
 one-year rule and, 164–165
 temporary, 194
 termination of agency relationship by,
 327
 Imposter, 293
 Impracticability, commercial, 194, 234
 Imprisonment, false, 56
 Improper filing, 418
 Improper incorporation, 379
 Inadequate warning, 252
 Incapacitation. *See also* Mental
 incompetence
 impossibility of performance by, 193
 Incentives, for exports, 556
 Incidental beneficiary, 183–184
 Incidental damages, 237
 Income. *See also* Wages
 security for employees, 337–339
 Incompetence. *See* Insanity; Mental
 incompetence
 Incomplete contracts, 170
 Incontestability clause, 456, 459
 Incorporation
 articles of, 378, 393

improper, 379
 procedures of, 377–378
 state of, 377
 Indemnification
 of agent, 322
 director’s right to, 396
 principal’s duty of, 322
 Independent contractor, 319
 vs. employee status, 327
 insurance broker as, 453, 455
 liability for torts of, 327
 Independent entity, partnership as, 363
 Independent regulatory agencies, 527
 Indirect exporting, 553
 Individuals, Chapter 13 bankruptcy and,
 442, 447–448
 Indorsee, 282
 Indorsement. *See also* Signature
 of checks, 282
 defined, 281
 of fictitious payee, 293
 forged, 292, 293, 305–306
 types of, 282–283
 unauthorized, 292–293
 Indorser, 282
 liability of, 291
 Inducement, fraud in (ordinary fraud),
 295
 Infants. *See* Children; Minor
 Influence, undue, 156–157
 Informal contracts, 100
 Information. *See also* Digital information;
 Freedom of Information Act
 pretexting and, 51
 Infringement
 copyright, 72–73
 no infringements warranty of title,
 246
 patent, 71
 trademark, 67, 69, 70
 Inheritance, property transfer by, 494
 Initial order, of ALJ, 530
 Injunction
 defined, 5
 restrictions on, 340
 Injury. *See also* Harm
 accidental, on job, 334
 caused by space objects, liability for,
 557
 damages and, 156
 to innocent party, 156
 non-compensable, 335
 as requirement for negligence, 61
 strict product liability and, 251, 252
 Innocent party
 injury to, 156
 justifiable reliance on misrepresentation,
 155
 voluntary consent, fraudulent
 misrepresentation and, 153–156
In personam (personal) jurisdiction, 28
In rem (property) jurisdiction, 28
 Insanity. *See also* Mental incompetence
 as defense to criminal liability, 87
 termination of agency relationship by,
 327
 Insider trading, 384

- Insolvency
 - of buyer or lessee, 237
 - of seller or lessor, 220
 - Insolvent, defined, 441
 - Inspection
 - by buyer or lessee, 235–236, 250
 - corporate director's right of, 395
 - on-site, by administrative agency, 528
 - partner's right of, 365
 - shareholder's right of, 386
 - Installment contract, 234
 - Installment(s), delivery of goods in, 234
 - Installment note, 277
 - Instrumentality, FSIA on, 553
 - Instrument. *See* Negotiable instrument(s); specific types
 - Insufficient funds, 303
 - Insurable interest, 225–226, 455
 - lack of, as insurance company defense, 458
 - Insurance
 - automobile, 454
 - classifications of, 454
 - cyber security and, 90, 459
 - defenses against payment of, 458–459
 - defined, 453
 - disability, 454
 - effective date of, 455–456
 - fire, 454
 - for foreign investments, 551
 - group, 454
 - health (*See* Health insurance)
 - homeowners', 433, 454
 - key-person, 454, 458
 - liability, 454
 - life (*See* Life insurance)
 - mortgage, 432
 - network intrusion, 459
 - policy and (*See* Insurance contract)
 - state regulation of, 145
 - terminology for, 453–454
 - unemployment, 338
 - for Web-related risks, 459
 - workers' compensation, 334–335
 - Insurance company
 - agents of, 453–454
 - risk management by, 454
 - Insurance contract (policy), 453–454
 - application for, 455
 - cancellation of, 457–458
 - cyberinsurance policies, 459
 - defenses against payment on, 458–459
 - effective date of, 455–456
 - delayed, 456
 - interpretation of, 456
 - provisions and clauses of, 456–457
 - Insured
 - defined, 453
 - duties of, 457
 - illegal actions as defense against payment, 458–459
 - Insurer
 - defined, 453
 - duties of, 457
 - Intangible personal property, 466
 - bailment of, 478
 - Intangible property, 205
 - Integrated contracts, 171
 - Intellectual property
 - copyrights (*See* Copyright)
 - defined, 67
 - international protection for, 75
 - licensing of, 71
 - patents, 70–71
 - service marks and, 69, 76
 - trademarks and related property, 67–70, 76
 - trade secrets, 74
 - Intended beneficiaries, 182–183
 - identifying, 183
 - types of, 182
 - vesting of rights of, 182–183
 - Intent, intention
 - in criminal law, 82
 - deceit, 57
 - to deceive, 155
 - donative, 468
 - of effective offer, 107–108
 - by minor to disaffirm, 130
 - monopolization and, 543
 - testamentary, 512–513
 - in tort law (*See* Intentional torts)
 - Intentional discrimination, 348, 352
 - Intentional torts
 - against persons, 55–58
 - assault and battery as, 56
 - defamation as, 57
 - false imprisonment as, 56–57
 - wrongful interference as, 58
 - against property, 58–60
 - conversion as, 59
 - trespass to land as, 58
 - trespass to personal property as, 59
 - Interest(s)
 - agency coupled with, 326
 - insurable, 225–226, 455
 - in partnership, 366
 - in real property, 492
 - nonpossessory, 492–493
 - security (*See* Security interest(s))
 - substantial government, 47
 - Interest rates
 - ARMs and, 431
 - usury and, 139
 - Interference, wrongful. *See* Wrongful interference
 - Intermediary bank, 306
 - Intermediate scrutiny, 50
 - Internal Revenue Code, Subchapter S of, 380
 - Internal Revenue Service (IRS),
 - determining if worker is employee or independent contractor, 328
 - International agreements, for intellectual property rights, 75
 - International business. *See also* Global entries
 - exporting, 553
 - franchising and, 554
 - intellectual property protection and, 75
 - international law and, 551–556
 - jurisdiction over, 553, 555
 - manufacturing abroad, 553–554
 - regulation of, 555–556
 - International contracts
 - letter of credit in, 100
 - provisions in
 - arbitration clauses, 555
 - choice-of-language clause, 554
 - choice-of-law clause, 555
 - force majeure* clause, 555
 - forum-selection clause, 554
 - sales, 100
 - International law, 551–556
 - defined, 7–8, 551
 - for outer space activities, 557
 - principles and doctrines of, 551–553
 - International treaties. *See* Treaties
 - Internet. *See also* Cyber entries; Digital entries; Internet service provider; Online entries
 - cyber crime and, 87–89
 - domain name on, 69
 - ethical issues and, 17, 20
 - fraud, 85, 263
 - ODR on, 37
 - Internet Corporation for Assigned Names and Numbers (ICANN), 69–70
 - Internet marketing, FTC guidelines for, 261
 - Internet service provider (ISP), liability of, 74
 - Interpretation, of contracts, 102, 152
 - Interrogatory, 34
 - Interstate commerce, 6, 44, 45
 - ADEA and, 352
 - Intestacy laws, 516–517
 - Intestate, defined, 516
 - Intoxication, 133
 - Invasion of privacy. *See* Privacy entries
 - Inventions. *See* Patent(s)
 - Inventory, floating lien in, 419
 - Investigation
 - by administrative agencies, 528–529
 - of cyber crime, 89
 - Investment, protection in foreign countries, 555
 - Invitation, to submit bids, 108
 - Involuntary bailment, 478
 - Involuntary bankruptcy, 441–443
 - creditor's petitions for, 442
 - Involuntary dissolution, 409
 - IRCA. *See* Immigration Reform and Control Act
 - Irresistible-impulse test, 87
 - Irrevocable living trusts, 518
 - Irrevocable offers, 99, 109, 110
 - ISP. *See* Internet service provider
 - Issue, defined, 274
 - Issuing corporation, 382
- ## J
- Joint and several liability, of partners, 367
 - Joint checking account, 304
 - Joint property ownership, in partnership, 363
 - Joint tenancy, 467
 - Judgment
 - appeal of, 35–36
 - default, 33

- deficiency, 420, 436
 - motion for
 - as matter of law, 35
 - summary, 33, 35
 - Judicial branch. *See also* Court(s); Supreme Court (U.S.)
 - checks and balances for, 44
 - controls over agency powers by, 530–531
 - Judicial decree, dissolution of partnership by, 368–369
 - Judicial foreclosure, 435
 - Judicial lien, 421–422
 - Judicial remedy, of secured party, 420
 - Judicial review, of administrative agency decisions, 530–531
 - Judiciary. *See* Court(s)
 - Jumpstart Our Business Startups Act (JOBS Act), 383–384
 - Jurisdiction
 - appellate, 29
 - concurrent, 31
 - in cyberspace, 28, 89
 - defined, 4, 27
 - exclusive, 31
 - of federal courts, 30, 31
 - general, 28, 29
 - international issues and, 553, 555, 557
 - limited, 28, 30
 - original, 30
 - over space objects and their personnel, 557
 - in personam* (personal) jurisdiction, 28
 - in rem* (property) jurisdiction, 28
 - of state courts, 28, 31
 - subject-matter, 29
 - Jury
 - in criminal law vs. civil law, 82
 - right to trial by, 83
 - Justice Department (DOJ), antitrust law enforcement by, 545
 - Justices (judges). *See* Judges
 - Justifiable ignorance of facts, contract legality and, 144
 - Justifiable reliance, on misrepresentation, 155
- K**
- Key-person insurance, 454, 458
 - Kickbacks, 86
 - KORUS FTA. *See* Republic of Korea–United States Free Trade Agreement
- L**
- Labeling and packaging laws, 262
 - Labor. *See also* Employee(s); Labor unions
 - child, 336
 - liens to recover payment for, 421–422
 - Labor law, federal, 340–341
 - Labor-Management Relations Act (LMRA, 1947), 341
 - Labor-Management Reporting and Disclosure Act (LMRDA), 341
 - Labor Management Services Administration (U.S. Department of Labor), 338
 - Labor unions
 - elections and, 341
 - labor laws and, 340–342
 - organization of, 341
 - strikes and, 342
 - Lack of consideration
 - in agreements, 121–123
 - as defense, 295
 - Lack of insurable interest, as defense, 458
 - Land. *See also* Real property
 - contracts involving interests in, 164
 - defined, 489
 - oral contracts for transfer of interests in, 167
 - trespass to, 58
 - Landlord
 - consent for assignment of lease, 505
 - as owner or lessor, 501
 - rights and duties of, 503–505
 - Landlord–tenant relationship, 502
 - Landowner, duty of, 60
 - Land sale contract
 - Statute of Frauds and, 164
 - writing requirement and, 168
 - Language, in e-mails, 172
 - Lanham Act (1946), 67
 - on false advertising claims, 261
 - Lapse of time
 - termination of agency by, 326
 - termination of offer by, 110
 - Larceny, 84
 - Latent defects, 250
 - Law(s). *See also* Statute(s); specific laws and types of law
 - administrative (*See* Administrative law; Regulation(s))
 - anticybersquatting, 70
 - antitrust (*See* Antitrust law)
 - business activities and, 2–3
 - business ethics and, 16–17
 - case (*See* Case law)
 - choice-of-, 555
 - civil (*See* Civil law)
 - common (*See* Common law)
 - Constitutional (*See* Constitutional law)
 - consumer protection, 259–268
 - contract (*See* Contract law)
 - contract unenforceable by, 101
 - on corporate political speech, 47
 - courts of equity and courts of, 5
 - for creditors, 420–425
 - criminal (*See* Criminal law)
 - decision making and, 2, 3, 17
 - defined, 2
 - on discrimination, 50
 - due process of (*See* Due process clause)
 - ethics and, 16–17
 - federal privacy, 50
 - on garnishment, 422
 - gray areas of, 17
 - immigration, 339–340
 - international (*See* International law)
 - intestacy, 516–517
 - labeling and packaging, 262
 - labor, 340–342
 - misrepresentation of, 154
 - mistakes of, 87
 - operation of (*See* Operation of law)
 - partnership (*See* Partnership)
 - pretexting and, 51
 - public accountability, for agencies, 532–533
 - regulating business (*See* Regulation(s))
 - small business and, 3, 4
 - sources of American, 3–7, 27
 - space, 556–558
 - statutory, 6–7
 - tort (*See* Tort law)
 - uniform, 6
 - Law courts. *See* Court(s)
 - Lawsuit, 55. *See also* Alternative dispute resolution; Case(s); Litigation
 - for breach of contract, 198
 - civil (tort), and criminal prosecution for same act, 56
 - defined, 3
 - gender discrimination, 350
 - procedural rules and standards for, 32–36
 - shareholder's derivative, 387, 398
 - stages in, 36
 - standing to sue and, 32
 - takeover attempts and shareholders', 407
 - Lawyer. *See* Attorney
 - Leadership. *See* Ethical leadership; Management; Officers, corporate
 - Lease(s)
 - assignment of, 505
 - consumer, 264
 - as express written contract, 99
 - by nonowners, 219–220
 - right to recover payments due, 237
 - sublease, 505–506
 - termination of, 506
 - types of tenancy created by, 501–502
 - UCC and, 206
 - Lease agreement, 206, 501
 - oral or written, 502
 - terms of, 502
 - Lease contracts, 237
 - breach of contract (*See* Breach of contract; Damages)
 - remedies in, 237–239
 - UCC and, 206
 - warranties in, 245–249
 - Leased property. *See also* Landlord–tenant relationship
 - possession of, 503
 - rent for, 504–505
 - transfer of rights to, 505–506
 - use and maintenance of, 503–504
 - Leave, family and medical, 335
 - Legacy, defined, 512
 - Legal claims. *See* Claim(s)
 - Legal counsel. *See* Attorney
 - Legality, of contract, 97, 139–145
 - Legally binding arbitration, 37
 - Legally sufficient value, 119–120
 - Legal persons, 46
 - Legal rate of interest, 279
 - Legatee, defined, 512
 - Legislation. *See also* Law(s)
 - enabling, 526, 530

Legislative branch
 checks and balances for, 44
 controls over agency powers by, 530
 Lender(s). *See* Creditor(s)
 Lending, predatory, 433
 Lesbians. *See* Sexual orientation
 Lessee, 206
 contract breached by, 225
 examination or refusal to inspect, 250
 insolvency and breach of, 237
 insurable interest of, 225–226
 obligations of, 235–237
 remedies of, 238–239
 right to recover damages for
 nonacceptance by, 237
 risk of loss and, 223
 Lessor, 206
 contract breached by, 225
 delivery of nonconforming goods by,
 233
 goods in possession of, 223
 insolvency of, 220
 insurable interest of, 226
 obligations of, 231–235
 remedies of, 237–238
 risk of loss and, 223
 Letters of credit, 100
 Liability. *See also* Crime; Limited liability;
 Negligence; Product liability; Strict
 liability
 of acceptor, 496–497
 of agent, 322, 324–325
 of bailee, 480, 482
 of banks, 304, 310
 in consolidation, 404
 of consumer credit reporting agencies,
 265
 corporate criminal, 381
 criminal, 82, 86–87
 for damage caused by space objects, 557
 defenses to
 criminal liability, 86–87
 universal and personal, 294–295
 defined, 57
 delegation and, 181
 of directors and officers, 290, 398
 discharge from, 296
 exculpatory clause and, 144
 force majeure clause and, 555
 for independent contractor's torts, 327
 of Internet service providers, 74
 of intoxicated person, 133
 joint and several, 367
 limitations, for common carrier, 483
 in LLC, 370
 in LLP, 370
 in LP, 369
 in merger, 403
 for negligence, 251
 of parents for contracts by minors, 132
 partnership, 364, 367
 primary, 290
 of surety, 423
 of principal, 324–325
 risk of, 226
 secondary, 291–292
 of guarantor, 423

 shareholder, 384
 signature, 290–293
 of sole proprietorship, 362
 strict (without fault), 62, 252–254
 successor, 406
 of tenant, 505
 for torts and crimes, 398
 of warehouse companies, 483
 warranty, 250, 293–296
 for wrongful payment, 304
 Liability Convention, 557
 Liability insurance, 454
 Libel, 57
 trade, 59
 Liberties. *See* Bill of Rights; Freedom(s);
 Right(s)
 License
 patent infringement and, 71
 in real property context, 493
 Licensee, 71
 Licensing
 of intellectual property, 71
 manufacturing abroad and, 554
 to protect patents, 71
 Licensing statutes, and illegality of
 contract, 140
 Lie-detector tests, 336–337
 Lien
 artisan's, 421
 defined, 245–246, 421
 to enforce bailee's right of
 compensation, 479
 floating, 418–419
 judicial, 421–422
 mechanic's, 421
 Life estate, 492
 Life insurance, 454–456
 cancellation of, 457–458
 Life tenant, 492
 Limitation(s)
 on bailee's liability, 480
 on garnishment, 422
 statute of, 193
 Limited jurisdiction
 courts of, 30
 state courts of, 28
 Limited liability
 of corporate shareholders, 384
 of Internet service providers, 74
 Limited liability company (LLC), 290
 advantages of, 370
 articles of organization of, 370
 defined, 370
 disadvantages of, 370
 formation of, 370
 liability of, 370
 management of, 370
 Limited liability partnership (LLP), 370
 formation of, 370
 liability in, 370
 Limited partner, in LP, 369
 Limited partnership (LP), 363
 formation of, 369
 liability and, 369
 Lineal heirs, 516
 Line of credit, continuing, for debtor,
 418

Liquidated damages, for breach of
 contract, 196
 Liquidation
 Chapter 7 bankruptcy and, 441, 443–446
 of corporate assets, 409
 Litigation. *See also* Lawsuit
 alternatives to, 36–37
 Living trust, 518
 LMRA. *See* Labor-Management Relations
 Act
 LMRDA. *See* Labor-Management
 Reporting and Disclosure Act
 Loan(s). *See also* Mortgage(s)
 Loan flipping, 433
 Local governments, police powers and, 44
 Long arm statute, 28
 Loss
 material, of goods, 233
 in partnership, 363, 365
 risk of, 221–225
 Lost property, 468, 470
 bailed, 482
 Loyalty. *See* Duty of loyalty

M

Magnuson-Moss Warranty Act (1975),
 250
 Mailbox rule, 112
 Mail fraud, 85
 Mail or Telephone Order Merchandise
 Rule (FTC), 262
 Main purpose rule, 166, 424
 Majority, age of, 129
 Majority shareholder. *See* Shareholders
 Maker
 defined, 276
 liability of, 291
 signature of, 278
 Malice
 actual, 57
 remedies under Title VII, 351
 Malware, 89
 Management
 corporate, 393–398
 of corporate reputation, 22
 ethics and, 14
 of LLC, 370
 quality control, 254
 of small business, 3, 4
 Management rights, in partnership, 363,
 365
 Mandatory registration, of space objects,
 557
 Manufacturing
 abroad, 553–554
 product defects and, 252
 Market(s)
 foreign, 553
 relevant, 542
 Market concentration, 545
 Market divisions, *as per se* violation, 540
 Marketing, pretexting and, 51
 Market-share test, 542
 Marriage
 promises made in consideration of, 166
 revocation of will by, 515

- Material breach, of contract, 191
 - Material fact
 - fraudulent misrepresentation of, 153–154, 252
 - mistakes and, 151
 - Material loss of goods, 233
 - Material modification, of contract, 424
 - Matter of law, motion for judgment as a, 35
 - Maturity date, of bond, 382
 - Means test, in bankruptcy, 443
 - Mechanic's lien, 421
 - Media. *See* Social media
 - Mediation, as type of ADR, 36
 - Medical information, disclosure of, 339
 - Medicare, 338
 - Meetings
 - to adopt corporate bylaws, 378
 - board of directors', 394
 - creditors' (bankruptcy), 443–444
 - shareholders', 385–386, 393
 - Member, of LLC, 370
 - Memorandum, written, 163, 168
 - Mental incapacity. *See* Mental incompetence
 - Mental incompetence. *See also* Insanity
 - of bank customer, 304
 - contracts and, 129, 133–134
 - as defense to liability on negotiable instrument, 295
 - Mental state, wrongful, 82
 - Merchant(s)
 - contracts
 - when one or both parties are merchants, 209
 - when one or both parties are nonmerchants, 208
 - defined, 206
 - entrustment rule and, 220
 - firm offer by, 207
 - no infringements warranty of title and, 246
 - risk of loss and, 223
 - written confirmation between, 210
 - Merchantability
 - disclaimer of, 250
 - of goods, 248
 - implied warranty of, 248
 - Merchant buyers, duties when goods are rejected, 238–239
 - Merger
 - antitrust law and, 545
 - consolidation vs., 403
 - defined, 403, 545
 - short-form, 405
 - Meta tags (key words), 70
 - Minimum-contacts test, 28
 - Minimum wage, 336
 - Ministerial actions, in foreign countries, 21
 - Minor. *See also* Children
 - contract by, 101, 129–135
 - emancipation of, 129, 132–133
 - ratification by, 129, 132
 - right to disaffirm, 129–131
 - Miranda rights, 84
 - Mirror image rule, 110, 208
 - Misdemeanors, 82
 - Mislaid property, 469
 - Misrepresentation
 - of age, disaffirmance and, 131
 - by conduct, 154
 - fraudulent, 153–156, 251–252
 - as insurance company defense, 458
 - justifiable reliance on, 155
 - of law, 154
 - securities fraud and, 384
 - by silence, 154–155
 - by words, 154
 - Mistakes
 - bilateral (mutual), 152
 - in contracts, 151–153
 - of fact, 87, 151–152
 - of law, 87
 - unilateral, 151–152
 - of value or quality, 153
 - Misuse, product, 253
 - Mitigation of damages, 197
 - Mobile banking, 310
 - Mode, of acceptance, 112
 - Modification(s)
 - of contract, 424
 - UCC on, 209
 - Molortron, Inc., 3
 - Money
 - fixed amount of, in negotiable instruments, 279
 - UCC definition of, 279
 - Monitoring
 - electronic, of employees, 337
 - practices of foreign suppliers, 21
 - Monopolization, 542
 - attempted, 542, 543
 - intent requirement for, 543
 - relevant product market and, 542
 - Monopoly power, 542
 - Monopoly, Sherman Act and, 542
 - Mooseback Outfitters, Inc., 15–16
 - Moral minimum, 16
 - Mortgage(s)
 - adjustable-rate, 431
 - contract provisions for, 432–433
 - defined, 431
 - fixed-rate, 431
 - foreclosures and, 434–436
 - protections
 - for borrowers, 433–434
 - for lenders, 432–433
 - recording, 432
 - refinancing, 433
 - Mortgagee, 431
 - Mortgage insurance, 432
 - Mortgage note, 277, 279
 - Mortgagor, 431
 - Motion
 - for a directed verdict (motion for judgment as a matter of law), 35
 - to dismiss, 33, 35
 - for new trial, 35
 - posttrial, 35
 - pretrial, 33–34
 - for summary judgment, 33, 35
 - Movies, pirated DVDs and, 74
 - Municipal courts, local, 29
 - Music files, sharing, 74
 - Mutual agreement, agency termination by, 326
 - Mutual assent. *See* Agreement(s), contractual
 - Mutual mistake, voidable contracts and, 101
 - Mutual rescission, discharge by, 192
- N**
- NAFTA. *See* North American Free Trade Agreement
 - Name
 - of debtor, 418
 - domain, 69–70
 - securing corporate, 378
 - trade, 69
 - National Conference of Commissioners on Uniform State Laws (NCCUSL), 6
 - National government. *See* Federal government
 - National Labor Relations Act (NLRA), 340
 - National Labor Relations Board (NLRB, 1935), 340
 - National law, 7
 - in global context, 7
 - National origin, discrimination based on, 349
 - Natural persons, 264
 - NCCUSL. *See* National Conference of Commissioners on Uniform State Laws
 - Necessaries, disaffirmance and, 131
 - Necessity, business, as defense to employment discrimination, 354
 - Negligence
 - of bank, 305
 - of bank customer, 305
 - causation and, 61–62
 - comparative, 62, 254
 - defenses to, 62
 - duty of care and, 60–61
 - forgery and, 292
 - injury requirement and, 61
 - product liability based on, 251
 - tort of, 60–62
 - Negotiable document of title, 223
 - Negotiable instrument(s). *See also* Signature; specific types
 - defenses barring collection of, 294
 - defined, 100, 274
 - dishonored, 289, 291–292
 - fixed amount of, 279
 - as formal contract, 100
 - HDC status and, 287–289
 - indorsements of, 282–283, 292–293
 - liability on, 290–296
 - payable
 - on demand or at definite time, 279–280
 - in money, 279
 - to order or bearer, 280–281
 - requirements for negotiability, 278–281
 - signatures on, 278, 292–293
 - transfer of, 281–283

- Negotiable instrument(s) (*continued*)
 types of, 274–277
 unconditional terms of, 278–279
 written form of, 278
- Negotiated settlement, with administrative agency, 529
- Negotiation
 collective bargaining and, 341
 preliminary, 108
 transfer of negotiable instrument by, 281
 as type of ADR, 36
- Neobanks, 311
- Network intrusion insurance, 459
- Ninth Amendment, 50
- No infringements warranty of title, 246
- No liens warranty title, 245–246
- Nonacceptance, right to recover damages for buyer's, 237
- Nonbinding arbitration, 37
- Noncarrier cases, place of delivery and, 232
- Non-compensable injury, 335
- Noncompete agreement, 122
- Noncompete covenants. *See* Covenant, not to compete
- Nonconforming goods, 208, 225, 233–234
 delivery by seller or lessor, 233, 234
- Nonmerchants, as parties to contract, 208
- Nonnegotiable document of title, 223
- Nonnegotiable instrument, 278
- Nonowners, sales or leases by, 219–220
- Nonperformance, *force majeure* clause and, 555
- Nonpossessory interests, 492–493
- Nonprofit corporation, 380, 383
- Normal-trade-relations (NTR) status, 552
- Norris-LaGuardia Act, 340
- Note(s). *See* Promissory note
- Notice. *See also* Notification
 of acceptance, 208
 of assignment, 179–180
 to debtor, in retention and disposition, 420
 of default, 436
 dishonored instrument and proper, 291–292
 HDC status and taking without, 289
 of proposed rulemaking, 527
 of sale, 436
 validation, under FDCPA, 266
- Notice-and-comment rulemaking, 527–528
- Notification. *See also* Communication; Notice
 by agent of principal, 321
- Novation, defined, 192
- Nutrition Labeling and Education Act, 262
- O**
- OASDI. *See* Social Security
- Obamacare, 339 *See also* Affordable Care Act (ACA, Obamacare, 2010)
- Obedience, agent's duty of, 322
- Objection, to discharge in bankruptcy, 445–446
- Objective impossibility of performance, 164, 193
- Objective theory of contracts, 97
- Obligations
 of buyer or lessee, 235–237
 minors', on disaffirmance, 130–131
 moral and legal of promises, 96
 payment by debtor, 424
 primary vs. secondary, 165–166
- Obligee, 178
 performance by third party varies materially from that expected by, 181
- Obligor, 178
 assignment changing risk or duties of, 179
- Obscene speech, 48
- Occupational Safety and Health Act, 335
- Occupational Safety and Health Administration (OSHA), 335
- ODR. *See* Online dispute resolution
- Offer
 acceptance of, 111–112, 208
 of bribe, 86
 communication of, 109
 for contract, 97
 counteroffers and, 110
 defined, 107
 definiteness of terms in, 108–109
 firm, 207
 intention and, 107–108
 irrevocable, 99, 109, 110
 by merchant, 207
 for mutual rescission, 192
 online, 112
 online acceptance of, 112–113
 open terms in, 207
 rejection of, 110
 requirements of, 107–109
 revocation of, 109
 self-tender, 407
 tender, 407
 termination of, 109–110
- Offeree, of contract, 98, 107, 111
- Offeror, of contract, 98, 107
- Office of the National Ombudsman (Small Business Administration), 529
- Officers, corporate, 377
 directors' functions delegated to, 395
 duties of, 396–398
 liability of, 290, 398
 overtime provisions and, 336
 removal of, 396
 role of, 318
 torts of, 381
 types of, 396
 violations of Securities Act and, 383
- Omission, act of, 82
- One-year rule, 164–165
- Online acceptances, 112–113
- Online arbitration, for domain name disputes and complaints, 70
- Online auctions, 108
- Online banking, 310
- Online business, advertising of, 68, 76
- Online contract. *See* e-contract
- Online deceptive advertising, 261
- Online dispute resolution (ODR), 37
- Online environment. *See also* Internet
 cyber crime in, 87–89
 trademark dilution in, 68
 trademark infringement in, 70
- Online issues
 acceptances, 112–113
 contracts (*See* e-contract)
 harassment, 351
- Online offers, 112
- Online payment systems, 309
- Online sales, 263
- “On-us” item, 307
- Open terms, UCC approach to, 207
- Operating agreement, for LLC, 370
- Operation of law
 agency by, 320–321
 termination of agency by, 327
 contract discharge by, 193–194
 dissolution of partnership by, 368
 termination by, 110
- Opinion
 expressions of, 107–108
 express warranties and, 247
 statement of, 154, 247
- Oppressive conduct, 387
- Option-to-cancel clauses, 122
- Oral contracts
 admissions for, 167–168
 agency agreement, 320
 for land sale, 167
 lease agreements, 502
 “main purpose” rule as exception, 166
 partial performance of, 167
 promissory estoppel and, 168
 Statute of Frauds and, 211
 writing requirement and, 167–168
- Orally agreed-on condition, 171
- Order(s). *See also* Check(s)
 of administrative agency, 530
 to pay (*See also* Check(s); Draft)
 unconditional, 278–279
 for relief, 442, 446
 stop-payment, 304
- Order instruments, 280, 281
- Order of distribution, intestacy laws and, 516
- Ordinances, 6
 landlord's compliance with, 504
- Ordinary bailments, 479
- Ordinary duress, as defense, 295
- Ordinary fraud, 295
- Organized crime, 86
- Original jurisdiction, 30
- OSHA. *See* Occupational Safety and Health Administration
- Outcome-based ethics, utilitarianism as, 19
- Outer space. *See* Space entries
- Outer Space Treaty, 557, 558
- Out-of-state corporations, court jurisdiction over, 28
- Overdrafts, 303–304
- Overdue instruments, notice for, 289
- Overtime, 336
- Ownership. *See also* Landowner; Personal property; Property; Real property
 concurrent, 467
 in fee simple, 467, 491–492

- of personal property, 467–471
 - of real property, 467, 491–493
 - of sole proprietorship, 362
 - transfer of, 493–495, 511
 - Owners in common, 218
 - Owners, rights of, 491
- P**
- Parent corporation, 404, 405
 - Parents, liability for minors' contracts, 132
 - Paris Convention (1883), 75
 - Parol evidence rule, 169–171, 211–212
 - exceptions to rule, 169–171
 - and integrated contract, 171
 - Partially disclosed principal, 325
 - Partially integrated contract, 171
 - Partial performance, of oral contract, 167, 211
 - Participation, right to, 395
 - Parties. *See also* Third party
 - in draft, 275
 - termination of agency by, 326
 - Partner
 - agency powers of, 367
 - dissociation of, 367–368
 - duties of, 366
 - general, 369
 - liability of, 367
 - limited, 369
 - ownership interest of, 366
 - rights of, 365–366
 - Partnership. *See also* Limited liability
 - partnership; Limited partnership; specific forms
 - agreement, 364
 - articles of, 364
 - creditors of, 366
 - defined, 363
 - dissolution of, 368
 - duties of, 366
 - elements of, 363
 - by estoppel, 364
 - formation of, 364
 - general, 363–370
 - interest in, 366
 - liability of, 364, 367
 - limited, 369
 - limited liability, 370
 - property rights of, 363, 366
 - taxation of, 363
 - termination of, 368–369
 - winding up of, 367, 369
 - Partnership law, agency law and, 363
 - Pass-through entity, 364, 370
 - Past consideration, 122
 - Patent(s)
 - defined, 70
 - infringement of, 71
 - licensing of, 71
 - Patriot Act. *See* USA Patriot Act
 - Payability requirements, of negotiable instruments
 - at definite time, 279–280
 - on demand, 274, 279
 - in money, 279
 - to order or bearer, 280–281
 - Payee, 275, 301
 - fictitious, 293
 - impersonated, 293
 - Payment
 - by buyer or lessee, 235
 - of debt on partnership dissolution, 369
 - by debtor, 424, 447
 - defenses against payment of insurance policy, 458–459
 - down, 432
 - electronic systems for, 309
 - on mobile devices, 301, 310
 - online systems for, 310
 - Payments due, right to recover lease, 237
 - Payor bank, 306
 - Pay. *See* Wages
 - Peaceful possession, of collateral, 420
 - Peaceful purposes, of space objects, 557
 - Penalties
 - for copyright infringement, 72
 - defined, 196
 - for immigration law violations, 339
 - for Sarbanes-Oxley Act violations, 16
 - Pension plans. *See* Social Security
 - Per capita* distribution, 516–517
 - “50 percent” rule, 62
 - Perfected security interest, conflicting, 419
 - Perfection
 - of security interest, 417
 - security interest in proceeds and, 418
 - Perfect tender rule, 233
 - exceptions to, 233–235
 - Performance, 231
 - agent's duty of, 321
 - commercial impracticability and, 194, 234
 - complete, 190
 - compromise and, 198
 - contract, 99, 101
 - course of, 170, 212
 - defined, 189
 - discharge by, 190–193
 - exceptions to perfect tender rule and, 233–235
 - impossibility of, 193, 327
 - objective impossibility of, 164, 193
 - of oral contract, 167, 211
 - partial, 167, 211
 - possibility of, 165
 - right to obtain specific, 239
 - to satisfaction of another, 191–192
 - specific, 167, 197, 239
 - subjective impossibility of, 193
 - substantial, 190
 - temporary impossibility of, 194
 - tender of, 190
 - by third party, varies materially from that expected by obligee, 181
 - time for, 164–165
 - written assurance of, 235
 - Periodic tenancy, 502, 506
 - Permanence, of written form of negotiable instruments, 278
 - Per se* violations, of Sherman Act, 540, 546
 - Person(s)
 - corporation as, 46, 377
 - defined in bankruptcy, 443
 - intentional torts against, 55–58
 - Personal contracts, 191, 193
 - Personal (limited) defense, 295
 - Personal duties, cannot delegate, 180–181
 - Personal income tax, sole proprietorship and, 362
 - Personal jurisdiction. *See In personam* jurisdiction
 - Personal property
 - bailment of, 477–483
 - considered part of land, 489
 - conversion of, 470
 - defined, 466
 - expansion of concept of, 466
 - as fixture, 164
 - as gift of by will, 512
 - insurable interest in, 455
 - misplaced, lost, and abandoned, 469–471
 - ownership of, 467
 - acquiring, 467–469
 - trespass to, 59, 468, 471
 - Personal representative, probate of will and, 511, 512
 - Personal services
 - breach of contract for, 197
 - contract for, 179
 - Per stirpes* distribution, 516–517
 - Petition(s)
 - in bankruptcy, 442–444, 447
 - for emancipation, 133
 - Pharmaceuticals. *See* Drugs
 - Philosophy, ethical principles based on, 18
 - Phishing, 88
 - Physical act of maker, revocation of will by, 514–515
 - Physical delivery, 468, 478
 - Physical harm, 252
 - Piercing the corporate veil, 379, 380
 - Place of delivery, 232–233
 - Plain meaning rule, 102
 - Plaintiff
 - complaint of, 32
 - defined, 32
 - Plan
 - reorganization (Chapter 11 bankruptcy), 442, 446–447
 - repayment (Chapter 13 bankruptcy), 442, 447–448
 - Plant life, as real property, 490
 - Pleadings, 32–33
 - Point-of-sale systems, 309
 - Poisonous tree, arrest as, 83
 - Police powers, 44
 - Policy, 453–454. *See also* Insurance contract
 - Political speech, corporate, 47
 - Portability, of written form of negotiable instruments, 278
 - Possession
 - adverse, 494–495
 - bailee's right of, 479
 - and failure to return bailed property, 481
 - delivery of, 478

- Possession (*continued*)
 of goods, peaceful, 420
 landlord's duty to deliver, 503
 of personal property, 468
 of real property, 501
- Posting, of checks, 307
- Posttrial motions, 35
- Power(s)
 agency, 367
 controls on administrative agencies', 530–531
 corporate, 381
 federal, 43–45
 monopoly, 542
 regulatory, of states, 44
 of shareholders, 385
- Power of attorney, 319, 323
- Power of sale foreclosure, 435
- Precedent, 3, 7, 27
 departures from, 4–5
 doctrine of, 4
- Predatory lending, 433
- Predatory pricing, 541
- Predominant-factor test, 205
- Preemption, 45
- Preemptive rights, to shareholders, 386
- Preexisting conditions, under HIPAA, 338–339
- Preexisting duty rule, 121–122
- Preferred stock, 382
- Pregnancy Discrimination Act (1978), 349
- Pregnancy, employment discrimination
 based on, 349
- Preliminary negotiations, 108
- Prenuptial agreements, 166
- Prepayment penalty clause, 432–433
- Preponderance of the evidence, as
 standard of proof, 81
- Presentment
 defined, 291
 electronic check, 307
 proper and timely, 291
 warranties, 294
- Pretext, pretexting, 51
- Pretrial motions, 33–34
- Price discrimination, 544
- Price-fixing agreement, 540
- Price lists, as invitations to negotiate, 108
- Pricing, predatory, 537
- Prima facie*
 case, 348, 349
 under ADEA, 352
 defined, 348
- Primary liability, on negotiable
 instrument, 290
- Primary obligations, 165–166
- Principal. *See also* Agency relationships
 agency by estoppel and, 320
 agent's duties to, 321–322
 conduct of, and agent's apparent
 authority, 320
 contractual capacity of, 319
 defined, 318
 disclosed, 324
 duties to agent, 322
 liability of, 324–325
 undisclosed, 325
- Principal-agent relationships, 318–319
- Principle
 of comity, 551
 of rights, 19
- Prior dealing, contracts and, 170
- Priority
 general rules of, 419
 payments and order of (bankruptcy), 445
- Privacy. *See also* Privacy rights
 invasion of, 51
 monitoring of employees and, 337
 protection for employees, 336–337
 reasonable expectation of, 83, 529
- Privacy Act (1974), 50
- Privacy rights. *See also* Privacy
 of employees, 336–337
 federal statutes affecting, 50
- Private corporation, 380
- Private employers, drug testing by, 337
- Private entities, outer space laws and, 557
- Private party, enforcement of antitrust law
 violations by, 545
- Private property, foreign government
 expropriation of, 552
- Privity of contract, rule of, 177, 251
- Probable cause, 56–57, 83
- Probate courts, 29, 511
- Probate, of will, 511
- Procedural due process, 49
- Procedural law, 32
- Procedural unconscionability, 143
- Proceeds, 418
- Product(s). *See also* Goods; Trademark
 disparagement of, 59
 protection against hazardous, 267
 unreasonably dangerous, 252
- Production, acquisition of personal
 property by, 468
- Product liability, 245
 defenses to, 253–254
 defined, 251
 due care and, 251
 strict liability applied to, 252–254
 warnings and, 252
- Product market, relevant, 542
- Product misuse, 253
- Professional. *See also* Attorney
 duty of, 61
 overtime provisions and, 336
- Profit
 corporate, 381
 in LLC, 370
 in partnership, 363–365
 in real property context, 492
- Prohibitions
 on imports, 556
 of TILA, 434
- Promise. *See also* Covenant; Offer
 collateral, 165–166
 consideration and, 119, 122
 in consideration of marriage, 166
 defined, 96
 of fact, affirmation or, 246
 illusory, 122–123
 moral vs. legal obligations created by, 96
 to pay (*See* Certificate of deposit;
 Promissory note)
 to perform, in bilateral contract, 98
 to ship, 208
 unconditional, 278–279
- Promisee, 96
- Promisor, 96
- Promissory estoppel, 124
 oral contracts and, 168
- Promissory note, 274, 276–277, 279, 290
- Proof of claim (bankruptcy), 444
- Proper presentment, time for, 291
- Proper purpose, shareholder rights and, 386, 387
- Property
 abandoned, 468, 471
 after-acquired, 418
 community, 467
 crimes involving, 84–86
 damages to by space objects, liability
 for, 557
 death and transfer of (*See* Trust; Will)
 defined, 466
 disparagement of, 59–60
 distribution of (bankruptcy), 444–445
 estate in, 444
 expropriation of private, 552
 insurable interest in, 455
 intangible, 205
 intellectual (*See* Intellectual property)
 intentional torts against, 58–60
 liens on, 421–422
 lost, 468, 470, 482
 mislaid, 469
 ownership of, 467
 partnership, 363, 366
 personal (*See* Personal property)
 real (*See* Real property)
 tangible, 205
 transferring rights to leased, 505–506
 trespass to, 58, 59, 468, 471
- Property insurance, 455, 457
- Property jurisdiction. *See* *In rem* jurisdiction
- Property rights
 of partnership, 363, 365–366
 in space, 558
- Prosecution
 civil and criminal for same act, 56
 of cyber crime, 89
 immunity from, 87
- Prospectus, for securities, 383
- Protected class(es)
 defined, 347
 statutes for, 144, 347–354
- Protected expression, under Copyright
 Act, 71–72
- Protection
 by business judgment rule, 398
 commercially reasonable, 90
 consumer, 259–268
 copyright, 71
 credit, 263–266
 for creditors, 420–425
 of FMLA leave, 335
 against hacking, 90
 investment (international business), 555
 patent, 70

trademark, 67–69, 76
 worker, 334–337
 Provisional credit, 307
 Provisions
 of insurance contract, 456–457
 in international contracts, 554–555
 Proximate cause, 62, 252
 Proxy, defined, 385
 Public Company Accounting Oversight Board, 16
 Public corporation, 380
 Public employers, drug testing by, 337
 Public health. *See* Health
 Publicly held corporation, 384
 Public official, bribery of, 86
 Public policy
 contracts contrary to, 142–144
 exceptions to employment-at-will doctrine, 334
 exculpatory clauses violating, 144
 free exercise clause and, 48
 Public safety, as substantial government interest, 49
 “Public use,” eminent domain and, 495
 Public welfare exception, to free exercise clause, 48
 Puffery, 57, 247, 259
 Punishment, for crimes, 83
 Punitive damages, 156, 196
 Purchase
 of corporate assets, 406
 of personal property, 467
 Purchase price, right to recover, 237
 Purchaser, good faith, 220
 Purpose
 agency termination and achievement of, 326
 course of implied warranties from, 249
 implied warranty of fitness for, 248–249
 particular vs. ordinary, 248–249

Q

Qualified indorsement, 283
 Qualified right to exclusive possession, tenant's, 501
 Quality
 mistakes of, 153
 slander of, 59
 Quality control
 management of, 254
 types of, 254
 Quantity term, 207
 Quasi contracts, 100
Quid pro quo harassment, 351
 Quiet enjoyment covenant, 494, 503
 Quitclaim deed, 494
 Quorum
 of directors, 394
 of shareholders, 385
 Quotas, on imports, 556

R

Race, discrimination based on, 349, 354
 Racketeer Influenced and Corrupt Organizations Act (RICO, 1970), 86

Rate of interest
 legal, 279
 variable, 279
 Ratification
 agency by, 320, 324
 of agent's unauthorized act, principal's failure to, 324–325
 in contract law, 101, 134
 mental incompetence and, 134
 by minor, 129, 132
 of signature, 292
 Rational basis test, 50
 Real estate. *See also* Land; Mortgage(s); Real property
 gift of by will, 512
 goods associated with, 205
 lien on, 421
 Real property. *See also* Land; Mortgage loans
 airspace and subsurface rights as, 490
 defined, 466, 489
 fixtures as, 490
 insurable interest in, 455
 land as, 58, 164, 489
 leased (*See also* Leased property)
 commercial lease terms, 505
 possession of, 503
 rent for, 504–505
 transfer of rights to, 505–506
 use and maintenance of, 503–504
 lien on, 421
 ownership interests in, 491–493
 ownership of, 467
 personal property vs., 489
 plant life and vegetation as, 490
 transfer of, 493–495
 written requirement for transfer of, 432
 Realty (real estate). *See* Land; Real estate;
 Real property
 Reasonable accommodation, for employees with disabilities, 353
 Reasonable care, bailee's exercise of, 480
 Reasonable doubt, in criminal law, 81
 Reasonable expectation of privacy, 83, 529
 Reasonable grounds, for belief in nonperformance, 236
 Reasonable hour, for tender, 231
 Reasonable manner
 for stop-payment order, 304
 for tender, 231
 Reasonable means, of acceptance, 112
 Reasonableness, commercial, 231
 Reasonable person standard, 97
 intended vs. incidental beneficiary identification, 183–184
 Reasonable reliance, 247
 Reasonable restrictions, on freedom of speech, 46–47
 Reasonable time
 disaffirmance within, 130
 offer termination at end of, 110
 for rejection of goods, 238
 for stop-payment order, 304
 Reasoning, ethical, 18–20
 Reason, rule of, vs. *per se* antitrust violations, 540

Receipt, warehouse, 219
 Receiver, in corporate liquidation, 409
 Recording, of mortgage, 432
 Record. *See* Electronic records; Writing
 Recovery
 by banks, 305
 of damages, 238, 239
 for breach of warranty, 239
 of purchase price or lease payments due, 237
 of space objects, 557
 under workers' compensation statute, 334
 Redemption right, for defaulting borrower, 420, 436
 Red flag indicators, of identity theft, 266
 Referrals, for locating attorneys, 8
 Refinancing mortgage, loan flipping and, 433
 Reformation, of covenants not to compete, 141
 Refusal, to deal, 543
 Registration
 of copyright, 71
 corporate statements of, 383
 of securities, 383, 384
 of trademark, 69–70
 Registration Convention, 557
 Regulation(s). *See also* specific laws
 administrative, 7, 526
 of businesses in interstate commerce, 6, 44
 of employee wages and hours, 336
 government, 17, 44
 of international business activities, 555–556
 of private retirement plans, 338
 of space, 556–558
 Regulatory agencies. *See also* Administrative agency; specific agencies
 independent, 527
 Regulatory Flexibility Act (1980), 532–533
 Reimbursement
 principal's duty of, 322
 right of, 425
 Rejection
 of goods, 234, 238–239
 of offer, 110
 Release, from legal claim, 123
 Relevant market, 542
 geographic, 542
 product market, 542
 Reliance. *See also* Promissory estoppel
 justifiable, 155
 reasonable, 247
 Relief
 bankruptcy, 444, 446
 order for (bankruptcy), 442, 446
 Religion
 discrimination based on, 349
 ethical principles based on, 18
 freedom of, 48–49
 Remanding, of case, 35
 Remedies
 for breach of contract, 194–197
 of buyer or lessee, 238–239

- Remedies (*continued*)
 in compliant, 32
 for creditors, 420–425
 for default, 420
 defined, 5, 194
 of seller or lessor, 237–238
 for Sherman Act violations, 545
 under Title VII, 351
- Rent, 501, 502, 504–506
- Renunciation, of agency relationship, 326
- Reorganization (Chapter 11 bankruptcy), 442, 446–447
- Repayment plans, in Chapter 13 bankruptcy, 442, 447–448
- Reports, credit, 265
- Repossession, of collateral, 420
- Republic of Korea–United States Free Trade Agreement (KORUS FTA), 556
- Repudiation
 anticipatory, 236–237
 of contract, 238
- Reputation
 defamation and, 57
 managing corporate, 22
- Requests
 for admissions, 34
 for documents, objects, and entry upon land, 34
 for examinations, 34
 to negotiate, 108
- Requirements. *See also* Writing requirement
 of contracts, 97, 98
 for corporate combination, 404
 of FDCA, 266
 of HDC status, 287–289
 intent to monopolize, 543
 for involuntary bankruptcy, 442–443
 for judicial review of administrative agency actions, 531
 for negligence, 61
 personal property, for bailment, 478
 for security interest, 417
 for stop-payment order, 304
 for strict product liability, 252
 substantial government interest, 47
 in TILA, 264, 434
 of valid contract, 97
 of valid will, 512–513
- Resale, of goods, 237
- Rescission. *See also* Cancellation
 for breach of contract, 196
 of contract, 122, 152
 defined, 122, 196
 discharge by mutual, 192
- Rescue Agreement, 557
- Residential loans, TILA and, 433
- Residual clause, 512
- Respondeat superior*, 325
- corporations and, 381
- Restitution
 for breach of contract, 196
 for minors' disaffirmance, 131
- Restraints of trade, 539
 contracts in, 140–141
- Restrictions. *See also* Control(s)
 reasonable, on free speech, 46–47
 on technology exports, 556
- Restrictive indorsement, 283
- Resulting trust, 519
- Retaliation, by employers, 333, 351
- Retention of collateral, by secured party, 420
- Retirement insurance. *See* Social Security
- Retirement plans, 338
- Return
 of bailed property, duty of, 481
 of goods, by revocation of acceptance, 236
 sale or, 224
- Reversal, of judgment, 35
- Reviewing courts. *See* Federal court system, appellate courts of; State court system, appellate courts of
- Review, of contract, 185
- Revocable living trust, 518
- Revocation. *See also* Cancellation
 of acceptance, 236–237
 of agency relationship, 326
 of bankruptcy discharge, 446, 448
 of contract, after performance has begun, 99
 of offer, 109
 for unilateral contracts, 99
 of will, 514–515
- RICO. *See* Racketeer Influenced and Corrupt Organizations Act
- Right(s). *See also* Bill of Rights
 airspace, 490
 appraisal, 405–406
 assignment of, 177–181
 of bailee, 479–480
 of contribution, 425
 of creditors, 420–425
 of cure, 233–234
 of debtors, 417, 420
 of directors, 395–396
 dissociation and, 367
 fundamental, 49
 to indemnification, 396
 of inspection, 235–236, 386, 395
 of landlords and tenants, 503–505
Miranda, 84
 to obtain cover, 239
 to obtain goods upon insolvency, 237
 to obtain specific performance, 239
 of owner, 491
 to participation, 395
 of partners, 365–366
 principle of, 19
 privacy, 50, 336–337
 to reclaim goods, 237
 to recover
 damages for buyer's nonacceptance, 237
 purchase price or lease payments due, 237
 of redemption, 420, 436
 of reimbursement, 425
 of rejection, 234, 238–239
 to resell or dispose of goods, 237
 of retention, in default, 420
 of shareholders, 386–387
 of subrogation, 424
 subsurface, 490
 of surety and guarantor, 424–425
 of survivorship, 467
 third party, 177–185
 vesting intended beneficiary, 182–183
 to withhold delivery, 237
- Right-to-work laws, 341
- Risk
 assignment and, 179
 assumption of, 62, 253
 insurance classification by, 454
 liability, 226
 of loss (*See* Risk of loss)
 strict liability and, 62
- Risk management, 454
- Risk of loss, 221–225
 passage of, 217, 223
 when sales or lease contract breached, 225, 226
- Risk pooling, 454
- Robbery, 84
- Royalties, 71
- Rule(s)
 administrative, 7
 business judgment, 398, 407
 entrustment, 220
 equal dignity, 319, 323
 exclusionary, 83
 fictitious payee, 293
 imposter, 293
 mailbox, 112
 main purpose, 166, 424
 mirror image, 110, 208
 one-year, 164–165
 parole evidence, 169–171, 211–212
 plain meaning, 102
 preexisting duty, 121–122
 of privity of contract, 177, 251
- Rulemaking, by administrative agency, 527–528
- Rule of reason, *per se* antitrust violations vs., 541
- Rulings, types of appellate, 35
- S**
- Safety
 consumer protection and, 267
 employee, 335
- Sale(s)
 based on open accounts, 184
 of collateral in default, 420
 conditional, 224
 consumer protection in, 262–263
 defined, 204
 of goods, 195, 204–206, 224, 275
 UCC on, 167, 168
 of land, contract for, 164, 168
 by nonowners, 219–220
 notice of, 436
 of ongoing business and covenants not to compete, 141
 online, 263
 of property, liens and, 421, 422

- of securities, 383–384
- short, 435
- TCPA and the TRACED Acts, 263
- telephone and mail-order, 262
- warranties and (*See* Warranty)
- Sale on approval, 224
- Sale or return, 224
- Sales contracts, 204. *See also* Damages;
 - International contract;
 - Performance; Statute of Frauds
- acceptance in, 208–209
- breach of contract, 195
- for goods, 195, 217–226
 - Statute of Frauds provisions and, 210–211
 - UCC and, 167, 206–212
- remedies in, 197, 237–239
- warranties in, 245–249
- Sample/model, goods conforming to, 246
- Sanctions, under criminal law and civil law, 81, 82
- Sarbanes-Oxley Act (2002), 16, 398
- Satisfaction
 - accord and, 123, 192–193
 - discharge by, 191
- Scienter*, 155
 - Securities Exchange Act and, 384
- Scope of authority
 - agent's authorized acts under, 325
 - agent's exceeding of, 325
- S corporation, 380
- Scrutiny
 - intermediate, 50
 - strict, 50
- Search. *See also* Search and seizure
 - Fourth Amendment on, 83
 - warrantless, 529
- Search and seizure, 83
- Search engines, meta tags and, 70
- Search warrants, 83
 - in administrative agency investigation, 529
- Seasonably, defined, 238
- Secondary liability, on negotiable instrument, 291–292
- Secondary meaning, trademarks and, 68
- Secondary obligations, 165–166
- Second-level domain (SLD), 69
- SEC. *See* Securities and Exchange Commission
- Section 1 and Section 2, Sherman Act. *See* Sherman Antitrust Act
- Secured party (secured creditor), 416, 442, 444, 448
 - default of debtor and, 420
 - disposition of collateral by, 420
 - notice requirements of, 420
 - retention of collateral by, 420
 - value given by, 419
- Secured transactions. *See also* Perfection; Priority; Security interest
 - defined, 416
 - terminology of, 416–417
- Securities. *See also* Bond(s); Debt; Securities law(s); Stock(s)
 - defined, 381
 - exemptions from registration of, 383
 - registration of, 383, 384
 - Regulation A, 383–384
 - Regulation A+, 383–384
 - sales of, 383–384
- Securities Act (1933), 383
 - exemptions to, 383
 - registration statements and prospectus under, 383
 - Regulation A and Regulation A+, 383–384
- Securities and Exchange Commission (SEC, 1934), 527
 - accuracy of financial statements and reports filed with, 398
 - corporate securities registered with, 383
- Securities Exchange Act (1934), 384
 - violations of, 384
- Securities fraud, 86, 384
- Securities law(s), criminal violations of, 384
- Security agreement, 416
 - written, 417
- Security interest(s), 226, 416
 - in after-acquired property, 418
 - conflicting perfected, 419
 - creating, 417
 - in future advances, 418
 - perfection of, 417–418
 - in proceeds, 418
 - scope of, 418–419
 - secured creditors and, 444
 - UCC general priority rules among, 419
 - warranty of title and, 246
- Security standards, for network intrusion insurance, 459
- Self-incrimination, 87
- Self-injury, 335
- Self-tender offer, 407
- Seller
 - contract breached by, 225
 - goods held by, 223
 - insolvency of, 220
 - insurable interest of, 226
 - obligations of, 231–235
 - passage of title and, 218–220
 - remedies of, 237–238
 - risk of loss and, 225
 - shipping arrangements and, 232–233
 - shipping of nonconforming goods by, 208
- Seller's talk, 57–58, 154
- Seniority system, 354
- Separation of powers, in national government, 43–44
- Serious intention, 107
- Service(s). *See also* Personal services
 - counterfeit, 69
 - goods associated with, 205
- Service mark, 69, 76
- Service members. *See* Military status
- Settlement
 - of claims, 123
 - negotiated with administrative agency, 529
- Sexual harassment, 351, 355
- Sexual orientation, discrimination based on, 347
- Share(s). *See also* Stock(s)
 - transfer of, 387
- Share exchange, 404
- Shareholders. *See also* Directors, corporate
 - appraisal right of, 405–406
 - approval, 405
 - of common stock, 382
 - consolidation and, 404
 - corporate, 377
 - derivative suit, 387, 398
 - dissolution of corporation and, 408, 409
 - duties of, 387
 - limited liability of, 384
 - majority, 387
 - meetings of, 385–386, 393
 - in merger, 403
 - minority, 387
 - powers of, 385
 - of preferred stock, 382
 - rights of, 386–387
 - short-form merger and, 405
 - in takeover, 406, 407
 - voting by, 382, 385–386
- Sherman Antitrust Act (1890)
 - enforcement of, 545, 546
 - Section 1 of, 540–541
 - Section 2 of, 541–543
 - U.S. foreign commerce and, 539
 - violations of, 540, 545, 546
- Shipment. *See also* Carriers
 - contract for, 218, 221, 232–233
 - of nonconforming goods, 208
- Short sale, 435
- Sight draft, 275
- Signature
 - e-signature, 169
 - on financing statement, 418
 - forged, 292–294, 305
 - on negotiable instrument, 278, 290–293
 - sufficiency of, 168–169
 - unauthorized, 292–293
 - on will, 513
- Signature liability, 290–293
- Silence
 - as acceptance, 111
 - misrepresentation by, 154–155
- Sixth Amendment, criminal protections in, 83
- Slander, 57
 - of quality (trade libel), 59
 - of title, 60
- Sliding-scale standard, for Internet-based jurisdiction, 28
- Small business. *See also* Business(es); Partnership
 - hacking and, 90
 - law and, 3, 4
 - regulatory flexibility analysis of regulations affecting, 533
- Small Business Administration (SBA), Office of the National Ombudsman at, 533
- Small Business Regulatory Enforcement Fairness Act (SBREFA), 533
- Small claims courts, state, 28

- Smartphones, 310
- Social media
 - business ethics and, 20
 - employer policies for, 337
- Social responsibility, corporate, 20, 22
- Social Security, 338
- Social Security Act (1935), 338
- Software, copyright protection for, 73, 75
- Sole proprietorships, 362
 - advantages of, 362
 - Chapter 13 bankruptcy and, 447
 - disadvantages of, 362–363
- Sound mind requirement, 512
- Sovereign immunity, 552–553
- Space debris, U.N. guidelines to reduce, 557
- Spaceflight, commercial, 558
- Space law
 - defined, 556
 - international, 557
 - U.S., 557–558
- Space objects
 - jurisdiction over, 557, 558
 - liability for personal injury and property damage caused by, 557
 - mandatory registration of, 557
- Space tourism, liability of, 558
- Special (extraordinary) bailments, 479, 483
- Special indorsement, 282
- Specially manufactured goods, 211
- Special power of attorney, 323
- Specific devise, 512
- Specific event, agency termination by
 - occurrence of, 326
- Specific performance, 167
 - as remedy for breach of contract, 197
 - right to obtain, 239
- Speech
 - freedom of (*See* Free speech)
 - obscene, 48
- Spending power, taxing power and, 45
- Spouse
 - intestacy laws and surviving, 516
 - revocation of will and, 515
- Spurring Private Aerospace Competitiveness and Entrepreneurship (SPACE) Act, 558
- Stakeholders
 - corporate social responsibility and, 20
 - outcome-based ethics and, 19
- Stale check, 304
- Standard(s)
 - of care, 60
 - moral minimum as, 16
 - sliding-scale, 28
- Standing to sue, 32
- Stare decisis*, doctrine of, 4
- State(s). *See also* Alternative dispute resolution; Workers' compensation
 - ADEA immunity and, 352
 - administrative agencies in, 526
 - commercial speech restrictions and, 47
 - Constitution (U.S.) and, 5, 43, 44
 - constitutions of, 5
 - courts of (*See* State court system)
 - dissolution through act of, 408
 - Fourteenth Amendment and, 46
 - incorporation procedures in, 377–378
 - intestacy laws and, 516
 - LLC statutes of, 370
 - LPs in, 369
 - minimum wage in, 336
 - powers
 - concurrent with federal government, 45
 - regulatory, 44
 - space tourism regulations of, 558
 - workers' compensation laws of, 334–335
- State court system, 27–29
 - appellate courts of, 29, 35
 - case process in, 32–36
 - highest (supreme) courts of, 29, 35
 - jurisdiction of, 28–29, 32, 33
 - small claims court in, 28
 - trial courts of, 28–29
- State law
 - appraisal right in, 406
 - for corporate combination, 404
 - for corporations, 377
 - for dissolution of corporations, 409
 - on garnishment, 422
 - insurance provisions and clauses
 - mandated by, 456, 457
 - on payment of dividends, 386
 - protected classes in, 347
 - Statute of Frauds and, 163
- Statement(s)
 - corporate registration, 383
 - of fact, creating express warranties, 247
 - financing, 417
 - of opinion, 247
 - fraudulent misrepresentation and, 154
- Statute(s). *See also* Law(s); specific statutes and types
 - assignment prohibited by, 179
 - contracts contrary to, 139–142
 - estray, 470
 - of Frauds (*See* Statute of Frauds)
 - liability for violations of, 398
 - licensing, 140
 - of limitations (*See* Statute of limitations)
 - long arm, 28
 - by operation of law, 139
 - for protected classes, 144, 347–354
 - state (*See* State(s); State law)
 - whistleblower, 333
 - workers' compensation (*See* Workers' compensation)
- Statute of Frauds
 - collateral promises and, 165–166
 - defined, 163
 - exceptions to writing requirement, 167–168
 - and oral contracts, 167, 168
 - on partnership agreements, 364
 - in UCC, 210–211
 - writing requirement and, 163–168, 210, 319
- Statute of limitations, discharge by
 - operation of law, 193
- Statutory code, in civil law system, 7
- Statutory law
 - defined, 6
 - sales of goods and, 206
- Steering and targeting, as predatory lending, 433
- Stepchildren, intestacy laws and, 516
- Stock(s). *See also* Share(s)
 - common, 382
 - corporate combining and, 403–405
 - defined, 377
 - preferred, 382
 - purchase in takeover, 406
 - as securities, 381
- Stock certificates, 386
- Stockholders. *See* Shareholders
- Stop-payment order, 304
- Strict liability, 62. *See also* Strict product liability
- Strict product liability
 - applied to product liability, 252–254
 - comparative negligence and, 254
 - inadequate warnings and, 252
 - product defects in, 252–253
 - requirements for, 252
- Strict scrutiny, 50
- Strike (labor), 340
 - defined, 342
- Student loans, bankruptcy and, 445, 448
- Subchapter S Revision Act (Internal Revenue Code), 380
- Subjective impossibility of performance, 193
- Subjective intention, 107
- Subject matter, destruction of
 - termination of offer by, 110
- Subject matter, destruction of and impossibility of performance, 193
- Subject-matter jurisdiction, 29
- Sublease, 505–506
- Subpoenas, in administrative agency investigation, 528–529
- Subrogation, right of, 424
- Subsequent modification, of written contract, 170
- Subsequent writing, revocation of will by, 515
- Subsidiary corporation, 404, 405
 - short-form merger of, 405
- Subsidiary, in foreign country, 554
- Subsidies, for exports, 556
- Substantial defects, 504
- Substantial effect, antitrust laws and, 546
- Substantial government interest, 47, 49
- Substantial performance, 190
- Substantive due process, 49–50
- Substantive unconscionability, 143
- Substitute check, 308, 309
- Substitute goods, 239
- Substitute method, of acceptance, 112
- Substitution of carriers, 234
- Subsurface rights, 490
- Successor liability, after corporate asset purchase, 406
- Sufferance, tenancy at, 502
- Sufficiency of the writing, 168–169
- Suggestive trademarks, 68

Suit. *See* Lawsuit
 Summary judgment, motion for, 33, 35
 Summons, 33
 Supervisors, sexual harassment by, 351
 Suppliers

of component parts, strict product liability and, 253
 evaluating employment practices of foreign, 21

Supremacy clause, 45
 Supreme court (state), 28, 29, 35
 Supreme Court (U.S.), 28–31
 on constitutional safeguards, 83
 on corporate political speech, 47
 jurisdiction of, 32
 privacy rights and (*See* Privacy rights)

Surety, 422–423
 actions releasing, 424
 defenses of, 424
 rights of, 424–425

Suretyship
 defenses of principal debtor and, 424
 defined, 422
 parties to, 422–423

Surrender, of collateral, 424

Surviving corporation, in merger, 403

Survivors' insurance. *See* Social Security

Suspects, *Miranda* rights of, 84

Suspect trait, strict scrutiny and, 50

Symbolic speech, 46

T

Takeover, corporate
 defined, 406
 responses to
 defenses to, 407–408
 directors' fiduciary duties and, 407
 tender offer in, 407

Taking
 eminent domain and, 495
 in good faith, HDC status and, 288
 of private property by foreign government, 552
 for value, HDC status and, 287–288
 without notice, HDC status and, 289

Tangible employment action, 351

Tangible personal property, 466
 bailment of, 478

Tangible property, 205

Target corporation, 406, 407

Tariffs
 antidumping duty as, 556
 defined, 556

Taxation
 exceptions to discharge and, 445
 of LLC, 370
 Medicare, 338
 of partnership, 363, 370
 Social Security, 338
 sole proprietorship and, 362

Taxing and spending powers, 45

Tax liability, independent contractor and, 327–328

Technology
 copyright infringement and, 73
 e-signature, 169

export restrictions on, 556

space, 558

file-sharing, 74

Telephone Consumer Protection Act (TCPA), 263

Telephone Records and Privacy Protection Act, 51

Temporary impossibility of performance, 194

Tenancy, tenant
 in common, 467, 469
 fixed-term (for years), 501
 joint, 467
 life, 492

periodic, 502, 506
 rights and duties of, 503–506
 at sufferance, 502
 termination of lease and, 506
 transfer of leased property by, 505–506
 at will, 502

Tender
 defined, 190
 of delivery, 218, 231–232

Tender offer, 407

Tenth Amendment, 44

Term(s)
 ambiguous, 102, 170
 consistent additional, 211
 contractual, 99
 interpretation of, 102
 definiteness of, in offer, 108–109
 on food labels, 262
 open, UCC and, 208
 specific delivery, 221
 UCC and Statute Frauds on, 168

Termination. *See also* Discharge

by act of parties, 326
 of agency, 326–327
 COBRA and employee, 339
 contract, 189–194
 of corporation, 382, 408–409
 of employees, 355
 of lease, 506
 of offer, 109–110
 by operation of law, 110, 327
 of partnership, 368–369
 of tenancy, 502
 wrongful, of agency, 326

Terminology

for insurance, 453–454

for a will, 511–512

Territorial restrictions, in distributions, 541

Terrorism, cyberterrorism, 89

Test(s)
 in administrative agency inspection, 528
 arbitrary and capricious test, in APA, 531

but for, 61

lie-detector, 336–337

market-share, 542

means test, in bankruptcy, 443

minimum-contacts, 28

predominant-factor, 205

rational basis, 50

reasonable person standard, 97

testing employees for drugs, 337

Testamentary capacity, 512

Testamentary intent, 512–513

Testamentary trusts, 518

Testator, 511–513

Theft, 82

conversion and, 59

cyber, 89

identity, 51, 88

Third Amendment, 50

Third party

agency by estoppel and, 320, 324
 agent's authority to bind principal and, 318

apparent authority of agent and, 320, 324

in arbitration, 37

assignments, 177–181

beneficiaries, 181–184

collateral promise by, 165

delegations, 177, 180–181

in garnishment, 422

in guaranty, 423

incorporation defects and, 379

in international arbitration, 555

in mediation, 36

partnership liability to, 364, 367

performance to satisfaction of, 191–192

rights of, 177–185

in suretyship, 422, 424

wrongful interference by, 58

TILA. *See* Truth-in-Lending Act

Time. *See also* Lapse of time; Reasonable time; Statute of limitations

agency termination and lapse of, 326

corporate dissolution and expiration of, 408

offer termination and lapse of, 110

one-year rule, 164–165

payable at definite, 279

Time draft, 275

Time instrument, 274. *See also* Negotiable instrument(s)

HDC status and overdue, 289

Timeliness

as acceptance, 111

of proper presentment, 291

for rejection of goods, 238

Timely examination, of bank statements, 305

Title

defect of, 494

defined, 204, 217, 467

document of, 219, 223

to mislaid, lost, or abandoned property, 471

as owners in common, 218

passage of, 217–220, 518

slander of, 60

void, 219, 220

voidable, 220

warranty of (*See* Title warranties)

Title VII, of Civil Rights Act (1964)

constructive discharge under, 350

employment discrimination and, 347–351

remedies under, 351

sexual harassment under, 351

- Title warranties
 disclaimer of, 249
 good title, 245
 no infringements, 246
 no liens, 245–246
- Top-level domain (TLD), 69
- Tort(s)
 agent's, 325
 basis of, 55
 business, 55–64
 corporation's liability for, 381
 defamation, 57
 defined, 55
 independent contractor's, 327
 intentional (*See* Intentional torts)
 lawsuits for, and criminal prosecution
 for same act, 56
 principal's liability for, 325
 strict liability of, 62
 unintentional (*See* Negligence)
- Tortfeasor, 55
- Tort law. *See also* Negligence
 basis of, 55
 civil law and, 81
intent in, 55–58
- Tort liability. *See* Liability; Tort(s)
- Tourism, space, 558
- TQM. *See* Total quality management (TQM)
- TRACED Acts, 263
- Trade. *See also* Export(s); Import(s);
 International business
 regional trade agreements, 556
 restraints of, 539
 contracts in, 140–141
 usage of, 170, 211
 implied warranties from, 249
- Trade associations, rule of reason applied
 to, 541
- Trade barriers, 556
- Trade custom, warranties implied from
 knowledge of, 249
- Trade libel, 59
- Trademark, 76. *See also* Lanham Act
 counterfeit goods and, 69
 defined, 67
 dilution of, 68
 distinctiveness of, 68
 infringement of, 67, 69
 in meta tag, 70
 registration of, 68–69
 service marks and, 69, 76
- Trade name, 69
- Trade-Related Aspects of Intellectual
 Property Rights (TRIPS
 Agreement). *See* TRIPS Agreement
- Trade secrets, 74
- Trading, insider, 384
- Trading with the Enemy Act (1917), 556
- Transaction. *See also* Secured transaction
 UETA and, 113–114
- Transfer(s)
 consumer fund, 309–310
 unauthorized, 310
 of contractual duties (*See* Delegation)
 of contractual rights (*See* Assignment)
 electronic fund, 309–310
 of leased property, 505–506
 of negotiable instruments, 281–283
 of personal property (*See* Bailment)
 of real property (*See* Real property)
 of shares, 387
 warranties, 293
- Transferee, 293
- Transferor, 293
- Treaties. *See also* specific treaties and
 agreements
 defined, 547
 in international space law, 557
- Treaty on Principles Governing the
 Activities of States in the
 Exploration and Use of Outer
 Space, including the Moon and
 Other Celestial Bodies (U.N.). *See*
 Outer Space Treaty
- Trespass
 to land, 58
 to personal property, 59, 468, 471
- Trial
 motion for a new, 35
 motions at, 35
 procedures in, 35
 right to jury trial, 83
 Sixth Amendment protections for, 83
- Trial courts
 district courts as, 30
 jurisdiction of, 28–29
 state, 28–29
- TRIPS Agreement (1994), 75
- Trust
 constructive, 518
 defined, 517
 express, 517–518
 implied, 518–519
 living, 518
 resulting, 519
 testamentary, 518
- Trustee
 bankruptcy, 443, 444
 board of directors as, in liquidation,
 409
 of trust, 518
- Truth-in-Lending Act (TILA), 433
 application requirements, 264
 credit cardholder protection in,
 264–265
 disclosure requirements for, 264,
 433–434
- Equal Credit Opportunity Act
 amendment to, 264
 prohibitions and requirements of, 434
- Tying arrangement, 544
- U**
- UCC. *See* Uniform Commercial Code
- UETA. *See* Uniform Electronic
 Transactions Act
- Ultra vires* acts, involuntary dissolution
 and, 409
- Unauthorized acts, contract liability and,
 325
- Unauthorized alien. *See* Undocumented
 immigrants
- Unauthorized signatures, 292
 special rules for, 292–293
- Unauthorized transfer, of consumer funds,
 310
- Unconditional terms, in promise or order
 to pay, 278–279
- Unconscionability
 of contracts, 142–143
 exculpatory clauses and, 144
 procedural, 143
 substantive, 143
- Unconscionable contract or clause,
 142–143
- Underwriter, 453
- Undisclosed principal, 325
- Undocumented immigrants, 339
- Undue hardship, vs. reasonable
 accommodation, 353
- Undue influence, 156–157
 testamentary intent and, 512–513
- Unemployment insurance, 338
- Unenforceable contract, 101–103, 139
- Unequivocal acceptance, of offer, 111
- Unethical practices, 13, 14
- Unforeseen difficulties, 122
- Uniform Commercial Code (UCC), 6–7.
See also Statute of Frauds; Title
 Article 2A (Leases) of, 206
 Article 2 (Sales Contracts) of, 204–206
 buyer in the ordinary course of business
 under, 419
 on checks, 301
 commercial reasonableness and, 231
 contract law and, 206
 good faith and, 231
 mirror image rule and, 208
 money defined by, 279
 negotiable instruments and, 274
 open-term provisions of, 207
 on place of delivery, 232–233
 priority rules of, 419
 on sale of crops, 490
 on secured transactions, 416–417
 Statute of Frauds in, 210–211
 on title, 218
 warranties under, 245
 writing requirement of, 167, 168
- Uniform Electronic Transactions Act
 (UETA, 1999), 113–114, 169
- Uniform laws, 6
- Uniform Partnership Act (UPA), 363.
See also Partner; Partnership
- Unilateral contracts, 99, 111
- Unilateral mistakes of fact, 151–152
- Unilateral mistakes of value, 153
- Unintentional benefit, from contract, 183
- Unintentional discrimination, 348–349,
 352
- Unintentional torts (negligence). *See*
 Negligence
- Union shop, 341
- Unions. *See* Labor unions
- United Nations
 guidelines to reduce space debris, 557
 Outer Space Treaty and agreements,
 557
- United States Copyright Office, 71

- United States Departments. *See* specific departments
 - United States, space law of, 557–558
 - Universal defenses (real defenses), 294–295
 - Unjust enrichment, quasi contracts and, 100
 - Unlimited jurisdiction. *See* General (unlimited) jurisdiction
 - Unperfected security interests, conflicting, 419
 - Unprotected speech, 48
 - Unreasonable searches, 83
 - Unreasonably dangerous products, 252
 - Unsecured creditors, 432, 442, 444, 446
 - USA Freedom Act (2015), 50
 - Usage of trade
 - contracts and, 170, 211
 - implied warranty from, 249
 - USA Patriot Act, 50
 - Use and maintenance of leased property, 503–504
 - Use of property, bailee's right to, 479
 - U.S. Food and Drug Administration, 267
 - U.S. Patent and Trademark Office, 69, 70
 - Usury, 139
 - Utilitarianism, as outcome-based ethics, 19
- V**
- Vacancies, on board of directors, 394
 - Validation notice, under FDCPA, 266
 - Valid contract, 101–102, 134
 - Value
 - vs. consideration, 288
 - given by secured party, 417
 - given to debtor, 417
 - legally sufficient, 119–120
 - mistakes of, 153
 - taking for, 287–288
 - Variable rate of interest, 279
 - Vegetation, as real property, 490
 - Venture capital, as corporate financing, 382
 - Verdict, motion for a directed, 35
 - Verification, employment, 340
 - Vested rights, of intended beneficiary, 182–183
 - Violations. *See also* specific issues
 - of Clayton Act, 541
 - of Securities Act (1933), 383
 - of Securities Exchange Act (1934), 384
 - of Sherman Act, 540, 545
 - Virus, computer, 89
 - Visas, 340
 - Voidable contract, 101–102, 129, 133–135, 170
 - Voidable instruments, 295
 - Voidable title, 220
 - Void contract, 102, 134, 170
 - Void instruments, 295
 - Void title, 219, 220
 - Voluntary bankruptcy, 441, 442
 - Voluntary consent
 - to agency relationship, 319
 - to contract, 98, 151
 - factors indicating lack of, 151–156
 - Voluntary dissolution, 408
 - Voluntary filing, of bankruptcy petitions, 442
 - Voluntary petitions, in bankruptcy, 442
 - Voting
 - by directors, 394
 - by shareholders, 382, 385–386
 - for union organization, 341
- W**
- Wages. *See also* Income
 - employment discrimination in, 350
 - garnishment of, 422
 - hours and, 336
 - laws for, 336, 350
 - minimum, 336
 - taxation of, 338
 - Warehouse companies, as bailees, 483
 - Warehouse receipts, 219
 - Warning(s), inadequate, 252
 - Warranties. *See also* Breach of warranty
 - defined, 245
 - disclaimers of, 249–250
 - express, 246–247
 - oral, 249
 - implied, 248–250
 - of habitability, 504
 - Magnuson-Moss Warranty Act and, 250
 - of title, 245–246
 - Warrantless searches, 525
 - Warrant, search, 83
 - Warranty deeds, 494
 - Warranty liability, 482
 - for defective goods, 250
 - presentment warranties, 294
 - transfer warranties, 293
 - War, termination of agency relationship
 - by, 327
 - Waste, injury to real property as, 501
 - Weapons of mass destruction, prohibition
 - in outer space, 557
 - Web. *See also* Cyber entries; Internet;
 - Online entries
 - sites
 - clear and conspicuous disclosure requirement for, 261
 - Internet-based legal jurisdiction and, 28
 - Web-related risks, insurance for, 459
 - Whistleblowers, defined, 333
 - White-collar crime, 84–86
 - Wild animals, title to, 468
 - Will
 - defined, 511
 - gifts by, 512
 - holographic will, 513
 - invalidation of, 512
 - property transfer by, 494, 512
 - requirements for valid, 512–513
 - revocation of, 514–515
 - terminology of, 511–512
 - testamentary trust and, 518
 - transfer of digital assets upon death, 513–514
 - writing of, 513
 - Winding up, of partnership, 367, 369
 - Wire fraud, 85
 - Withdrawals
 - direct, 309
 - from illegal agreement, 145
 - Without cause, corporate director's
 - removal by, 385
 - Witness(es)
 - in trial, examination of, 35
 - to will, 513
 - Words, misrepresentation by, 154
 - Workers' compensation
 - laws (state), 334–335
 - unemployment insurance, 338
 - Work hours. *See* Hours
 - Workplace
 - discrimination in, 347
 - gender discrimination in, 350
 - harassment in, 350–351
 - OSHA and safety in, 335
 - privacy rights in, 336–337
 - statutes and administrative
 - agency regulations affecting, 333–342
 - World Trade Organization (WTO), trade
 - barriers and, 556
 - Writ
 - of attachment, 422
 - of execution, 422
 - Writing
 - contracts requiring, 163–168
 - misrepresentation by, 154
 - revocation of will by subsequent, 515
 - sufficiency of, Statute of Frauds and, 168–169, 210
 - Writing requirement
 - for agent's authority, 319, 323
 - collateral promise, 165–166
 - contracts, 163–168
 - involving interests in land, 164
 - for sale of goods, 167
 - exceptions to, in Statute of Frauds, 167–168
 - for firm offer, 207
 - for LP agreement, 369
 - modifications in sales contract, 210
 - for mortgages, 432
 - for negotiable instrument, 278
 - one-year rule, 164–165
 - oral contracts and, 167
 - for partnership agreement, 364
 - promises made in consideration of
 - marriage, 166
 - for security agreement, 417
 - Statute of Frauds and, 163–168
 - in Statute of Frauds, in UCC, 210
 - for warranty disclaimers, 250
 - for will, 513
 - Written contracts. *See also* Parol evidence
 - rule
 - parol evidence rule and, 169–171
 - Written memorandum, 163, 168
 - Wrongful interference, 58
 - Wrongful payment, 304
 - Wrongful termination, of agency
 - relationship, 326

