

Business Law: An Introduction

by

TheBusinessProfessor.com

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& colleagues

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Dear Students,

If you are reading this introduction, you are either interested in or forced to learn about the legal environment of business practice. It is our hope that this text makes your learning path easier to navigate. This text is for you. We welcome your comments and feedback in hopes of making this a stronger learning tool. Before beginning, you may want to know a bit more about the background and purpose of this text.

This text began with the objective of providing learning material to individuals who otherwise lack the means or resources to purchase more expensive text or video resources. Specifically, the purpose of this text was to ease the financial burden on college students taking business law courses. While maintaining this mission, the project quickly expanded into a comprehensive approach to teaching general business-law topics that lays the groundwork for a new model for higher education. Specifically, the text employs numerous pedagogical techniques to effectively transmit information to the lector. The methods of communication include text, video lectures, defined vocabulary, situational examples, discussion questions, practice questions with video explanation, appellate case references (briefs and recommended full-text cases), and content outlines. The text flips the traditional classroom teaching model by introducing the material in a fashion that reinforces the underlying learning objectives in multiple ways.

This project has grown far beyond the ability of a single individual to maintain. It now includes (or will soon include) the contributions of many talented educators and legal professionals. It is their generosity and creativity that makes this project possible. We will work to provide you with the most comprehensive and diverse legal text available for your introduction to business law.

While this text has become a stand-alone learning resource, it is most effective when used in conjunction with classroom discussion and lecture. Classroom lecturers can spend time elaborating on legal concepts, introducing current events that implicate legal principles, and digging deeper into the philosophy and beliefs that underpin the legal system. We hope that you use this material to better your understanding of the law and business.

Best wishes,

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Director of BusinessProfessor, Inc.

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Overview

Access to Text - All of this material in this text is available in desktop and mobile browser or PDF format at TheBusinessProfessor.com.

- *Note:* This PDF document allows you to expand the Table of Contents on the left-hand side of the page. You can easily search, bookmark, highlight, and underline the text material.

Summary of Content

The material in this text is organized into subject-matter topics. Each topic is delivered as follows:

- *Chapter Overview* - Each chapter begins with a high-level overview of what you will learn about in the chapter. The video explanation briefly introduces the key topics and explains how they come together to provide a cohesive legal structure. This provides students with a holistic view of the material they will experience in the following section. Presenting a high-level overview prior to diving into specific concepts has been shown to aid learns in connecting material and increase proficiency. After watching the video, student should review the key concepts and ask yourself if you recognize or understand these concepts.
- *Questions and Answers* - Each concept is presented as question and explanatory answer. This method is known as “chunking”. It isolates key concepts and drives student comprehension. The explanation will generally include a simple example of the concept. Following the explanation of the concept, in the grey-highlighted areas, you will find discussion questions, practice questions, and resource videos. The resource video is a 1 to 6 - minute video containing lecture and powerpoint presentation of the concept.

- ***Discussion Question:*** The discussion question is designed to help you think about the conceptual underpinnings of the covered concept.
- ***Practice Question:*** The practice question is a sample of a type of question you may see on an exam that tests the covered concept. It includes a video explanation of the question and an acceptable answer.
- ***Resource Video:*** The resource video is short video lecture explaining the concept along with PowerPoint slides. This is very useful if you did not fully understand the reading material.

- *Review Outline* - The review outline provides a summary of the material presented in the chapter. It allows students to test their familiarity of the material by presenting key words and short statements that should spark the student’s memory of the extended explanation of the material. Students can print this material for class and handwrite notes from the classroom discussion of the topic. Handwriting has been shown to increase information recall far better than typing notes.
- *PowerPoint Slides* - All of the powerpoint slides used in the Chapter Overview and Questions and Answers are available for download. Professors may integrate these slides into classroom lectures and students can use these

slides a study aids.

Recommended Teaching Methods

Pre-session Assignment and Preparation - Provide students with the dynamic text material prior to class. Students should be instructed to begin by watching the chapter overview video, which provides a holistic overview of the entire chapter. The video sets the stage for what students will learn. Students should then have a quick view of the key concepts that will be covered in the chapter. The students should then read the material, which is structure in a question and answer format. After reading the material, students should immediately read the theoretical discussion question and the practice question. Students do not attempt the questions at this point. The practice question engages the student as to how the material applies to a real-life problem; while, the discussion question explores the theoretical underpinnings of the law and seeks to invoke an emotional reaction and opinion. The student should watch the resource video. Each resource video is 2-5 minutes long and is a recording of the lecturer teaching the relevant topic from PowerPoint slides. This reinforces the short reading section and questions. The students repeat this process for every question in the topic material.

In-Class Session - When students arrive to the class, begin the class with a 10 minute recitation of the chapter overview. At this point, students can ask general questions about the material. You may proceed to choose question from the material at random. Call on students to briefly read the question and provide her answer (1-3 minutes). Allow other students to add to the answer. Then reference a specific aspect of the discussion question and ask for volunteers. Students should now have formed an opinion on the matter and readily volunteer to voice that opinion. Done correctly, this should engage a discussion (2-10 minutes). Proceed with this method for the more challenging topics throughout the class session. Students are active and engaged (and often passionate in their involvement) throughout the entire session. The instructor should serve as a guide through the material and discussion moderator. Students are then instructed to review the study outline to make certain they fully understand all concepts. The outline is constructed to allow students to quickly read the outline and determine if they have a firm grasp of the material.

Recommended Methods of Evaluation

Homework Assessment - Following the in-class activity, students are required to individually attempt an answer to the undiscussed practice questions. Students upload their attempts to an electronic system (D2L or Blackboard). Release a video explanation of each question along with the assignment. Students may use this in answering the question; but encourage them to attempt the question without reviewing the explanation first. Evaluate the student's attempt rather than grade the detailed content of the effort. More specifically, look to see that the student has identified the legal attribute that applies to the situation. Do not judge whether the student has arrived at a legally accurate conclusion. This incentivizes students to not just copy my explanation in an effort to record the correct answer; rather, students can test themselves to see if they can identify the legal principles.

Examination - The recommended examination method consists of a combination of hybrid multiple-choice questions and short answers. The multiple-choice format is to choose the best answer of A, B, C, All of the Above, or None of the Above. Students have the opportunity to treat any multiple-choice question as a short-answer question. There is no limit (other than time) on the student's ability to make this election. This allows me to cover a breadth of topics while also allowing students to demonstrate conceptual understanding beyond simple answer recognition. This reinforces the class objectives of demonstrating understanding.

In-Class Assessment - Lastly, a stated percentage of student grades may be based upon participation. Participation consists of a combination of attendance and engagement in the classroom. The lecturer might note each student who answers a practice question or otherwise volunteers to voice an opinion on the discussion question. (Note: This level of assessment may be difficult larger sections.).

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Table of Questions

Topic 1: Legal Theory & Foundations

1. What is “law”?
2. What is “jurisprudence”?
3. When is a state economically strong or weak and what is the role of law in this determination?
4. What is the “rule of law”?
5. What is “property law” (or property rights)?
6. What is “ownership”?
7. Why would a system establish ownership of property rights?
8. How does law or the legal system protect or promote property rights?
9. What are the “common law” and “civil law” systems?
10. What is the difference between “public law” and “private law”?
11. What is “civil law” and “criminal law”?
12. What is “substantive law” and “procedural law”?
13. What are the sources of federal, state, and local law?
14. What is the role of the judiciary in the legal system?
15. What effect does the legal recognition of business entities have on the conduct of business?

Topic 2: US Constitution

1. What is included in the US Constitution?
2. What is the “Separation of Powers”?
3. What is “Federalism”?
4. What is the “Supremacy Clause” and “Preemption”?
5. What is the “Full Faith and Credit Clause”?
6. What is the “Privileges and Immunities Clause”?
7. What is the “Commerce Clause”?
8. What is the “Taxing and Spending Power”?
9. What is the “Contract Clause”?
10. What is the “1st Amendment”?
11. What are the “Establishment Clause” and “Free Exercise Clauses”?
12. How does freedom of religion affect business practice?
13. What conduct is protected pursuant to the 1st Amendment’s assurance of “freedom of speech”?
14. What type of speech is either not protected or receives limited protection?
15. What is “overbreadth” or an “overbroad” law affecting freedom of speech?
16. What is the “Freedom of Press” granted under the 1st Amendment?
17. What is the “Freedom of Assembly”?
18. What is the 5th Amendment to the Constitution?
19. What is “Due Process” of Law?
20. What is the 14th Amendment’s Due Process Clause - “Incorporation Doctrine” and “Equal Protection Clauses”?

21. What are the standards by which the government (through laws or actions) may infringe on individual rights?

Topic 3: Court System

1. What is the authority for the federal and state judicial systems in the United States?
2. What is the authority for Article III federal courts?
3. What types of courts exist in the state judicial system?
4. What is “Subject-Matter Jurisdiction”?
5. What is the Federal Court’s Subject-Matter Jurisdiction?
6. What is the State Court’s Subject-matter Jurisdiction?
7. Can federal courts hear matters of state law? And vice versa?
8. What is “Personal Jurisdiction”?
9. How does a federal court get personal jurisdiction over someone in a civil case?
10. How does a state court get personal jurisdiction over someone in a civil case?
11. What is a state “Long-arm Statute”?
12. What is “Venue”?
13. Who are the primary players in the judicial system?
14. What types of judges are part of the judiciary?
15. What are the duties of trial judges in the legal system?
16. What are the duties of appellate court judges or justices?
17. How do cases arrive before the appellate courts?
18. What is the role of “Jurors” in the judicial system?
19. How many jurors and juror votes are required to find someone guilty in a criminal case or liable in a civil case?
20. What do attorneys do?
21. Who are some of the other players in the court system?
22. What are the theoretical (political) views toward judicial review?

Topic 4: Administrative Law

1. What are “Administrative Agencies”?
2. What are the functions of agencies?
3. What authority exists for creating and vesting authority in administrative agencies?
4. How are administrative agencies organized?
5. How are key agency personnel appointed and removed?
6. What is the administrative agency process for creating regulations?
7. What is the judiciary’s authority to review agency rule making?
8. What is the judiciary’s authority to review administrative court decisions?
9. What are the advantages of administrative agencies?
10. What are the disadvantages of administrative agencies and regulations?

Topic 5: Criminal Law & Procedure

1. What is “criminal law”?
2. What are the elements of a crime?
3. What are the classifications of criminal conduct?

CRIMINAL LAW PROCESS

4. What is the process for initiating and processing criminal charges against a defendant?
5. What is the process for executing an arrest?
6. How does the government initiate criminal charges?
7. What is the “initial appearance” and the “arraignment”?

CONSTITUTIONAL PROTECTIONS IN CRIMINAL LAW PROCESS

8. What protections does the 4th Amendment provide to individuals subject to criminal charges?
9. What protections does the 5th Amendment provide to individuals subject to criminal charges?
10. What protections does the 6th Amendment provide to individuals subject to criminal charges?
11. What protections does the 8th Amendment provide to individuals subject to criminal charges?
12. What are some common crimes involving the property of others?

13. What type of activity constitutes fraud?
14. How does “good faith” affect fraud?
15. What are some common types of business fraud?
16. What is the crime of “Conspiracy”?
17. What is the crime of “Obstruction of Justice”?
18. What is the crime of providing a “False Statement”?
19. What is “Aiding and Abetting” criminal activity?

WHITE COLLAR AND BUSINESS CRIMES

20. What is a “White-collar Crime”?
21. What are crimes directed at conduct endangering workers?
22. What is bribery and other illegal payments (kickbacks)?
23. What is the “Racketeer Influenced and Corrupt Organizations Act” (RICO)?
24. What is the “False Claims Act”?
25. What is the “Sarbanes-Oxley Act”?
26. What is a “Cyber Crime”?
27. What defenses exist to criminal conduct?

THEORIES OF CRIMINAL PUNISHMENT

28. What types of punishment exist for criminal activity?
29. What are the theories for criminal punishment?
30. What are the “Federal Sentencing Guidelines”?

Topic 6: Civil Litigation Procedure

1. What is a “civil lawsuit” or “civil action”?
2. Who are the “parties” to a lawsuit?
3. What is “standing” to sue in a civil trial?
4. What is “personal jurisdiction” in a civil suit?
5. What is a “class action” lawsuit?
6. What are “pleadings” in a civil lawsuit?

7. What is “discovery” in a civil lawsuit and how is it used?
8. What is the “scope of discovery” in a civil lawsuit?
9. What are “motions” and how are they used in a civil lawsuit?
10. What is a “frivolous case” and how are such cases regulated?
11. What is the process for selecting a jury (“jury selection”) in a civil case?
12. What is the general process or steps involved in a civil trial?
13. What is the “burden of proof” in a civil trial?
14. How is a civil trial decided?
15. What is “joint and several liability”?
16. What is the process and procedure for appealing (“appeal”) the decision in a civil trial?
17. How does a party enforce a civil judgment?
18. What is “*res judicata*” in civil trials?

Topic 7: Alternative Dispute Resolution

1. What is “settlement” of a legal dispute?
2. What is “Alternative Dispute Resolution” (ADR)?
3. What are the advantages of using ADR to resolve disputes?

MEDIATION

4. What is “Mediation”?
5. What are the advantages and disadvantages of mediation?
6. How do the parties initiate mediation?
7. What are the procedures for carrying out mediation?
8. Challenging the mediation agreement?

ARBITRATION

9. What is “Arbitration”?
10. What are the advantages and disadvantages of arbitration?
11. How do the parties initiate arbitration?
12. What are the procedures for carrying out an arbitration?
13. What rules govern the arbitration process?
14. Challenging the “arbitration award”?
15. How are arbitration awards enforced?

Topic 8: The Property System

1. What is “Property”?
2. What is the role of government with regard to individual ownership of property?
3. How are property rights linked to economic activity?
4. How do individuals acquire an “ownership” interest in property?
5. How is an ownership interest transferred between individuals?

OWNERSHIP INTERESTS IN REAL PROPERTY

6. How do individuals establish and document an ownership interest in real property?
7. What is a “fee simple” interest in real property?
8. What is a “life estate” interest in real property?

9. What is a “leasehold estate” in real property?
10. What types of co-ownership interests exist in property?
11. What is an “easement interest” in real property?

PERSONAL PROPERTY

12. What is a “license” of real or personal property?
13. What is a “bailment”?
14. What is a “unilateral benefit bailment” and “mutual benefit bailment”?

LIMITATIONS ON PROPERTY RIGHTS

15. How are property ownership rights limited?
16. What is “Nuisance”?
17. What is “Zoning”?
18. What is “Eminent Domain”?
19. What is “taxation” of personal and real property?

Topic 9: Tort Law

1. What is a “Tort”?
2. What types of torts exist?

INTENTIONAL TORTS

3. What is “assault and battery”?
4. What is the “intentional infliction of mental distress”?
5. What is the tort - “invasion of privacy”?
6. What is “false imprisonment”?
7. What is “malicious prosecution”?
8. What is “trespass”?
9. What is “conversion”?
10. What is “defamation”?
11. What is “fraud”?
12. What is the “intentional interference with economic relations”?

NEGLIGENCE TORTS

13. What is “negligence”?
14. What is a “legal duty”?
15. What is “unreasonable behavior” that constitutes a breach of duty?
16. What is “Causation in Fact”?
17. What is “Proximate Causation”?
18. What are the common defenses to negligence actions?

STRICT LIABILITY TORTS

19. What is “strict liability”?
20. What is “strict products liability”?
21. What other common strict liability causes of action exist?
22. What defenses exist to strict product liability actions?

TORT DAMAGES

23. What are “compensatory damages”?

24. What are “punitive damages”?

Topic 10: Contract Law

1. What is a “contract”?
2. What are the sources of contract law?
3. What are “unilateral contracts” and “bilateral contracts”?
4. What are “express contracts”, “implied-in-fact contracts”, and “implied-in-law contracts”?
5. What are “valid contracts”, “enforceable contracts”, “void contracts”, and “voidable contracts”?

CONTRACT FORMATION

6. What elements are required to form a valid contract?
7. What constitutes an “offer” to contract?
8. When does an offer to contract terminate?
9. What is “acceptance” of an offer?
10. What is “consideration” in the context of contract formation?

ENFORCEABLE, VOID, & VOIDABLE AGREEMENTS

11. What is “mental capacity” to contract?
12. What is the requirement that a contract have a “lawful purpose”?
13. What common situations give rise to a voidable contract?
14. When is a contract required to be in writing?
15. What type of writing is required to satisfy the “statute of frauds”?
16. What exceptions exist to the requirement that a contract be in writing to be enforceable?

INDIVIDUALS WITH RIGHTS UNDER THE CONTRACT

17. Who are the beneficiaries of the contract?
18. What is “assignment” and “delegation” of contracts?

CONTRACT PERFORMANCE

19. When is a party relieved from her obligations under a contract?
20. What are “executed contracts” and “executory contracts”?
21. What is performance of a contract?
22. What is performance of a “divisible contract”?

RELIEF FROM DUTIES UNDER THE CONTRACT

23. What situations relieve individuals from performing her duties under a contract?
24. What are “conditions” upon the duty to perform a contract?
25. What are the conditions regarding payment, delivery, and tender of performance?
26. What are “impossibility”, “impracticability”, and a “supervening frustration of purpose” of a contract?
27. What is “waiver” or “release” from a contract?

BREACH OF CONTRACT

28. What is a “breach of contract”?
29. What methods exist for resolving a breach of a contract?
30. What remedies exist for breach of a contract?
31. What is “efficient breach”?

INTERPRETING A CONTRACT

32. What rules or standards do courts apply when interpreting contracts?

33. What is the “Parol Evidence Rule”?
34. What is a “complete integration” and “partial integration”?
35. When does the parol evidence rule not bar the consideration of extrinsic evidence to a contract?
36. What is a “patent ambiguity” and “latent ambiguity”?

Topic 11: Agency & Liability

1. What is “agency”?
2. What are the types of agent?
3. What is the agency status of an employee as compared to an independent contractor?
4. What are the types of principal?
5. What is required to form a principal-agent relationship?
6. What are the duties of a principal?
7. What are the duties of an agent?
8. To what extent is a principal bound in contract by the actions of the agent?
9. To what extent are agents liable in contract to third parties and to the principals they represent?
10. To what extent are principals liable for the torts committed by agents?
11. What is a “frolic and detour”?
12. When and how does the agency relationship terminate?

Topic 12: Business Entities

1. What are “business entities”?
2. Why is studying business entities important?
3. What is the difference between a “closely-held company” and a “publicly-held company”?
4. What are the main types of business entities?
5. What are the main characteristics of a particular business entity?
6. What is “creation” of a business entity?
7. What are the “maintenance” requirements for a business entity?
8. What is “continuity” of a business entity?
9. What is the “ownership structure” for a business entity?
10. What is “control” over a business entity?
11. What is the potential “personal liability” of owners of a business entity?
12. How is an owner of a business “compensated”?
13. How are business entities “taxed”?
14. What are the major characteristics of a “sole proprietorship”?
15. What are the major characteristics of a “general partnership”?
16. What is a “joint venture”?
17. What are the major characteristics of a “limited partnership”?
18. What are the main characteristics of a “limited liability partnership”?
19. What are the main characteristics of a “limited liability company”?
20. What are the main characteristics of a “corporation”?
21. What are the requirements to qualify as an “S corporation”?

Topic 13: Corporate Governance

- 1. What is “business governance”?**
- 2. Who are the members of a corporation?**
- 3. What is a “closely-held corporation”?**
- 4. What is the distinction between a “private company” and “public company”?**

THEORETICAL FOUNDATIONS

- 5. What is the role and purpose of the corporation?**
- 6. What is “agency theory” and why is it relevant for the business entity?**
- 7. What is the “stakeholder theory” of corporate governance?**

SHAREHOLDERS OF THE CORPORATION

- 8. What is the role of “shareholders” of the corporation?**
- 9. What are the many variations in characteristics of the “ownership structure” of the corporations?**
- 10. What are the “fiduciary duties” owed by shareholders of the corporation?**
- 11. To what extent are shareholders of the corporation personally liable for obligations of the corporation?**
- 12. How can shareholders enforce their rights?**
- 13. What is the process for shareholders bringing a “derivative action”?**
- 14. What are corporate vote “proxies” and how are they used?**
- 15. What is “shareholder activism” and what is the significance of “institutions as shareholders”?**

BOARD OF DIRECTORS

- 16. What is the role of “directors” of the corporation?**
- 17. What is the composition of the “board of directors”?**
- 18. What standards govern the actions and decisions of the board of directors?**
- 19. What is the “business judgment rule”?**
- 20. What other protections exist for directors acting in their official capacity?**

MANAGERS

- 21. What is the role “managers” in the corporation?**
- 22. What standards govern the actions of corporate managers?**

LAW AND CORPORATE GOVERNANCE

- 23. What state and federal laws primarily contribute to corporate governance?**
- 24. What is the role of state law in corporate governance?**
- 25. What is the role of “securities laws” in corporate governance?**
- 26. What is the “Foreign Corrupt Practices Act” (FCPA) and how does it affect corporate governance?**
- 27. What is the “Sarbanes-Oxley Act”?**
- 28. What is the “Dodd-Frank Wall Street Reform and Consumer Protection Act” (Dodd-Frank)?**
- 29. What industry organizations place standards on corporate governance?**
- 30. What are “proxy advisory firms” and what is their effect on corporate governance?**
- 31. What is the role of ethics within corporate governance?**

CAUSES OF CORPORATE GOVERNANCE ISSUES & TECHNIQUES FOR EFFECTIVE PRACTICE

- 32. What are some of the major causes of corporate governance issues?**
- 33. How does shareholder access to information give rise to issues in corporate governance?**
- 34. What corporate decision-making procedures give rise to issues in corporate governance?**

35. How does competition for authority within the corporation give rise to issues in corporate governance?
36. What is a “hostile takeover” and what effect does it have upon corporate governance?
37. How does the alignment of benefits and interests cause corporate governance issues?

Topic 14: Securities Law

1. What are “securities laws”?
2. What is a “security”?
3. What qualifies as an “investment contract”?
4. What are the primary security laws?
5. What are the regulatory goals of security laws?
6. What is the “Securities and Exchange Commission” (SEC)?

BUSINESS FINANCING AND PUBLIC OFFERINGS

7. What is an “initial public offering”?
8. What is a “direct public offering”?

THE SECURITIES ACT OF 1933

9. What is an “offer” to sell securities?
10. Who are the parties regulated in an offer to sell securities?
11. What are the primary disclosure documents required in a offer to sell securities?
12. What is an issuer allowed to do during each stage of the registration process?
13. How are issuers of securities classified for purposes of the registration and offering process?
14. What is an issuer allowed to do during the “Pre-Filing Period” (and the exceptions)?
15. What are the limitations on an issuer during the “Post-Filing Waiting Period”?
16. What is an issuer allowed to do during the “Post-Effective Period”?
17. What is an “Emerging Growth Company” and why is it important?
18. What type of information must an issuer disclose?
19. What laws govern the mechanics of disclosure of information in a securities offering?

EXEMPTIONS FROM '33 ACT REGISTRATION REQUIREMENT

20. What are “exempt securities” and “exempt transactions”?
21. What are “restricted securities”?
22. What is a “Section 3 exemption” from registration under the '33 Act?
23. What is “Rule 147” and how does it relate to a Section 3 exemption?
24. What is a “Section 4” exemption from registration under the '33 Act?
25. What is a “Regulation A” exemption?
26. What are “Regulation D exemptions”?
27. What is a Rule 504 “small offerings exemption”?
28. What is a Rule 505 “small offerings” exemption?
29. What is a “Rule 506” exemption?
30. What is a “Rule 502(d)” and “Rule 144 Safe Harbor”?
31. What are the general information disclosure requirements for companies seeking an exemption from registration?
32. What is the requirement to file “Form D”?
33. What is the effect of failing to register an offering under Section 5 and failing to perfect an exemption to the

registration requirement?

34. What is “crowdfunding” and how is it affected by securities registration laws?

LIABILITY UNDER THE SECURITIES EXCHANGE ACT OF 1933

35. What is civil liability under “Section 11” of the ’33 Act?

36. What is civil liability under “Section 12” of the ’33 Act?

37. What defenses exist for issuers with potential liability under Sections 11 and 12 of the 33’ Act?

38. What is liability under “Section 17” of the ’33 Act?

39. What is the potential criminal liability for violations of ’33 Act?

THE SECURITIES EXCHANGE ACT OF 1934

40. When must a company register with the Securities Exchange Commission pursuant to the ’34 Act?

41. What disclosures are required of registered companies under the ’34 Act?

LIABILITY UNDER THE SECURITIES EXCHANGE ACT OF 1934

42. What is liability under “Section 10(b)” and “Rule 10(b)(5)” of the 1934 Act?

43. What is “insider trading” under Rule 10(b)(5)?

44. What damages are available to a plaintiff under Section 10(b) and Rule 10(b)(5)?

45. What is “insider trading” under Section 14 of the 1934 Act?

46. What is liability under “Section 16” of the 1934 Act?

47. What is liability under “Section 18” of the 1934 Act?

48. What is liability pursuant to the “Securities Enforcement Remedies Act”?

49. What is criminal liability under the 1934 Act?

BLUE-SKY LAWS

50. Are all issuers of securities required to comply with state blue sky laws?

51. What are the registration requirements under state law?

52. What types of coordinated registration are available under state laws?

Topic 15: Employment Laws

1. What is an “employee”?

2. What are the legal obligations regarding the terms of employment between an employer and employee?

EMPLOYMENT LAWS

3. What are the major employment laws?

4. What tax and other compensation withholding requirements do the state and federal governments place on employers with regard to employees?

5. What is the “Fair Labor Standards Act”?

6. What is the “Family Medical Leave Act”?

7. What is the “Worker Adjustment and Retraining Act”?

8. What is the “Occupational Safety and Health Act”?

9. What is the “Employee Retirement Income Security Act”?

10. What is the Consolidated Omnibus Budget Reconciliation Act?

11. What is the “Health Insurance Portability and Accountability Act”?

12. What are “Worker’s Compensation” laws?

13. What are the “employee verification laws”?

14. What “worker privacy laws” apply to the workplace?

LABOR RELATIONS AND LAWS

- 15. What are “labor laws”?**
- 16. What are the major federal labor laws?**
- 17. What is the “Norris-LaGuardia Act”**
- 18. What is the “National Labor Relations Act”**
- 19. What is the “Taft-Hartley Act”?**
- 20. What is the “Labor Management Reporting and Disclosure Act”?**

Topic 16: Employment Discrimination

- 1. What is “employment discrimination”?**
- 2. What are the major employment discrimination laws?**

CIVIL RIGHTS ACT OF 1964

3. What are the protections against employment discrimination provided by the “Title VII” of the Civil Rights Act of 1964?

- 4. How are employment discrimination actions under the Title VII enforced?**
- 5. What must a plaintiff demonstrate to the court to win a lawsuit under Title VII?**
- 6. What is discrimination on the basis of race or color under Title VII?**
- 7. What is discrimination on the basis of national origin under Title VII?**
- 8. What is discrimination on the basis of religion under Title VII?**
- 9. What is discrimination on basis of sex under Title VII?**
- 10. What is “sexual harassment” and “hostile work environment”?**
- 11. What are the protections under Title VII against discrimination based upon pregnancy?**

OTHER STATUTES AND EMPLOYMENT CONSIDERATION

- 12. What is the “Civil Rights Act of 1866”?**
- 13. What is the “Age Discrimination in Employment Act”?**
- 14. What is the “Americans with Disabilities Act”?**
- 15. What is the “Rehabilitation Act”?**
- 16. What is the “Genetic Information and Non-Discrimination Act”?**
- 17. What laws protect employees from discrimination in receiving health insurance coverage?**
- 18. What anti-discrimination protections exist for employees who are also military service members?**
- 19. What federal protections exist from discrimination based upon sexual orientation or identity?**
- 20. What is “affirmative action”?**
- 21. What is the role of state governments with regard to anti-discrimination laws?**

Topic 17: Consumer Protection

- 1. What is “consumer protection law”?**
- 2. What major federal laws protect consumers?**

REGULATORY AGENCIES

- 3. What is the “Federal Trade Commission”?**
- 4. What are the enforcement procedures of the FTC?**
- 5. What penalties and remedies may the FTC seek for violations of FTC regulations?**
- 6. What type of commercial practices does the FTC prohibit in an effort to protect customers?**

7. What is the “Consumer Financial Protection Act”?

REGULATION OF CREDIT AND LENDING PRACTICES

8. What is the “Equal Credit Opportunity Act”?

9. What is the “Fair Credit Reporting Act”?

10. What is the “Truth in Lending Act”?

DEBT LIABILITY PROTECTION

11. What is the “Fair Debt Collection Practices Act”?

12. What is the “Fair Credit Billing Act”?

13. What is the “Electronic Funds Transfer Act”?

CONSUMER PRODUCT PROTECTIONS

14. What is the “Consumer Product Safety Act”?

15. What are the applicable labeling laws regulating consumer products?

16. What is the Federal Food, Drug, and Cosmetic Act?

17. What is the “Magnuson-Moss Warranty Act”?

CONSUMER PRIVACY PROTECTIONS

18. What is the “Privacy Act of 1974” (Privacy Act)?

19. What is the “Right to Financial Privacy Act of 1978” (RFPA)?

20. What is the “Electronic Communication Privacy Act of 1986” (ECPA)?

21. What is the “Children’s Online Privacy Protection Act of 1986” (COPPA)?

22. What role do states play in consumer protection?

Topic 18: Antitrust Law

1. What is “antitrust law”?

2. What are the major antitrust laws in the United States?

3. What entities are charged with carrying out these Acts?

ANTITRUST LAWS

4. What is the “Sherman Act of 1890”?

5. What is the “Clayton Act of 1914”?

6. What is the “Federal Trade Commission Act of 1914”?

THE SHERMAN ACT

7. What is a “contract, combination, or conspiracy” in restraint of trade?

8. What is “*per se* illegality” and the “rule of reason”?

9. What is a “Monopoly”?

10. What businesses are exempt from the provisions of the Sherman Act?

ANTICOMPETITIVE ACTIVITY REGULATED BY THE SHERMAN ACT

11. What are the commonly recognized types of “horizontal restraint”?

12. What are the commonly recognized types of “vertical restraint”?

13. What is “monopolization” under the Sherman Act?

CLAYTON ACT ANTITRUST CASES

14. What is “Price Discrimination”?

15. What are “special arrangements” prohibited by the Clayton Act?

16. How does the Clayton Act regulate “mergers and acquisitions”?

17. What is the “Federal Trade Commission Act “and how does it regulate unfair competition?
18. What sanctions are available under the antitrust laws?

Topic 19: Secured Transactions

1. What is a “Security Interest”?
2. What are the benefits of a security interest to creditors?

SECURITY INTERESTS IN LAND

3. What are the common types of “security interest in land”?
4. What is a “mortgage”?
5. How does a security interest protect the mortgage holder?
6. What is a “deed of trust” or “security deed”?
7. What is a “land sale contract”?

SECURITY INTEREST IN PERSONAL PROPERTY

8. What is a security interest in personal property?
9. How does one establish a security interest in personal property?

PERFECTION OF A SECURITY INTEREST

10. What is “perfection” of a security interest?
11. What methods exist for perfecting a security interest in personal property?
12. How does a secured party establish a security interest in real property (land)?

AUTOMATIC PERFECTION

13. What is “automatic perfection” of a security interest?
14. What is a “purchase money security interest” (PMSI) in consumer goods?
15. What is a “purchase-money grace period” for a purchase-money security interest in non-consumer goods?
16. How does one continue perfection of or permanently perfect a purchase money security interest in non-consumer goods?

17. What is “temporary automatic perfection” in “proceeds” from the sale of goods?
18. How is a security interest through the “assignment of accounts receivable” and “contract rights” created?

SECURITY INTEREST BY POSSESSION or CONTROL

19. How does one perfect a security interest by “possession “of the collateral?
20. How does one perfect a security interest by “control” of the collateral?

PERFECTION BY FILING

21. What information is required in a “financing statement” filing?
22. What authorization is required to file a financing statement?
23. Where is the appropriate office to file a financing statement?

PRIORITY OF SECURITY INTERESTS

24. What is “priority” of a security interest?
25. What role does perfection play in establishing the priority of a secured party?
26. What are the common types of conflicts regarding the priority of security interests?
27. What is the priority of parties secured by “common law and statutory liens”?
28. What is the “priority of buyers of collateral” that is subject to a security interest?
29. What is required to be a buyer in the “ordinary course of business”?
30. What statutory provision protects individuals purchasing goods from a buyer in the ordinary course?

31. What is the “Shelter Principle” - Section 2-403(1)?

PRIORITY OF PERFECTED & UNPERFECTED SECURITY INTERESTS

32. What are the general “priority rules” for security interests?

33. Who has “priority in proceeds” from the sale of collateral?

34. What is a secured party’s priority in “future advances” of funds to the debtor?

PRIORITY OF PURCHASE MONEY SECURITY INTERESTS

35. What is the priority of a purchase-money security interest in goods (other than inventory and livestock)?

36. What is the priority of a purchase-money security interest in inventory?

37. What is the priority of conflicting purchase-money security interests?

FIXTURES AND SECURITY INTERESTS

38. What is the priority of security interests in fixtures?

39. What is the scope of fixture priority rules?

Topic 20: Commercial Paper

1. What is “Commercial Paper”?

2. What are common types of commercial paper?

3. Who is a “holder” of commercial paper?

NEGOTIABILITY

4. What is “negotiability” and why is it important?

5. What is required for commercial paper to be “negotiable”?

6. When does commercial paper contain an “unconditional promise to pay”?

7. What is “payable on demand” paper and “payable on time” paper?

8. What is “order paper” and “bearer paper”?

9. How is a payee identified on the negotiable instrument?

10. What rules does the court apply when determining negotiability?

NEGOTIATION OF AN INSTRUMENT

11. How is commercial paper negotiated to a holder?

12. What is the “transfer” of commercial paper?

13. What is “indorsement” of a negotiable instrument?

14. What are the various types of indorsement of a negotiable instrument?

LIABILITY - OBLIGATION OF PAYMENT

15. How does a holder of commercial paper receive payment of the instrument?

16. Who is potentially liable on (obligated to pay) a negotiable instrument?

17. When is an individual (including businesses) liable for a representative signing a negotiable instrument?

18. What rules apply if a holder of a negotiable instrument loses the instrument?

19. When is payment on a negotiable instrument overdue?

20. What effect does a negotiable instrument have on the underlying obligation?

HOLDER IN DUE COURSE

21. What is a “holder in due course” and what are the benefits?

22. What are the requirements for a holder of an instrument to become a holder in due course?

23. What does it mean to receive an instrument for value?

24. What does it mean to receive an instrument in good faith?

25. What does it mean to receive an instrument without notice of a valid defense to enforcement?
 26. How does discharge of the underlying obligation affect a holder in due course?
 27. What is the “Shelter Rule”?
 28. Can you limit holder in due course status?
 29. Does a payor have any defenses to paying an instrument that is presented for payment by a holder in due course?
 30. What is a “claim in recoupment”?
 31. What are the rights of a holder in due course if the underlying transaction is a consumer transaction?
 32. What is the result if a negotiable instrument is forged?
 33. What is the result if a negotiable instrument is stolen?
 34. What is the role of a guarantor or surety of a negotiable instrument?
 35. What is an “accord and satisfaction”?
- LIABILITY AND WARRANTIES FOR NEGOTIABLE INSTRUMENTS**
36. What is “drawer or maker liability” for a negotiable instrument?
 37. What is “transferor warranty” of a negotiable instrument?
 38. What is “indorser warranty” of a negotiable instrument?
 39. What is “presentment warranty” of a negotiable instrument?
 40. To what extent is a warrantor liable for damages suffered by a holder of a dishonored note or draft?
 41. Is there a time limitation for exercising warranties on negotiable instruments?
 42. When are the warranties of a negotiable instrument discharged?

Topic 21: Bankruptcy

1. What is “bankruptcy”?
2. What are the types of business bankruptcy?

THE BANKRUPTCY PROCESS

3. Who are the primary participants in the bankruptcy process?
4. What key concepts are necessary to understand the bankruptcy process?
5. What rules govern the bankruptcy process?
6. What is the authority of the bankruptcy court?
7. What is the authority of the trustee (debtor in possession) in bankruptcy?
8. What assets of the debtor are included in the bankruptcy estate?
9. What is the automatic stay in bankruptcy?
10. What is a claim by creditors of the bankruptcy estate?
11. What is voluntary and involuntary bankruptcy?

CHAPTER 7 and CHAPTER 11 BANKRUPTCY

12. What is the “Chapter 7” bankruptcy process?
13. What is the Chapter 11 bankruptcy process?
14. What is the authority of the debtor in possession?
15. What is appointment of a trustee or examiner?
16. What is a plan of reorganization?
17. What is “cramdown” of a reorganization plan?
18. To what extent does the bankruptcy process relieve a debtor’s debts?

Topic 22: Environmental Law

1. What are “environmental laws”?
2. What is the structure of environmental protection law?
3. What is the Environmental Protection Agency?
4. How are the environmental laws enforced?

MAJOR ENVIRONMENTAL PROTECTION LAWS

5. What is the National Environmental Policy Act of 1970?
6. What is the Clean Air Act?
7. What is The Clean Water Act?
8. What is the Endangered Species Act of 1973?
9. What federal laws control pesticides?
10. What laws govern solid waste disposal?
11. What is the Toxic Substance Control Act of 1976?
12. What is the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)?

Topic 23: Intellectual Property

1. What is intellectual property?
2. What is the purpose behind granting ownership rights in intellectual property?
3. What does an individual have to do to capture intellectual property rights?

TRADE SECRETS

4. What are trade secrets?

PATENT RIGHTS

5. What are patents or patent rights?
6. What are the primary types of patents?
7. What are the general requirements for an invention or discovery to be capable of patent protection?
8. What are the specific requirements for a creation to receive design patent protection?
9. What are the specific requirements for a creation to receive utility patent protection?
10. What is the process and information necessary for securing patent rights?
11. What is a provisional patent application?
12. What is the process for enforcing one’s patent rights?

TRADEMARK LAW

13. What is a Trademark?
14. What are the types of trademarks?
15. What is required to secure trademark protection?
16. What is the “distinctiveness” requirement for trademark rights?
17. What is the process for determining whether a descriptive mark is sufficiently distinctive?
18. What is Federal Registration of a Trademark (Lanham Act)?
19. What is trademark protection under state law?
20. What are the primary reasons for denying claims of trademark rights?
21. What are common trademark designations used to indicate a claim of trademark rights in a mark?
22. What is the process for filing a federal trademark registration?

- 23. What is trademark infringement?
- 24. How does an individual enforce Trademark Rights?
- 25. How does a trademark holder demonstrate infringement of its trademark?

COPYRIGHT LAW

- 26. What is a “copyright”?
- 27. What are the rights of the holder of a copyright?
- 28. What are the requirements for establishing copyrights?
- 29. How long does a copyright last?
- 30. What is the process for registering a copyright?
- 31. Who can claim copyright protection?
- 32. What is infringement and how does one enforce a copyright against infringement?
- 33. What defenses are available to a copyright infringement action?
- 34. How does a court determine if use of a copyright constitutes “Fair Use”?
- 35. What is the “First Sale Doctrine”?
- 36. What international protections exist for intellectual property rights?

Topic 24: Insurance Law

- 1. What is “insurance”?
- 2. What is an “insurance contract”?
- 3. What is an “insurable interest”?
- 4. What are the common categorizations of insurance
- 5. What are the common types of insurance coverage?
- 6. What are the primary obligations of the insurer?
- 7. What are the primary obligations of the insured?
- 8. What is the general structure of an insurance contract?
- 9. What are the common provisions in an insurance contract subject to legal dispute?
- 10. What is required for termination of an insurance contract?

Topic 25: International Law

- 1. What is “international law”?
- 2. What are the types of international law?
- 3. What are the major international governmental organizations?
- 4. What international courts exist and what are their functions?

INTERNATIONAL BUSINESS AND THE LAW

- 5. What are the methods of carrying on international business?
- 6. What are the legal risks associated with carrying on international business?
- 7. What major international agreements affect international trade?
- 8. When is carrying on business in a foreign country prohibited under US Law?
- 9. What is the significance of boycotts between foreign countries?
- 10. What US laws apply to limit specific business practices in all foreign countries?

IMPORTING AND EXPORTING GOODS

- 11. What regulations apply to exports from the United States?

12. What are the limitations on importing goods into the United States for sale?
13. How are private international business agreements generally enforced?
14. How do parties determine the rules, location, and method of resolving a dispute under an international agreement?

TOPIC 1: LEGAL THEORY & FOUNDATIONS

Overview

This chapter provides an understanding of how law and the legal system establishes the foundation for a functioning economy. It explores how law originates and focuses on key principles that underlie the legal system. Notably, this chapter discusses the concepts of property, ownership, and enforcement of one's ownership rights. This brings into consideration the role the law plays in the economic prosperity of a nation. We introduce the two types of legal systems that exist in the United States — the common law and civil law systems — and explain how the common law system is organized. This includes explaining the difference between public and private law. Lastly, we explore the sources of law and the role that the judiciary plays in the US legal system.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• <u>Law</u>	• <u>Justification for Property</u>	• <u>Civil and Criminal Law</u>
• <u>Rule of Law</u>	• <u>Promoting Property Rights</u>	• <u>Substantive and Procedural Law</u>
• <u>Law & Economic Strength</u>	• <u>Jurisprudence</u>	• <u>Sources of Law</u>
• <u>Law and Property Rights</u>	• <u>Common & Civil Law</u>	• <u>Role of the Judiciary</u>
• <u>Ownership</u>	• <u>Public and Private Law</u>	• <u>Law & Business</u>
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TOPIC 1: LEGAL THEORY & FOUNDATIONS - QUESTIONS & ANSWERS

1. What is “law”?

The common understanding of law is that it consists of rules and regulations established and enforced by a governing body. In the United States, the governing body is a combination of federal, state, and local governments. While the above definition is accurate, it is important to understand the source or genesis of societal law. Laws are also commonly understood as manifestations of societal norms or beliefs. That is, if society believes that certain rights or procedures should be in place, the representative lawmakers act to bring about a rule effectuating that societal norm in pursuit of the orderly administration of that society.

- *Note:* In Old England, individuals unable to obtain an adequate remedy at law could petition the King directly for justice. This was known as a court of “equity” or “in chancery”. The King would order an outcome that was fair in light of the absence of a legal remedy. The King was said to act in equity. Equity or the power to do equity still exists in courts today. It exists independently but works in concert with the law to deliver justice.
- **Discussion:** Individuals living in certain parts of the country may be familiar with laws prohibiting the purchase of alcohol on certain days of the year. In the southeastern region of the United States, many local governments prohibit the purchase of alcohol on Sundays. These laws, commonly known as “blue laws”, reflect the local community’s sentiment regarding the sale of a controversial item on a day that is sacred to Christians. Many of these communities have members with religious beliefs other than Christianity (e.g., Judaism, Islam, Buddhism, Hinduism, Universalism, etc.). Nonetheless, the dominant community belief results in a societal norm or belief that becomes law through the actions of the representative government. Take a moment to think about other laws that are a reflection of societal norms. For example, think of the things individuals do every day, such as driving, purchasing property, getting married, entering into contracts. For a more in-depth discussion, ask yourself why do states regulate the trade of securities on public markets?
- **Resource Video:** <http://thebusinessprofessor.com/law/>

2. What is “jurisprudence”?

Jurisprudence generally refers to the ideas or philosophies of law that have developed. Understanding the philosophy behind the existence of law is important for understanding: 1) the justification for legislation, and 2) the judicial reasoning applied when interpreting laws.

- *Natural Law* – This legal philosophy relies on reason drawn from perceived universal moral principles in order to explain laws. It assumes that some values or beliefs are universal due to a common human nature and the ability to reason. Natural law theorists often cite the Declaration of Independence (stating “the separate and equal station to which the Laws of Nature and of Nature's God entitle them”), to support the Founders’ belief in natural law.
- *Positive Law* – This legal philosophy looks at laws as the legal standards of conduct outlined by governments. It does not look at the natural existence of standards leading to law; rather, it focuses on the objectives outlined by the governing body. Rather than occurring naturally, law and the rights resulting therefrom are the result of human

insistence.

- *Historical Law* – This view recognizes law as the embodiment of human cultures and traditions. Like natural law, it focuses on the influence of nature, logic, ethics, and religion on law. It focuses on a historical understanding of right and wrong in society.
- *Sociological Law* – This legal philosophy sees law as an ever-evolving embodiment of societies beliefs. Particularly, it focuses on the interaction between law and societal norms. Law has evolved over time in relation to the influences on society, such as cultural, social, political, and economic factors. In turn, this philosophy recognizes that law and social interaction develop in concert and influence each other. As such, law is only partially distinct from these influences.
- *Legal Realism* – This philosophy goes behind the legal principle to look at what the administrators of law do or are thinking as they carry out their roles. It posits that laws (particularly common law) are subjective. The development of law is based upon the predilections of state and federal lawmakers and judges. As such, legal reasoning is not separate from the ethical, moral, social, and political beliefs of those charged with making and interpreting the law.

The above examples of legal philosophy are commonly recognized examples of the theoretical underpinnings of legal reasoning. Individuals may employ or be influenced by any of these philosophical approaches when confronted with any type of law.

- **Discussion:** Ask yourself, what is the legislatures purpose and beliefs that drove/drive the drafting of the relevant law? Further, what judicial philosophy does an appellate judge employ when interpreting statutes (developing the common law)?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-jurisprudence/>

3. When is a state economically strong or weak and what is the role of law in this determination?

Economists use a number of factors to determine the size and economic strength of a state. The most common of these measures are gross domestic product (GDP) and the purchase power parity (PPP) between currencies. GDP represents "an aggregate measure of production equal to the sum of the gross values added of all resident, institutional units engaged in production (plus any taxes, and minus any subsidies, on products not included in the value of their outputs)." In contrast, PPP normalizes currencies and compares the purchasing power of each at a given point. One other measure of economic productivity is the *per capita* income of the individuals within the state. Taken together, these metrics help leaders or planners take action to maintain or improve conditions within the state. Important for this course, we focus on the role of law in the economic development of a state.

A commonly accepted theory about the economic strength of a nation regards the influence of law and the legal system. Many theorist believe that a strong legal system is the foundation for a functioning economy. That is, a strong legal system, through the clear delineation of individual rights and enforcement methods, provides confidence to individuals when undertaking productive activities. In nations with such a system, individuals will trade or undertake transactions with the confidence that they can enforce their rights against the other party. Not having to take extensive measures to protect her interests lowers transaction costs associated with an activity. The result is more and continued business

relationships.

- *Example:* An individual or business may lend you money without taking physical possession of your belongings to secure payment of the debt. In the event you fail to pay the debt, the lender can use legal channels to recuperate the funds lent. This confidence allows you to possess and make productive use of the property while you are paying for it.
- **Discussion:** How big is the US economy in terms of GDP? Which country has the largest GDP? Which country has the largest economy based upon PPP? Have you ever thought about what is happening when you purchase a share of stock in a corporation? Let's use Apple, Inc. (Apple), as an example. Suppose you go to a stockbroker and request to purchase one share of Apple stock. You are effectively giving over some form of currency in exchange for a piece of paper that says you own a given percentage of the Apple. You may have never seen the Apple headquarters and you may be completely unaware of the assets that Apple owns. Nonetheless, you feel confident in exchanging your currency for this certificate of ownership with the understanding that you will be able to enforce any rights granted by that piece of paper. If the share entitles you to vote for corporate directors, you have a means and method of enforcing that right. If the piece of paper entitles you to a dividend from corporate earnings, you can enforce that right against the corporation. A strong legal system provides the security one desires when purchasing an interest in a corporation. In turn, Apple uses your invested funds to trade or undertake transactions. This sort of economic activity strengthens the economy. Would any of this be possible if you and the millions of other owners of Apple stock did not have the confidence to purchase that piece of paper?
- **Resource Video:** <http://thebusinessprofessor.com/law-and-economic-strength/>

4. What is the “rule of law”?

The rule of law is the orderly passage and execution of laws by a governing body. In the United States, a representative democracy, laws exist to serve or represent the interests of the greatest number of people. Enforcement of the law is done to both maintain order within the community and to create a system in which individuals can be productive. An important aspect of the rule of law is that it applies uniformly to all individuals. That is, the law is not applied selectively to some individuals and not others. If laws are applied generally to all individuals, there is little reason or motivation for the use of law to oppress or gain advantage over others. A functioning rule of law system is essential for economic productivity. Again, the just and uniform application of law across the population creates trust and confidence. Individuals can rest assured that their rights will be protected through the elimination of any unfair advantages or disadvantages to individuals under the law.

- **Discussion:** Imagine a society where the law applies differently to different individuals because of status, wealth, demographic characteristics, etc. For example, Tom could enter into an agreement with Anna and blatantly breach that agreement with no repercussions or method for Anna to enforce her contractual rights. In contrast, if Anna were to breach the agreement, Tom could seek redress and Anna could suffer negative repercussions under the law. This is a common occurrence in countries with weak rule-of-law systems. In such countries, individuals in power manipulate the law to the advantage of certain individuals or classes of people over others. In the business context, such occurrences result in a lack of confidence by those disadvantaged individuals in taking part in commercial activity. Looking back on the history of the United States, can you think of examples of movements to strengthen the rule of law? *Hint:* Look up the Civil Rights and Women's Suffrage Movements.

- **Practice Question:** Jane is a diplomat. She is participating in a presentation to a judicial figure in a rebuilding Middle-Eastern country. When explaining the role of each branch of government in the United States, the judicial official asks the following questions. “The Supreme Court may do away with a law that it believes treats certain people unfairly? What if the President wants to continue to enforce that law? How can a court with nine members order the commander of the military to do something?” Can you respond to these questions in a way that summarizes the US system’s dependence upon the rule of law?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-rule-of-law/>

5. What is “property law” (or property rights)?

Most people understand property to be a physical item. The definition of property, however, is far broader than something that you can see or hold in your hand. Property is, more precisely, an individual’s rights with regard to something in existence. Property includes all of the commonly understood rights associated with physical or intangible things, such as: the right of possession (to the exclusion of others), the right of use, the right to sell or transfer, or the right to destroy.

- **Example:** The writer of a book can hold the book in her hands. The book is a form of property. The owner of the copyright possesses the exclusive right to sell or license those rights to third parties for use or production. She also has the ability to prevent others from copying, selling, or licensing that book. The copyright extends far beyond the physical book to include the content within the work. In this sense, it is more of a right to something that has been created, rather than the possession of a physical asset.
- **Discussion:** Try comparing the concept of property (or those rights you possess in something in existence) to any form of ownership interest in property. Is your home or car property? Is your pet property? Is a stock certificate in Apple, Inc. property? Is a patent on a new invention property? Is a secret recipe property? Is an easement on someone else’s land property? Is a membership to a gym property? Is a stream running through your back yard property? Is the server space dedicated to hosting your website a form of property?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-property/>

6. What is “ownership”?

Ownership is a concept closely related to property. It is the legally recognized and enforceable rights that a person has to property. This concept is important because it is possible to possess property and not own it. For example, you find a valuable item on the side of the road and you cannot determine the owner. You possess the property, but you do not own it. Likewise, it is possible to own property and not possess it. Think of a situation in which you lend one of your physical possessions to a neighbor. Your neighbor has possession of the property, but you retain ownership. Ownership of property (or the bundle of rights that is property) is a form of legally provided assurance. The legal system affords the owner a claim of right that cannot be infringed upon by others without violating the law. Violating or infringing upon one’s property rights allows the property owner to use legal channels to enforce her rights (e.g., the police or court system).

- **Note:** Within the legal system, property is often classified based upon who owns it. For example, property may be “public property” (resources owned by the government) or “private property” (resources owned by an individual)

or entity). This classification will be important later when discussing the extent of property rights.

- **Discussion:** What would you do if someone were to break into your house and take some of your physical assets? Most people answer, “I would call the police”. This is an example of using the legal system to enforce your property rights. The law allows for the ownership of those rights. Now, what would you do if someone borrows and alters a piece of machinery that you own and it no longer works? What would you do if you wish to sell one of your physical assets, but the sale falls through because someone has erroneously filed a notice of lien (ownership interest) indicating that they have ownership rights to the property? What would you do if someone distributed pictures of you to advertise her product or began earning money by playing a song you wrote? Each of these questions offers unique situations where the legal system recognizes your ownership and protects your property rights.
- **Resource Video:** <http://thebusinessprofessor.com/purpose-of-ownership-rights-in-property/>

7. Why would a system establish ownership of property rights?

There are numerous theories regarding the reason or justification for the legal system recognizing property ownership rights. Some theories adopt a pessimistic view of human nature and the intentions of those to exclude others from their resources. Other less cynical theories attribute ownership rights with incentivizing individuals to undertake activities that benefit society at large. That is, ownership of property incentivizes individuals to increase productivity and create new resources, which ultimately benefits society.

- **Discussion:** These theories underlie two contrasting, yet common, forms of government: Communism and Capitalism. Communism centralizes control of property in the governing body. For example, Cuba is a communist state that is familiar to most Americans. In Cuba, the government retains membership of land and industry. How do you think this form of government affects individual and business productivity? The United States, in contrast, is a capitalist system that seeks to promote or incentivize private wealth among individuals. How do you think this form of government affects individual and business productivity? Take some time to think about these two forms of government and how their concept of property ownership differs.
- **Resource Video:** <http://thebusinessprofessor.com/justification-for-recognizing-property-rights/>

8. How does law or the legal system protect or promote property rights?

The Constitution (and all amendments thereto) provides the basic structure for the Federal Government. It also delineates the rights of all US citizens. These rights can be viewed as a form of property that is protected against government infringement. The structural provisions of the Constitution allow for the establishment of a legal system that further protects and promotes individual rights. The federal, state, and local governments create and enforce laws that flow from these protections.

- *Criminal law* - Seeks to protect the property of individuals from harm by others.

- *Example:* Think of your state's criminal statutes regarding theft and vandalism.
- *Contract law* - Allows for the formalization of relationships between individuals.
 - *Example:* A breach of contract actions allows individuals to enforce the rights established through contract.
- *Tort law* - Allows for the remediation of or recover for harm to property suffered due to the actions or inactions of others.
 - *Example:* Individuals can sue others for intentionally or negligently harming them or their property.
- *Property Law* - Allows for the recognition of ownership rights. Also, the legal system affects property rights through the recognition of business entities. Business entities are organizational forms that have an existence separate and independent from the owners or employees of the entity. Allowing the formation of entities to carry on commercial activity has a wealth-spreading effect that allows individuals to more effectively undertake commercial activity.

- **Discussion:** Can you think of specific examples of how executive actions, criminal laws, tort laws, contract laws, or laws of business entities serve to protect property rights?
- **Resource Video:** <http://thebusinessprofessor.com/why-does-the-legal-system-promote-property-rights/>

9. What are the “common law” and “civil law” systems?

Two legal systems exist within the United States, the common law system and the civil law system. Forty-nine of the fifty US States exclusively follow the common law system. Louisiana is the one US state that recognizes common law and civil law systems. Despite the dominance of the common law system within the United States, it is important to understand the civil law system - as many foreign legal systems are based in civil law.

- *Civil Law System* - The civil law system is “code-based”. The law-making body seeks to address specific areas of law through statute or codified rules. When a case comes before a court, the judiciary is charged with interpreting the codified rules when applying those rules to the facts of the case. This process is similar to that of the common law system. The difference lies in the effect of the judiciary's interpretation of the law. While the court's decision may be influential in future cases, its reasoning and interpretation of the law have little legal effect outside of the respective case. The judicial interpretation does not constitute “precedent” that binds the court (or any subordinate courts) in future trials.
- *Common Law System* - The common law system, in contrast, centers on the judicial interpretation of statutes. That is to say, courts interpret statutes to determine the intent of lawmakers in passing the law. This interpretation guides how the statute is to be applied in a given context. Appellate review of legal cases provides opportunity for the judiciary to write opinions explaining how the law should be applied. These opinions serve as precedent for the court and any subordinate courts within that jurisdiction. In Latin, this is known as “*stare decisis*” or “let the decision stand”. The court's interpretation becomes the common law in that jurisdiction. In this way, the court

develops a body of common law that applies alongside the statute.

- **Discussion:** What do think are some of the advantages of the civil law system? What about the common law system? Try to identify some countries follow a common law system similar to that of the United States? Try to identify some countries that follow a civil law system similar to that of Louisiana.
- **Resource Video:** <http://thebusinessprofessor.com/common-law-vs-civil-law-systems/>

10. What is the difference between “public law” and “private law”?

The distinction between public law and private law concerns who the law directly governs or affects.

- **Public Law** - Public law consists of laws aimed at regulating the function of society. The main areas of public law are constitutional law, administrative law, and criminal law.
 - *Constitutional law* - Centers on the determination of whether government action (either federal or state) somehow interferes with the rights granted to individuals under the Constitution.
 - *Administrative law* - Concerns the laws and procedures developed by administrative agencies to regulate a particular subject matter.
 - *Criminal law* - Concerns the rules prohibiting bad acts that the state directly enforces against individuals.
- **Discussion:** How does an appellate court protect the constitutionally granted rights of individuals against infringement? Try to think of examples of how federal and state administrative agencies enforce laws? Who brings charges against an individual who violates a criminal statute?
- **Private Law** - Private law concerns the legal relationships between individuals. The main areas of private law are property law, contract law, and tort law.
 - *Property law* - Centers on the ownership rights of individuals with regard to tangible or intangible assets.
 - *Contract law* - Regards the ability of individuals to form and enforce agreements.
 - *Tort law* - Protects the rights of individuals against infringement by other individuals.
- **Discussion:** How is it possible that individuals can have rights in things to the exclusion of others? What are some examples of property rights? What allows individuals to enter into business transactions with others? What is the effect if the parties have no confidence in the other party complying with their obligations under an agreement? What is the effect of being able to enjoy one's right with or without fear of infringement by others?

- **Practice Question:** Richard has a business and needs capital for expansion. He decides to sell an interest in his business to public investors to raise capital. He realizes that his company's performance may not be attractive to most investors, so he alters his financial statements to drastically inflate its apparent profits. Richard sells shares of his business to investors for a total of \$100,000. In doing so, he fails to follow federal and state securities filing and disclosure laws. If the Securities and Exchange Commission brings a civil action against Richard, is this an example of public or private law? Is it a public or private action if the investors bring a legal action against Richard to recover their invested funds?
- **Resource Video:** <http://thebusinessprofessor.com/public-law-vs-private-law/>

11. What is “civil law” and “criminal law”?

Do not be confused by the various uses of the word civil within the legal system. Civil law may refer to a system of law, but it generally refers to civil actions — which are legal actions between individuals. In this case, it means suing or bringing a lawsuit against an individual, a business, or a governmental body. Criminal law, in contrast, refers to the rules and procedures for enforcing those rules prohibiting “bad acts” of individuals within the governing body's jurisdiction. While civil actions seek compensation for losses or an order from the court restricting certain conduct, criminal actions seek to punish individuals for violating a criminal law. Often, an individual's actions will subject her to a criminal prosecution by the government as well as a civil action by an injured party.

- **Discussion:** What are some types of criminal activity that are also civil causes of action? Can you think of any examples of criminal prosecutions that resulted in acquittal in a criminal trial but resulted in liability in a civil lawsuit?
- **Practice Question:** Anne-Marie is generally a likable person. One day while hanging out with her friends, she gets into an argument with Wilson. During the argument, he says some very offensive and slanderous things about Anne-Marie. Unwilling to take Wilson's verbal abuse, Anne-Marie sprays him in the face with a can of mace that she carries in her purse. Wilson falls to the ground in pain. Some bystanders see Wilson in pain and call the police and rescue squad. It turns out that Wilson suffers severe damage to his sight because of the caustic spray. Because of the incident, Anne-Marie ultimately serves 30 days in jail and is forced to pay a judgment to Wilson for \$50,000. Is Anne-Marie's punishment a result of criminal law, civil law, or both?
- **Resource Video:** <http://thebusinessprofessor.com/civil-law-vs-criminal-law/>

12. What is “substantive law” and “procedural law”?

A substantive law defines a legal relationship or prohibits certain conduct. That is, it says what you can or cannot do. For example, a state that says, “though shalt not steal”. This would be a substantive law. Procedural law, on the other hand, dictates how the substantive law is administered or carried out. For example, a state statute reads, “an individual has 30 days to file a response to a civil complaint.” This is a procedural law dictating how to carry out a civil action.

- **Discussion:** What type of law says that you cannot intentionally take someone else's property? What type of law

says that you have to file a legal action, if at all, within 2 years of learning of the tortious conduct (legal violation)?

- **Resource Video:** <http://thebusinessprofessor.com/substantive-and-procedural-law/>

13. What are the sources of federal, state, and local law?

The Constitution is the supreme law of the land. Congress passes federal acts made up of statutes that are published in the Federal Code of Statutes. Federal agencies pass administrative regulations as the procedural rules for executing the statutes. These regulations are published in the Code of Federal Regulations. Congress authorizes treaties with foreign nations and the President issues executive orders that also have the force and effect of law. State legal systems are quite similar to the federal legal system. State law is derived from the State's Constitution. State legislatures pass statutes and administrative agencies adopt regulations to carry out these statutes. States authorize local governments to pass local ordinances and to enforce state law. In state and federal systems, the judiciary provides appellate opinions that have the same legal force in that jurisdiction as the laws being interpreted. In terms of legal priority, federal law is superior to state law, and state law is superior to local law. The state may regulate any area of law not specifically reserved to or preempted by federal law. State constitutions specifically designate the areas of law that localities can regulate.

A list may help you to visualize the hierarchy of federal, state, and local laws:

- US Constitution and Amendments
- Federal Statutes & Common-Law Interpretations
- Federal Regulations
- Treaties & Executive Orders
- State Constitutions
- State Statutes & Common-Law Interpretations
- State Regulations
- Local Ordinances

- **Discussion:** What are some areas of federal law? What are some areas of state law? Can you think of some areas of law that are regulated by both state and federal governments? Can you think of a situation in which state and federal laws conflict? (Hint: Think about employment law and immigration law.)
- **Resource Video:** <http://thebusinessprofessor.com/sources-of-federal-state-and-local-law/>

14. What is the role of the judiciary in the legal system?

The judicial branch is charged with adjudicating disputes under the law and reviewing the laws passed by the legislative branch and executed by the executive branch. Below is a step-by-step synopsis of the role played by the judiciary in the legal system and an introduction to how the judiciary is a check on the power of the legislative and executive branches:

- **Step 1: Trial Court** - Federal and state trial courts serve as the mechanism for enforcing the law. The government enforces criminal laws against individuals (including businesses) and individuals enforce their rights against other

individuals. The trial judge enforces the procedural laws governing the trial process (such as the timing and presentation of evidence) and instructs the jury on the substantive law to be applied in a case. The jury is the fact-finder and determines a defendant's guilt or liability. In some trials the judge will also serve as fact finder.

- *Note:* Some courts do not allow parties a jury trial. Also, a defendant may choose to forgo the right to jury trial and have the judge act as fact finder.
- *Step 2: Appellate Court* - Once a trial jury renders a verdict and the trial is complete, the parties have the opportunity to file an appeal. An appeal will generally allege the trial court's erroneous application of procedural or substantive law or that the law applied in the case is unconstitutional. The appellate court will review the request for appeal and decide whether the case merits review. If the appellate court opts to review the case, any opinion rendered by the court becomes precedent for the court and all subordinate courts in that jurisdiction. If the court determines that a law was applied incorrectly or that it violates a party's constitutional rights, the case (or part of the case) may be overturned and remanded to the trial court. The parties may then retry the case, applying the appellate court's interpretation of the law.
 - *Note:* The appellate court may modify the trial court's judgment or sentence without remanding the case.
- *Step 3: Supreme Court* - The US Supreme Court has "original" and "exclusive" jurisdiction to hear any disputes or controversies between states. It has original, but not exclusive, jurisdiction to hear: cases where ambassadors, public ministers, or consuls of foreign states are a party; disputes between the US Government and a state government; and actions by a state against citizens of another states. In this role, the Supreme Court serves the function of a trial court. In practice, the Supreme Court rarely exercises its original jurisdiction. Rather, it primarily serves as the appellate court for all Federal Circuit Courts of Appeal and any state supreme court. The US Supreme Court will only hear appeals of state supreme court decisions that allegedly violate the appellant's constitutional rights. In most states, the state supreme court acts as a second level of appeal and hears cases appealed from the intermediate state appellate court. Some states do not have an intermediate appellate court. In such cases, the state supreme court acts as the appellate court for all trial court decisions. The state supreme court (state cases) or US Supreme Court (federal cases) may direct that a trial court decision be appealed directly to it. This procedure skips the appellate court stage.
 - *Note:* The state supreme court determines if a state law violates individual rights under the US Constitution or the state's constitution. If either State or Federal Supreme Court finds a law or application of a law to be unconstitutional, it can remand the case back to the subordinate appellate court for continued review or overturn the case (or part of the case) and remand it back to the trial court.

The judiciary ensures that the laws passed by the legislative branch do not run afoul of the rights granted to individuals under the Constitution. Further, it checks the execution of those laws by the executive branch. A law that is found to be unconstitutional is struck down. Congress may then go through the process of drafting a new law. Likewise, if an executive action is deemed unconstitutional, the executive must develop a new manner of executing the law that falls within the guidelines of the court's decision.

- **Discussion:** Can you think of any laws that have been overturned by the state or US Supreme Courts? What constitutional right(s) did the court find that the law violated?

- **Practice Question:** What is the role of the trial court? What is the role of the appellate court? What is the authority of the US Supreme Court to hear cases?
- **Resource Video:** <http://thebusinessprofessor.com/role-of-the-judiciary-in-the-legal-system/>

15. What effect does the legal recognition of business entities have on the conduct of business?

Business entities exist pursuant to state laws recognizing their existence. They are efficient mechanisms through which to carry on business. They allow for greater economic productivity and this provides an overall benefit to society. The business entity is generally considered to be separate being from its owners or employees. The concept is commonly known as “corporate personhood”. Businesses have rights similar to those of individuals that cannot be infringed. Likewise, businesses cannot infringe upon the rights of others without facing criminal or civil liability. A business acts through its agents (owners, directors, employees, etc.) and can enforce its rights or be found liable or guilty in civil or criminal proceedings. Because of the unique nature of business entities, the government undertakes considerable efforts to prevent the use of business entities to harm individuals. Much of the material covered in this text focuses on the laws and regulations that the government uses to control the activity of businesses and the individuals associated with those businesses.

- **Discussion:** What rights do businesses have that are similar to those of humans? What are some of the laws that just apply to businesses? How can business entities cause harm to the economy? What role did businesses have in the financial collapse of 2008? What role did individuals have in the collapse?
- **Resource Video:** <http://thebusinessprofessor.com/legal-system-allows-for-business-entities/>

TOPIC 2: US CONSTITUTION

Overview

The US Constitution is the supreme law of the United States. It provides the framework for our Federal Government and is the model for state governments. It establishes certain individual rights and provides protection against government interference with those rights. It also provides the authority for the federal and state governments to pass laws governing individuals and property. This chapter will review the major provisions (Articles) of the Constitution that establish the framework for the legal system. It will explore the dichotomy between federal and state governments and touch on the major constitutional protections of individual rights — primarily contained in the Bill of Rights and subsequent Amendments. Notably, it will explore the procedural protections for those made subject to the legal system. Lastly, it will explain the government's authority to pass laws and the standards that apply when determining the legality of the laws they pass.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

- [US Constitution](#)
 - [Separation of Powers](#)
 - [Checks and Balances](#)
 - [Legislative Branch](#)
 - [Executive Branch](#)
 - [Judicial Branch](#)
 - [Federalism](#)
 - [Supremacy Clause](#)
([Preemption](#)).
 - [Full Faith & Credit Clause](#)
 - [Privileges & Immunities](#)
[Clause](#)
 - [Commerce Clause](#)
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 - [Contract Clause](#)
 - [1st Amendment](#)
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 - [Business & Freedom of](#)
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 - [Commercial Speech](#)
 - [Defamation and Speech](#)
 - [Political Speech](#)
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 - [5th Amendment](#)
 - [Due Process Clause](#)
 - [Incorporation Doctrine](#)
 - [Equal Protection Clause](#)
 - [Constitutional Standard of](#)
[Review](#)
 - [Strict Scrutiny](#).
 - [Quasi-strict Scrutiny](#)
 - [Rational Basis Review](#)
-

TOPIC 2: US CONSTITUTION - QUESTIONS & ANSWERS

1. What is included in the US Constitution?

The US Constitution is divided into seven articles. Article I, II, III establish the governance structure of United States. Article I establishes two legislative bodies, the House of Representatives and the Senate, to make the laws to govern the nation. Article II establishes the executive branch, which is led by the President, to enforce laws. Article III establishes the judicial branch of government to review the constitutionality of laws and their execution. Since its passage, the Constitution has been amended 27 times. Most of these amendments serve to protect individual rights, known as “fundamental rights”, against government infringement. Perhaps the best-known constitutional rights are stated in the first ten amendments to the US Constitution, which make up the Bill of Rights. The 14th Amendment, arguably the most important amendment, extended the protections afforded individuals under the Constitution by applying those provisions to state governments. Notably, the 14th Amendment introduced the Due Process and Equal Protection Clauses.

- *Note:* The Constitution protects against government infringement of individual rights. It does not protect against infringement by individuals.
- **Discussion:** Do you think that the brevity of the Constitution is positive or negative? Why do you think the document is concise? Do you believe that the Constitution should be subject to amendment? If so, under what conditions should the Constitution be amended?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-included-in-the-us-constitution/>

2. What is the “Separation of Powers”?

The Constitution divides the US Government into the following three separate-but-equal branches.

- Legislative Branch (Article I) – House of Representatives and Senate (collectively, “Congress”)
- Executive Branch (Article II) – President
- Judicial Branch (Article III) – US Supreme Court

- **Resource Video:** <http://thebusinessprofessor.com/separation-of-powers/>

Checks and Balances - The government is structured as a checks-and-balance system whereby each branch independently checks the authority of the other branches. This system prevents any branch from becoming too powerful and eroding the rights of citizens. Below is brief description of how each branch checks the authority of the other branches.

- **Resource Video:** <http://thebusinessprofessor.com/checks-balances-us-system/>

- *Legislative Branch* - This branch of government passes laws that guide the executive branch in the execution of the law. Congress must approve the executive branch's budget and certain presidential appointments to high-level administrative positions. The US House of Representatives retains the authority to impeach (bring charges against) the President for misconduct committed while in office. Further, the US Senate has the authority to determine the merits of the impeachment and render judgment. Congress checks the power of the judiciary by passing laws that supersede or replace the existing common law developed by the judiciary. Lastly, Congress must approve the President's nomination of an individual for appointment to federal judicial positions, including the US Supreme Court.

- **Resource Video:** <http://thebusinessprofessor.com/legislative-branch-law/>

- *Executive Branch* - The executive branch is controlled by the President of the United States. This branch checks Congress's authority through the power to veto (strike down) legislation. When Congress presents the President with an approved bill to sign into law, the President can sign it, not sign it, or veto it. Signing it or failing to sign it will result in the bill becoming law. Vetoing the law strikes it down. Congress can only override a veto with a two-thirds (2/3) majority vote of both the House and Senate. The President, in turn, may selectively enforce laws that are within the executive branch's regulatory authority. Selective enforcement has the effect of reducing the impact of a law passed by the legislative branch. Lastly, the executive branch checks the judicial branch by nominating members to the federal judiciary and through the power to pardon those convicted under certain criminal statutes.

- **Resource Video:** <http://thebusinessprofessor.com/executive-branch-law/>

- *Judicial Branch* - The judicial branch checks the legislative branch by reviewing laws for constitutionality. Any law is subject to challenge on the grounds that it violates rights ensured under the US Constitution. The judicial branch also checks all executive orders or actions for constitutionality. In either case, it has the ability to overturn unconstitutional laws and executive orders or actions. Further, the court can limit the scope of a law by narrowly or broadly interpreting it in a manner that does not infringe upon constitutional rights.

- **Resource Video:** <http://thebusinessprofessor.com/judicial-branch-law/>

- **Discussion:** How many bills last year did Congress present to the President to sign into law? How many times did the President exercise his veto authority? Can you provide an example of a federal law that was overturned by the US Supreme Court? An executive action overturned by the US Supreme Court? Can you think of an example of a law that was narrowly or broadly interpreted to either limit or expand the breadth of the law?
- **Practice Question:** Congress passes a bill in the House and Senate and sends it to the office of the President for signature. What happens if the President does not want to sign the bill into law? By what method can the bill still

become law? What if the President signs the bill into law but refuses to enforce the law in accordance with its terms? Is there any method or remedy for challenging the President's failure to enforce the law in accordance with its provisions? What happens if the President signs the bill into law, but the law seems to burden or infringe upon the Constitutional rights of a group of US citizens? What methods and authority exist for challenging the validity of the law?

3. What is “Federalism”?

Federalism regards the separation between a central government and independent governmental sub-units. In the US system, federalism is the separation between the federal and state governments. The Constitution, under the 10th Amendment, specifically reserves power of self-governance to the states. This includes the authority to pass laws. For the Federal Government to pass a law, it must be based on a specific power or authority granted under the Constitution. States pass laws pursuant to their state constitutions and the “police power” inferred from the 10th Amendment. Police power is a state's authority to legislate for the public safety, health, general welfare, and morals of its citizens.

- **Discussion:** Can you identify any conduct that is almost entirely regulated under State law? Federal law?
- **Resource Video:** <http://thebusinessprofessor.com/federalism-us-system/>

4. What is the “Supremacy Clause” and “Preemption”?

Article VI, Section 2 of the US Constitution provides that the Constitution is supreme over all laws and that federal law is supreme over state law. Generally, the state and federal governments may regulate the same type of conduct. This is known as “concurrent power”. However, any state law that prevents or interferes with the accomplishment and execution of the full purposes and objectives of Congress is invalid. Congress can expressly reserve an entire area of law for federal regulation. In such a case, the federal law “preempts” state law. If Congress does not expressly reserve the area of law for federal regulation, the state may also regulate it. State appellate courts or the US Supreme Court may review a state law and overturn it if it determines that the law conflicts with or violates a federal law.

- **Note:** Generally the state law can be more restrictive than the federal securities law.
- **Example:** The Federal Government regulates the immigration process. It expressly preempts states regulating this area of law. The Federal Government also regulates the purchase and sale of securities. States are not preempted from regulating the purchase or sale of securities, but a state law may not conflict with or prohibit the accomplishment of federal law.

- **Discussion:** Can you think of any recent state laws that were struck down because they conflicted with federal law? Can you think of any areas of law that are regulated by both state and federal law?
- **Practice Question:** The Federal Government passes a statute that regulates certain business practices. Specifically, it requires businesses to seek federal approval through a licensing process. The law does not include a provision that specifically prohibits states from also regulating this conduct. Arizona determines that it wants to regulate this same activity by states within its borders. So, it passes a state statute that requires businesses to also seek a state

license prior to undertaking the cover practice. Is this permissible? What if the state is far more stringent than the federal statute? Less stringent? Can the state require that a state license issue before a business may apply for a federal license?

- **Resource Video:** <http://thebusinessprofessor.com/supremacy-clause-us-constitution/>

5. What is the “Full Faith and Credit Clause”?

Article IV, Section 1 states, “Full faith and credit shall be given in each state to the public Acts, Records, and judicial proceedings of every other state.”

- *Example:* State A issues a warrant for the arrest of Jane Smith. If the arrest warrant is transferred to State B for execution, State B may not intentionally fail to recognize the validity of the State A’s warrant.

Restated, Article IV requires that each state recognize the laws of every other state. The only exception to this rule concerns laws that violate the public policy of another state. In such case, a state may refuse to recognize the legality of the foreign law or legal agreement.

- *Example:* State A grants marriage licenses and performs marriages for same-sex couples. State B must recognize these marriages as valid. State B may attempt to argue that recognizing the marriages violates public policy. This argument, however, has generally been rejected by the US Supreme Court.

- **Discussion:** Can you think of laws recognized in one state but not another based on public policy? Currently, there is a debate across states regarding each state’s recognition of same-sex marriage. What are the implications of one state recognizing same-sex marriage and others not?

- **Practice Question:** John sues Donna in Maryland for losses suffered as a result of Donna’s fraudulent business practices. The court rules in favor of John and issues judgment against Donna for \$1 million. Instead of paying the judgment, Donna goes to California and resumes her business practices. If John attempts to collect the judgment against Donna, does California have any obligation regarding the recognition and enforcement Maryland’s civil judgment?

- **Resource Video:** <http://thebusinessprofessor.com/full-faith-credit-clause/>

6. What is the “Privileges and Immunities Clause”?

Article IV, Section 2 states that, “Citizens of each state shall be entitled to all privileges and immunities of citizens in the several states.” This clause seeks to avoid individuals gaining an advantage or being discriminated against by a state government simply because of the person’s state or residency. States may discriminate against members of other states in favor of its residents if there is a “substantial justification”. Substantial is a floating standard that may be subject to challenge by a court.

- *Note:* Try to think about the methods that a state could treat members of another state differently, such as through voting rights, ownership of property, taxation, etc.

- *Example:* State A cannot charge businesses organized in State B a higher rate of sales taxation on sales carried out in State A. This would be an unconstitutional privilege in favor of members of State A.
- **Discussion:** Can you think of a way in which a state has discriminated against citizens of another state that was held invalid by the court? What about a situation where one state discriminates against the citizens of another state and it is held to be valid? (Hint: If you are in a public university, think about your tuition payments.)
- **Practice Question:** Ellen and Gina are romantically involved and decide to marry in the state of Vermont. Soon after marrying, Ellen's employer transfers her to its office in Alabama. Alabama does not recognize same-sex marriage. Because of the transfer, Alabama state law does not recognize any of Gina's rights as Ellen's spouse. This becomes particularly important with regard to state insurance, real property, and inheritance law. Do you see any constitutional law issue?
- **Resource Videos:** <http://thebusinessprofessor.com/privileges-immunities-clause/>

7. What is the "Commerce Clause"?

Article I, Section 8, specifically grants to the Federal Government the right to "regulate commerce ... among the several states..."

The Commerce Clause allows the Federal Government to regulate any activity that affects "interstate commerce". It is the most commonly employed justification for the passage of federal laws affecting citizens and businesses within the US. In reality, almost any sort of business activity affects interstate commerce and thus falls under the regulatory authority of the Federal Government. The Federal Government does not, however, have the authority to regulate an activity that is carried out solely within a state's borders and has no discernible effect on interstate commerce.

- *Example:* The Federal Government may prohibit discrimination by hotels and theaters that serve individuals crossing state lines. It would not, however, be able to prohibit an individual from raising plants for personal consumption on private land, when the seeds for those plants do not originate outside of the state and the plants produced will never be sold commercially or transferred outside of the state.

Unless an area of law is expressly reserved for federal regulation, states have the authority to pass laws based upon their police power. The state law cannot "intend to regulate" or "substantially conflict with" interstate commerce. The substantially conflict with provision is known as the "Dormant Commerce Clause".

- **Discussion:** Can you think of any activities that are regulated under state law that would be outside of the regulatory authority of the Federal Government? Can you think of any historical cases where the Federal Government has passed a federal law that overturns state law? (Hint: Think about civil rights legislation and state laws discriminating against certain individuals.)
- **Practice Question:** Clarence owns land in Georgia. He plans on extracting a rare type of mineral from the land and selling it to baseball teams to rub on the baseball to reduce the bright glare of the ball when batting. The Federal Government passes a law that prohibits the sale of this type of product. Clarence is outraged that the

Federal Government will not allow him to collect and sell mud from his own land. Does the Federal Government have authority to prohibit Clarence's intended business? Explain.

- **Resource Video:** <http://thebusinessprofessor.com/commerce-clause/>

8. What is the “Taxing and Spending Power”?

Article 1, Section 8, expressly grants to the Federal Government the “Power to lay and collect Taxes, Duties, Imports, and Excises.”

- **Resource Video:** <http://thebusinessprofessor.com/taxing-spending-power-us-constitution/>

The taxing and spending power allows for the funding of Federal Government operations. The ability to tax is limited by the requirement that all taxes be uniformly applicable to all individuals.

- **Discussion:** Can you think of a recent, landmark Supreme Court decision affecting health care that turned on the Taxing and Spending Power?

Article 1, Section 8 further allows the Federal Government to “Pay the debts and provide for the common Defense and general Welfare of the US.”

This authority allows the Federal Government to incur and manage domestic and foreign debt. It also allows for the formation of the military and funding of the military defense budget.

- **Discussion:** Through what process does the United States incur foreign debt? What portion of the total revenue collected from taxes within the United States is allocated to defense spending? How does this compare to other countries in the world?
- **Practice Question:** The Federal Government seeks to determine automobile use parameters across the US. To begin the process, the Federal Government passes a law requiring individuals to register their vehicle as part of a national sales tax exemption program. Registering the vehicle will allow individuals to avoid a federal ad valorem tax on the value of the vehicle. Failure to register the vehicle will result in a 1% annual tax being assessed against the vehicle. The tax will be payable as part of the federal income tax return. Does the Federal Government have the authority to assess this tax penalty for failure to register a vehicle? Explain.

9. What is the “Contract Clause”?

Article I, Section 10 states that, “No state shall pass any Law impairing the obligation of contracts.”

The Contract Clause prohibits state governments from specifically legislating to interfere with (or usurp) private contract

rights. It is, however, limited by the ability of state governments to legislate to interfere with those rights under their police power. The state may pass legislation impairing a contract if the law is passed to deal with a specific emergency situation. Further, a state government may generally legislate to regulate an industry or commercial activity. Such legislation may have the effect of interfering with existing contracts. Because the legislation is not directly targeted at interfering with an individual's (or business's) contract rights, it does not violate the Contracts Clause. The Contract Clause demonstrates the drafters' regard for the importance of individual contract rights.

- *Note:* The Contract Clause does not limit the power of the Federal Government to interfere with private contract.
- *Example:* John has a business in State A that conducts international trade. His largest trading contract is with ABC Company (a French Company). State A passes a law requiring that all trading with ABC Company can only be carried out by State A. This would be unconstitutional if State A is intentionally legislating to usurp John's contract rights. A general prohibition against all trade with ABC company, however, may be legal.
- **Discussion:** Historically, can you think of why the founders felt it necessary to include the Contract Clause into the Constitution?
- **Practice Question:** ABC Corporation in Boston has an ample tea trade with England. ABC brings in nearly \$500 million annually. The fears that ABC Corp is creating a sort of monopoly and passes a law that no single corporation can gross more than \$100 million in annual sales from a single commodity. Is this type of statute constitutional?
- **Resource Video:** <http://thebusinessprofessor.com/contract-clause-us-constitution/>

10. What is the “1st Amendment”?

The 1st Amendment to the Constitution states that, “Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the government for a redress of grievances.”

This amendment provides for the following fundamental freedoms:

- Freedom of Religion
- Freedom of Speech
- Freedom of Press
- Freedom of Assembly
- **Discussion:** Why do you believe the Framers decided to group these rights together? What political significance did the Framers hope to achieve through the 1st Amendment?
- **Resource Video:** <http://thebusinessprofessor.com/1st-amendment-us-constitution/>

11. What are the “Establishment Clause” and “Free Exercise Clauses”?

The freedom of religion portion of the 1st Amendment is made up of the Establishment Clause and the Free Exercise Clause.

- **Resource Video:** <http://thebusinessprofessor.com/freedom-religion/>

Establishment Clause

The 1st Amendment states that, “Congress shall make no law respecting an establishment of religion” or “prohibiting the free exercise thereof.” The first provision of this clause is known as the “Establishment Clause”. It stands for the principle that the government should not force any particular religion(s) onto its citizens.

- **Discussion:** Historically, why did the Framers seek to prohibit the Government from establishing a state religion? How has this clause been interpreted with regard to government actions and religious activity?

Free Exercise Clause

The second provision of the 1st Amendment addressing religion is known as the “Free Exercise Clause”. It provides that the government cannot prohibit individuals from practicing any religion. The Free Exercise Clause has been the subject of significant litigation charging the government with discriminating against individuals’ religious practices. The common law test for determining whether a government statute runs afoul of the Free Exercise Clause by unduly restricting the free exercise of religion is as follows:

- **Secular Purpose:** Does the statute or government action affecting religion have a secular (non-religious) purpose? If the purpose of the statute or government action is to somehow promote any single or particular group of religions, the statute is unconstitutional. If the purpose of the statute or government action is not to promote religion, then move onto the next step.
 - **Example:** If a government allows a manger scene on government property during Christmas and denies citizens the right to put a menorah or minaret, this action would not have a secular purpose.

- **Discussion:** Can you think of any examples of government action that have been challenged as effectively promoting a particular religious practice?

- **Primary Effect:** Is the primary effect of the statute or government action to advance or inhibit religion? Even if the purpose of the statute or action is secular, it may violate the Establishment Clause if the primary effect is to somehow advance or inhibit a religion among the citizens. The word “primary” is of particular importance. It leaves room for statutes or actions that only incidentally promote a particular religion. If the primary effect is something other than advancing or inhibiting religion, move on to the next step.

- **Discussion:** Can you think of any examples of laws or government actions that have a purpose other than promoting a religion, but do have an incidental effect of promoting a religious practice?
- **Excessive Entanglement:** Does the statute cause excessive government entanglement with religion? Even if the statute only has a secondary effect upon religion, it may still result in too much government involvement with religious practice to comply with the Establishment Clause. This is a floating standard that greatly depends on the specific law and how it affects religious practice.
- **Discussion:** How do you feel about allowing a court this level of autonomy for determining when a statute or government action is simply too closely related to religious activity?

If a law or government action violates any one of the above elements, it is an unconstitutional infringement of the 1st Amendment's religious protections.

- **Discussion:** Do you think that the government should pass laws that have an effect on any single religion? Can you think of any examples of a law that has a secular purpose but has an effect of promoting a religion? How would you measure whether an effect on promoting religion is strong enough to be considered a primary effect? At what point do you think government influence on religious practice becomes excessive entanglement?
- **Practice Question:** Mary is the mayor of Small Town, Texas. She is a Christian and believes that everyone else in the world should be as well. She proposes a resolution to the city council to make Christianity the official religion of Small Town. As part of her proposal, she lays out a plan to convert part of the city hall into a sanctuary to hold Christian services on Sunday. What are the Constitutional issues implicated by these proposals?
- **Resource Video:**

12. How does freedom of religion affect business practice?

Generally, for-profit businesses covered by Title VII of the Civil Rights Act of 1964 may not discriminate against employees on the basis of religion. There is an exception for religious organizations whose primary purpose necessitates religious practice or affiliation among its employees. Aside from the prohibitions on employment practices, common law holds that closely-held corporations may have religious protections similar to those of citizens.

- **Note:** This issue came to the forefront of consideration in the case, *Burwell v. Hobby Lobby Stores, Inc.*, The Court found that the religious beliefs of owners of the closely-held entity were sufficiently tied to the religious beliefs of the owners to be susceptible to protection under the 1st Amendment. The court's holding exempts closely-held businesses from laws that mandate or prohibit certain conduct conflicting with that belief.
- **Example:** ABC, LLC is a small restaurant with 25 employees. ABC is solely owned by a family of devout Christians. ABC refuses to hire any employees who are not Christian. Further, ABC refuses to offer a health insurance plan than covers subscriptions for birth control. ABC's failure to hire non-Christians may constitute illegal discrimination. The common law, however, allows a closely-held business entity to adopt the religious

beliefs of its owners. As such, refusing to sponsor a health insurance plan that contains provisions conflicting with the owner's religious beliefs is likely legal. This example demonstrates the fine line between business practices that discriminate against others based upon religious belief with practices that cause a business to violate its own beliefs.

- **Discussion:** Why do you think the government makes an exception to the employment discrimination laws allowing religious organizations to discriminate? What is your view of the holding in the Hobby Lobby case that a business entity can adopt (and enforce) the religious rights of its owners?
- **Practice Question:** John is the sole owner of Outdoor, LLC, a hunting and fishing store. Outdoor is located in a town that has an ordinance requiring all downtown shops to be open on weekends for customer shopping. The ordinance is part of an economic revitalization effort in the town. John has 15 employees in his shop. He observes fundamental Christian beliefs. He refuses to open his shop on Sundays in observance of his beliefs. He also refuses to hire any women employees because he believes that women should not work and should be subservient and remain in the homes of their fathers or husbands. Are there any legal issues with John refusing to open on Sundays or refusing to hire women?
- **Resource Video:** <http://thebusinessprofessor.com/businesses-and-religious-freedom/>

13. What conduct is protected pursuant to the 1st Amendment's assurance of "freedom of speech"?

The 1st Amendment provides for the freedom to speak and express oneself. The freedom of speech is far broader in its protections than simply protecting the spoken word. It protects individual rights with regard to any form of expression. Forms of expression may include speech, writings, physical expressions, symbols or symbolic activity, etc. The freedom of speech may still face certain limitations by the government. Certain types of speech are not protected. Further, the government may place certain limitations on the location and timing of speech that takes place on government property or somehow affects the rights of others.

- **Note:** Remember, the Constitution protects an individual's rights against infringement or repression by the government. Individuals or businesses cannot infringe upon an individual's freedom of speech.
- **Example:** ABC is a small town. A local ordinance limits the ability of citizens to give speeches or carry out other forms of expression on municipal property without first obtaining a permit. The permit procedure requires that any form of public expression be conducted within certain hours and not exceed a certain noise level. These are examples of government interference with free speech. This may, however, be legal as a limited restriction on speech. The standards applied by courts when a law infringes upon a fundamental right are discussed at the end of this chapter.

- **Discussion:** Why do you think the freedom of speech is interpreted broadly to include all forms of expression? What type of events have you witnessed that are protected under the 1st Amendment's freedom of speech? Does the breadth in types of conduct to which the freedom of speech applies surprise you?
- **Practice Question:** Small Town is a small city located in Mississippi. Small Town has a local ordinance that prohibits publicly criticizing state officials who visit the town as part of their official duties. This includes writing

derogatory articles in the newspaper or speaking ill of these individuals in public. The objective of the ordinance is to prevent citizens of the town from alienating state officials who may be linked to state funding or other resources that the town needs. Can you see any Constitutional issues with this ordinance?

- **Resource Video:** <http://thebusinessprofessor.com/freedom-speech/>

14. What type of speech is either not protected or receives limited protection?

The Supreme Court has interpreted the 1st Amendment to not protect all forms of speech. That is, some forms of speech or expression may be limited or fully prohibited by the Government. In determining whether a type of speech or expression is protected, the court will balance the rights of the individual against the potential harm to or effect upon the rights of others. Because the freedom of speech is a fundamental right, the Government cannot limit speech without a compelling government interest justifying the restriction. Pursuant to this understanding, statutory and common law often prohibit or limit the protections offered to: Obscene Speech, Fighting Words, Commercial Speech, Defamation, and Political Speech.

- **Discussion:** Do you think it is important that the Supreme Court has recognized exceptions to the blanket protection of an individual's freedom of speech?
- **Practice Question:** ABC township passes an ordinance that prohibits any form of speech that in the town center that causes a disruption to the local businesses surrounding the square. This ordinance obviously limits the rights of individuals to express themselves in the public square. If this ordinance is challenged in court on constitutional grounds, what type of analysis will the government undertake to determine whether it violates the Constitution?

Each type of non-protected or partially-protected speech is:

- **Obscenity** - Obscene expressions are those that appeal to the "prurient interest". Such expressions are deemed harmful to the community. There is no standard definition of obscenity; rather, courts determine whether an expression is obscene based upon the beliefs, perceptions, or standards of the local population. While there is no common definition of obscenity, a state or local law that is too restrictive or broad in its provisions limiting expression is subject to be overturned by the judiciary as an undue restriction on the freedom of speech.
 - **Example:** One community may feel that allowing fully nude dancing in night clubs is obscene; while other communities may not believe it to be obscene.
- **Discussion:** How do you feel about using a floating standard for determining what is obscene? Can a law, therefore, begin to violate 1st Amendment protections if the beliefs and understandings of the local population change or evolve?
- **Practice Question:** ABC Town has a local ordinance that prohibits any form of nude dancing. XYZ Town is located just north of ABC. XYZ does not restrict any form of public nudity. If a citizen of ABC Town challenges the local ordinance, what standard will the court apply in determining whether the ordinance violates the citizen's 1st Amendment freedom of speech? (Hint: Ignore any argument that such a statute is

overbroad.)

- **Resource Video:** <http://thebusinessprofessor.com/obscene-speech-and-the-1st-amendment/>

- *Fighting Words* - Fighting words are those deemed likely to immediately incite violence by listeners. An important requirement for an expression to constitute fighting words is that the threat of violence be immediate. This means that the subject-matter exception is determined by the physical presence and likely reaction of third parties.

- *Example:* Many public presentations openly calling for violent activity by the crowd are limited or regulated; however, the same form of expression recorded and later distributed to listeners may not constitute fighting words. The difference is the immediacy of the threat of violence created by the presence of a crowd.

- **Discussion:** Can you think of any activities in history that have been censored under the grounds that it is inciting immediate violence? Can you think of any examples of speech that have incited violence, but have been protected because the incitement was not immediate in the location of the speech?

- **Practice Question:** Eric is a separatist and anti-government activist. He routinely calls for the succession of State B from the United States. He holds a rally in State B, during which he plans to deride the minority population in the state. Local authorities are worried about the rally resulting in violence. If the permit for the rally is denied because of these concerns and Eric challenges the denial in court, what facts will the court review in determining whether the denial is Constitutional? Would it matter if Eric plans to hold the rally in a small private venue, but the speech will be broadcast *via* a number of media sources?

- **Resource Video:** <http://thebusinessprofessor.com/fighting-words-and-the-1st-amendment/>

- *Commercial Speech* - There is only a limited right to undertake commercial speech. Such expressions necessarily involve third parties who take actions based upon that speech. The government's regulation of commercial speech is based upon the potentially negative effect on the general welfare of society. The limitation upon the regulation of commercial speech is that the government must have a compelling state interest to justify the restriction.

- *Note:* Common law holds that corporations have limited rights to free speech that are very similar to those of individuals. The Constitutional standards applied by a court when determining the validity of government laws or actions limiting an individual's rights are discussed in a separate section.

- *Example:* Business practices that knowingly deceive individuals may constitute fraud. Many deceptive advertising practices violate consumer protection laws. The federal and state governments require disclosure of material information about publicly-held companies. All of these examples demonstrate a balance between protecting the public and protecting the freedom of speech afforded individuals.

- **Discussion:** Can you think of any type of commercial speech that is prohibited by federal, state, and local

laws? What is the risk to the public of allowing this type of unregulated speech?

- **Practice Question:** Hickory, NC is famous for its production of fine, wood furniture. Every year, thousands of people and stores come to Hickory to purchase furniture. Numerous companies that produce their furniture in other places have opened shops in Hickory to sell to customers. These companies routinely assemble the pieces of furniture in Hickory and advertise the furniture as “Made in Hickory”. The town passes an ordinance prohibiting this practice. If a merchant challenges the ordinance, what will the court examine in determining whether the ordinance is constitutionally valid.
- **Resource Video:** <http://thebusinessprofessor.com/commercial-speech-and-the-1st-amendment/>

- **Defamation** - Defamation is the publication (open communication) of false statements about others that will knowingly subject that person’s character to ridicule or disrepute. “Slander” is verbally defaming someone. “Libel” is defaming someone through a writing. “Disparagement” is defaming someone’s business prowess or practice. Defamation statutes do not prohibit this type of speech (a prior restraint of the speech); rather, they allow an individual harmed by the speech to recover damages for harm suffered as a result of the speech. Potential liability for defamation, however, can have the effect of dissuading free speech. This fact must be balanced against the protections afforded the individual who is the subject of the defamatory expression. In any case, the defamed individual must demonstrate an actual harm suffered as result of the defamation.
 - **Example:** A state passes a law that allows for a civil cause of action (and damages) against an individual who makes a false statement about another person that results in harm to that person’s reputation. While an individual has a 1st Amendment right to make any form of speech or expression, this right must be balanced against the rights of those who may be harmed by such speech or expression. In this case, promoting the well-being of citizens is a compelling interest of the state. Allowing a cause of action for this sort of defamation is likely constitutional.
 - **Note:** To lessen the potential for the suppression of the free and open press, a plaintiff must show intentional defamation or “malice” by the publisher toward the defamed person. Likewise, a public figure or celebrity must demonstrate this higher standard of intent to hold someone liable for defamatory statements. Disparagement represents the societal interest of allowing individuals to undertake commercial activity free of the damaging effects of defamatory attacks.

- **Discussion:** How do you feel about the balancing of an individual’s freedom of speech rights against the rights of individuals to not be harmed by false speech? Remember, the freedom of speech is expressly stated in the Constitution, while an individual’s protection against harm from false statements is not.
- **Practice Question:** Martin is under investigation from acts of terrorism. When the news media learns of this, they report on national television that Martin is a suspect. This leads to all sorts of hate mail and threats against Martin. Martin is ultimately ruled out as a suspect for the terrorist activity. Nonetheless, the investigation and television coverage has caused serious harm to Martin’s career and lifestyle. What would Martin have to show to hold the new media liable for its reporting?
- **Resource Video:** <http://thebusinessprofessor.com/defamation-and-the-1st-amendment/>

- **Political Speech** - Individuals and corporations are entitled to only limited protection of political speech. Political speech includes the spending or donation of money to political campaigns or undertaking political activism. As such, political contributions by individuals or entities may be subject to regulation. Individuals and businesses are limited in the amount of funds that they can contribute to political candidates for federal office and certain groups that donate to political candidates. Historically, corporations were also limited in their ability to directly fund or undertake political activism. The issue of direct spending in elections came to the forefront in the case, *Citizens United v. Federal Election Commission*. In this case, the court held that corporations hold rights similar to those of individuals with regard to political speech. As such, many of the existing regulations of the amount of funds or activity that a corporation may spend or undertake with regard to political campaigns were held invalid. This case did not, however, affect the legal limits on individuals and organization to make contributions directly to candidates and groups dedicated to making contributions to candidates.
 - **Note:** These provisions apply to federal elections and not state elections. Also, there is currently no limit on the amount of money that an individual or corporation can make to independent-expenditure-only committees, also known as “Super-Pacs”. These groups spend directly on political activity in support of particular candidates.
 - **Example:** A state passes a law that limits the amount of money that citizens and corporations can give directly to state politicians running for office. While giving money is a type of expression that is protected under the 1st Amendment, this restriction upon individual rights aimed at preserving the integrity of the election system may be constitutional.
- **Discussion:** How do you feel about a corporation being deemed to have the same freedom of speech protections as individuals? Should the rights of freedom of speech be weighed against the impact of allowing corporations to impact the outcome of political elections?
 - **Practice Question:** Dorothy is very dedicated to supporting her preferred political party and its candidates. She routinely makes donations to candidates and to political groups. She inherits a large sum of money from her grandmother and is considering donating all of the money directly to a candidate that she supports for federal office. Can this result in any legal issues? What are some other options or methods of donating the money in support of the political candidate?
 - **Resource Video:** <http://thebusinessprofessor.com/political-speech-and-the-1st-amendment/>

15. What is “overbreadth” or an “overbroad” law affecting freedom of speech?

To pass constitutional muster, the government must have a compelling interest in passing a law regulating free speech. The law is deemed overly broad if, in the process of regulating unprotected speech, it negatively impacts protected speech that was not intended. In this way, it affects more speech than is necessary to achieve the government’s compelling interest. While the law may be constitutional in some applications, the possibility that it could negatively affect the protected free speech means that it is unconstitutional.

- *Example:* A state passes a law that restricts individuals from urging support for a political candidate at a polling location. The purpose of the statute is to prevent undue pressure of individuals in exercising their right to vote. The statute, however, is likely too broad in that it could prohibit individuals from having casual conversations about their voting activity. As such, the law would have to be more “narrowly tailored” for it not to violate 1st Amendment protections.

- **Discussion:** Do you believe that overly broad statutes could have the effect of causing individuals refrain from speech or expression that would otherwise be constitutionally protected?
- **Practice Question:** ABC Town passes an ordinance that prohibits any form of nudity in public. The local theater wants to put on a production of a famous ballet that requires the lead ballerina to temporarily expose her breasts during the performance. If the theater brings a court action challenging the ordinance, what will the court consider in determining whether the ordinance is constitutional?
- **Resource Video:** <http://thebusinessprofessor.com/overbreadth-and-overly-broad-laws/>

16. What is the “Freedom of Press” granted under the 1st Amendment?

The 1st Amendment states that, “Congress shall make no law ... abridging the freedom of ... the press.” Generally, it prohibits attempts by the government to curtail the freedom of expression through the public dissemination of information. More specifically, it prohibits any restraint prior to the publication of information, or “prior restraints”. Rather, protections of free press are commonly reduced after the publication of the information. That is, an individual or organization may be held liable subsequent to the publication of information, as the publication may run afoul of laws protecting the public (e.g., defamation).

- *Example:* The local news channel may report on any matters of public interest pursuant to the freedom of the press. Limiting the content that the media may cover is a prior restraint and would abridge this freedom. Holding the new channel liable for intentionally defaming a person is a limitation on freedom of press that is generally constitutional.
- **Discussion:** How do you feel about the freedom of press? Should it be broader or more limited? Why? Why do you think the law distinguishes between prior restraints and restraints after the fact?
- **Practice Question:** Ernie has an Internet blog covering political issues that is becoming increasingly popular. Ernie’s state legislature passes a law that limits the ability to cover special interest group spending on lobbying activity. If Ernie challenges the law in court, what do you think will be the outcome?
- **Resource Video:** <http://thebusinessprofessor.com/freedom-press/>

17. What is the “Freedom of Assembly”?

The freedom of assembly, commonly known as the “freedom of association”, protects individuals’ rights to assemble in groups for the purpose of expressing common beliefs or pursuing common interests. The right of assembly includes the

right to physically assemble and the right to be a member of an organization. The right of physical assembly is commonly restricted by “time, place, and manner” restrictions. These restrictions must meet the highest level of scrutiny when determining whether such restrictions are constitutional.

- *Example:* The government commonly requires permits or licensing for assembly. This is a limited regulation of the time, place, and manner of assembly. The application process cannot totally close off the assembly. But, it may require that the participants adhere to limited restrictions.
- **Discussion:** Do you feel that common time, place, and manner restrictions on the freedom of assembly are overly burdensome? Or do you feel that this government authority is sufficiently extensive? Can you think of historical acts of assembly that were challenged based upon time, place, and manner or permit restrictions?
- **Practice Question:** Beverly is interested in having a public rally protesting police brutality in the city. Public gatherings are generally limited to Monday through Saturday, but Beverly wants to hold the rally on Sunday. The city manager that approves requests for permits is adamantly against Beverly’s cause. He refuses Beverly a permit based upon the request for a Sunday date. Is there any issue with this situation?
- **Resource Video:** <http://thebusinessprofessor.com/freedom-of-assembly-or-association/>

18. What is the 5th Amendment to the Constitution?

The 5th Amendment contains a number of protections for US Citizens. Specifically it protects against self-incrimination by individuals (not corporations). That is, an individual cannot be compelled to testify against herself. It prohibits subjecting an individual to double jeopardy for alleged criminal conduct. This means that the government cannot subject an individual to multiple prosecutions for the same activity. The 5th Amendment also requires the government to pay just compensation to individuals for property taken or appropriated for public use. This concept most frequently arises in cases of “eminent domain” (discussed in a subsequent chapter). Arguably, the most important protection, however, is the protection of an individual’s right against deprivation of “life, liberty, and property without due process of law.” This protection is known as the “Federal Due Process Clause”. It assures the protection of citizen’s substantive and procedural rights in the passage and execution of laws by the Federal Government.

- *Example:* I receive a subpoena to testify in a criminal trial. While on the stand, I am asked questions that may incriminate me if I answer truthfully. I request not to answer the question based upon the observance of my 5th Amendment right against self incrimination.
- *Note:* The 5th Amendment does not prevent the federal and state governments from bringing charges against an individual for the same conduct. The Supreme Court also recognizes a fundamental right to privacy implied in the 5th Amendment protections.
- **Discussion:** Many people are familiar with the 5th Amendment in criminal law cases because of popular comedy skits (see The Dave Chapelle Show) or through popular movies (see Double Jeopardy). In what contexts are you familiar with the use of Amendment?
- **Practice Question:** Meredith is confused about what protections exist under the 5th Amendment of the

Constitution. She knows that there are criminal law protections and procedural protections. Can you briefly explain the various protections of the 5th Amendment to her?

- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-5th-amendment/>

19. What is “Due Process” of Law?

Due Process rights assure “fundamental fairness and decency” in any governmental act or process that may affect the “life, liberty, property or other constitutional rights” of its citizens. The concept of due process is broken down into “substantive due process” and “procedural due process”. Substantive due process allows the court to safeguard the rights of individuals against infringement by the government. More specifically, it introduces a standard that laws that touch upon the fundamental rights of individuals may be outside of the authority of the government to regulate. This tends to protect a minority population from the unfair consequences of laws passed by the majority. Procedural due process stands for the principle that the government may not act in a manner that is “arbitrary, capricious, or unreasonable” when subjecting an individual to the laws of the state. Procedural due process further entails the observance of individual rights in the passage of laws and regulations. The government establishes certain standards for determining when a law may justifiably infringe upon an individual’s constitutional rights. That is, a law that infringes on a fundamental right must meet a certain standard (discussed further below) to be constitutional.

- *Note:* The due process clause applies to both individuals and corporations.
- *Example:* Procedural due process requires fair procedures in the carrying out of a criminal trial, such as the right to notice and the ability to respond to an accuser. It may also include the right to public vote or comment on a proposed law or regulation.

- **Discussion:** Are you familiar with *Miranda* rights? How does the *Miranda* rights doctrine demonstrate principles of due process of law?
- **Practice Question:** Jake wants to open a restaurant in his town. He purchases some land and begins the process of getting the necessary licenses and permits. There is a local board charged with determining whether to grant licenses for in-town businesses. The board does not believe the town needs another restaurant and denies Jake a license. Jake inquires about a process for appealing the board’s decision, but the code of ordinances does not allow for appeal from board decisions. If Jake files a lawsuit challenging the ordinance and the board’s process, what arguments might he raise against the board procedure?
- **Resource Video:** <http://thebusinessprofessor.com/5th-amendment-federal-due-process-clause/>

20. What is the 14th Amendment’s Due Process Clause - “Incorporation Doctrine” and “Equal Protection Clauses”?

The 14th Amendment to the Constitution states that, “No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the US; nor shall any state deprive any person of life, liberty, or property, without due process of law, nor deny to any person within its jurisdiction the equal protection of the laws.” These provisions are known as the Due Process Clause and the Equal Protection Clause. Each of which are discussed below.

- **Resource Video:** <http://thebusinessprofessor.com/14th-amendment-us-constitution/>

Due Process Clause - Incorporation Doctrine

- The 14th Amendment's Due Process clause is an incorporation doctrine. In addition to requiring that states observe principles of due process in the execution of laws, it makes all of the provisions of the Bill of Rights applicable to state governments. That is, state governments cannot act to infringe upon the constitutionally protected rights of its citizens. As previously stated, the 5th Amendment's Due Process Clause applies strictly to the Federal Government.
 - *Example:* If a state arrests an individual, it must follow procedures that protect her constitutionally-granted rights. This may include providing the individual with an attorney, notification of the charges against her, a speedy trial (if requested), a jury trial, etc. Further, if an individual is subject to administrative action by the government, the administrative process must not infringe upon her constitutionally-granted rights. This may include a notice of administrative action, the opportunity to be heard, and the ability to seek review of an agency's decision in a court of law.

- **Discussion:** What would be the effect if the Bill of Rights did not apply to state government?
- **Practice Question:** State A passes a law that states that all forms of public speech involving political matters is prohibited. If the Constitutionality of the law is challenged, what Constitutional provisions are implicated?
- **Resource Video:** <http://thebusinessprofessor.com/incorporation-doctrine/>

Equal Protection Clause

- The Equal Protection Clause of the 14th Amendment embodies the ethical idea that law should not treat people differently without a satisfactory reason. This generally protects citizens from discrimination under the law or through government action based upon their exercise of a fundamental right or based upon race, gender, and ethnicity. This clause focused on the historical discrimination present from the days of involuntary servitude. It forced upon state governments the Civil Rights Act of 1866.
 - *Example:* The Equal Protection Clause prohibits a state from penalizing criminal conduct of a particular race more severely than the same conduct by another race.
- **Discussion:** Can you think of historical incidences where state laws have been held unconstitutional per the Equal Protection Clause? Hint: Think of voting and education rights.
- **Practice Question:** State A passes a law that all Hispanics in the state must provide proof of citizenship and residence prior to registering children for public school. Does this provision violate any

Constitutional protections?

- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-equal-protection-clause-of-the-14th-amendment/>

21. What are the standards by which the government (through laws or actions) may infringe on individual rights?

The above discussions should demonstrate that many laws, to some extent, infringe upon the rights of citizens. Individuals often challenge the constitutionality of these laws in court. As previously stated, one role of the judiciary is to determine the constitutionality of laws and the execution of those laws. For a law to pass constitutional muster, it must meet a certain standard justifying its existence. The standard that the court applies depends upon the rights infringed upon. Below are explanations of the applicable standards.

- **Resource Video:** <http://thebusinessprofessor.com/standards-constitutionality/>
- **Minimum Rationality** - This standard, also known as the “Rational Basis Standard of Review”, requires that a law have a rational connection to a permissible state end (a legitimate goal of the government). The classification must have a reasonable basis (not wholly arbitrary), and the courts will assume any statement of facts that can be used to justify the classification. This standard applies to laws that affect a non-fundamental right or one that is not expressly protected under the Constitution, such as social welfare and economic matters. As such, it is the default standard by which the court reviews a law to determine constitutionality. The standard is higher if the law affects a fundamental right, such as due process or equal protection rights.
 - **Example:** The state passes a law concerning the speed limit on state highways. This law is not related to a fundamental right; rather, it is related to the privilege of driving. As such, this law would need to have a rational connection to a legitimate state goal. The goal of reducing traffic accidents or promoting motorist safety is sufficient to find the statute constitutional.
- **Discussion:** The court is left to interpret what constitutes a legitimate government interest. There is no formal test established for this purpose. How do you feel about the level of autonomy left to the court in making this decision? (Note: When the government fails to provide a legitimate interest promoted by its law or action, the duty of the court is to “seek out other conceivable reasons for validating” the law or action.)
- **Practice Question:** The state government passes a law stating that individuals cannot watch any sort of screen or video projector while driving in a car. If a group of drivers and makers of car video players challenges the constitutionality of the law, what standard would a court apply in determining constitutionality?
- **Resource Video:** <http://thebusinessprofessor.com/minimum-rationality-rational-basis-review-for-constitutionality/>

- *Strict Scrutiny* - This standard requires that a law have a compelling state purpose to be constitutional. Further, the law in question must be “narrowly tailored” to achieve that purpose and must be the “least restrictive means” of achieving that purpose. This means that the government must make certain that the law is not overly broad in the

the statute would turn on the interest of the state versus the burden that it places on an individual's constitutionally protected right.

- **Discussion:** Can you think of any recent cases applying intermediate scrutiny to overturn a government law affecting a suspect class or individual rights?
- **Practice Question:** Town A passes a law stating that no individual may transport a loaded weapon on public property without a license. A gun rights group challenges this law in court as restricting the 2nd Amendment's right to bear arms. What standard will the court likely apply in determining the Constitutionality of this law?
- **Resource Video:** <http://thebusinessprofessor.com/intermediate-scrutiny-or-quasi-strict-scrutiny/>

TOPIC 3: COURT SYSTEM

Overview

This chapter discusses the purpose, design, and members of the state and federal court systems (collectively, “court system”). It explores the authority for the court system under the Constitution; the authority of the court to hear types of disputes; the ability to exercise control over individuals; and the role of administrative, trial, and appellate courts. Understanding these aspects of the court system is foundational to internalizing how laws are developed and enforced against those governed. Recognizing the authority for state and federal administrative and judicial courts, aside from relating valuable civic knowledge, provides an understanding of the systemic approach developed to administer laws as they affect business practice. Further, understanding the structure of the court system allows for strategic decision-making by businesses manages to avoid legal violations and enforce their legal rights.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• <u>Article III Courts</u> • <u>Article I Courts</u> • <u>Article III Authority</u> • <u>Article II Authority</u> • <u>Article I Authority</u> • <u>Article VI Authority</u> • <u>Types of State Courts</u> • <u>Subject-Matter Jurisdiction</u> • <u>Federal Subject-Matter Jurisdiction</u> • <u>State Subject-Matter Jurisdiction</u>	• <u>Trial Court Authority- Procedure</u> • <u>Appellate Authority - Procedure</u> • <u>Personal Jurisdiction</u> • <u>Personal Jurisdiction - Federal</u> • <u>Personal Jurisdiction - State</u> • <u>Long-Arm Statute</u> • <u>Venue</u> • <u>Types of Judges</u> • <u>Duties of Trial Judges</u> • <u>Duties of Appellate Judges</u>	• <u>Appeals Process - Intermediate</u> • <u>Appeals Process - Supreme Court</u> • <u>Appeals Process - Admin Courts</u> • <u>Appeals Process - State Courts</u> • <u>Role of Jurors</u> • <u>Juror Votes Required</u> • <u>Role of Attorneys</u> • <u>Members of Judicial System</u> • <u>Judicial Activism & Restraint</u>
-

TOPIC 3: COURT SYSTEM - QUESTIONS & ANSWERS

1. What is the authority for the federal and state judicial systems in the United States?

The authority for the federal and state judicial systems is found in the US and state Constitutions. Below is a breakdown of the courts as authorized under Articles I, II, and III of the US Constitution. State constitutions are modeled after the US Constitution and generally establish a similar state-court structure.

Federal System

- **Article III** - “The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish.” The US Supreme Court is the only court specifically established by the Constitution. Congress has created several subordinate courts below the Supreme Court, which include the Federal District Courts, Federal Circuit Courts, and numerous ancillary courts that have special jurisdiction. Pursuant to Articles I and II, all members of Article III courts and tribunals are appointed by the President and are confirmed by vote of the Senate.

- **Discussion:** Can you think of any reasons why Congress decided to create numerous courts that are subordinate to the Supreme Court? How do you feel about the right of the President to nominate judges? How do you feel about the requirement that the Senate approve judicial nominees? Can you recall any instances where the Senate has refused to confirm a Presidential nominee to a federal court?
 - **Practice Question:** At the end of the year, it is expected that there will be approximately 150 federal judgeships open. The President of the United States has assembled a list of nominees for the positions. His list is very well planned and all of the candidates have the appropriate credentials for the position. Can the President rest assured that all of his nominees will receive the nominated judicial position?
 - **Resource Video:** <http://thebusinessprofessor.com/article-iii-courts/>
- **Article I** - Article I of the Constitution creates the legislative branch of the Federal Government. Pursuant to the authorization of Article I, Congress has the authority to create inferior courts under the US Supreme Court. Also, Congress has the authority to create legislative courts and a limited ability to delegate law-making authority to other branches. The Supreme Court has ruled that Congress has the latitude to delegate regulatory powers to executive agencies as long as it provides an "intelligible principle" to govern the agency's exercise of the delegated authority. As such, Congress delegates to the administrative agencies the responsibility for formulating regulations to effectuate and expand upon the statutes passed by Congress. These agencies, under the supervision of the executive branch, establish administrative courts to adjudicate disputes arising pursuant to agency regulations.

- **Discussion:** How do you feel about Congress' ability to delegate law-making authority? Have you ever thought about who drafts regulations surrounding a statute?

- **Practice Question:** Congress passes a federal act easing the restrictions on the sale of securities by private companies. Congress outlines the specific purposes of the Act, but fails to provide any procedural mechanisms for carrying out its function. Congress, in the Act, direct the Securities and Exchange Commission (an Independent Federal Agency), to create regulations sufficient to carry out the statutory provisions. Where does Congress receive the authority to make this delegation and what statutory level of guidance is required to make this delegation constitutional?

- **Resource Video:** <http://thebusinessprofessor.com/authority-for-judiciary-article-i-of-us-constitution/>

- **Article II** - Article II of the Constitution establishes the executive branch. It grants the President authority to preside over certain administrative agencies and legislative courts created by Congress. Many administrative agencies create special courts for the adjudication of disputes arising under its jurisdiction or within its regulatory authority. These administrative courts are known as “Article I courts” based upon their authorization. Legislative courts are courts of special jurisdiction created by Congress to hear special matters.

- **Example:** Article I courts include bankruptcy, military, tax, and immigration courts. Appeals from these special courts go to Article III courts.

- **Discussion:** How do you feel about administrative agencies establishing their own courts? How do you feel about the Executive branch overseeing administrative courts? Does the ability to appeal administrative decisions to an Article III court provide sufficient check on the executive branch’s authority?

- **Practice Question:** The Internal Revenue Service (IRS) is an executive agency under the purview of the President of the United States. John receives a letter from the IRS explaining that he has income tax liability far beyond what John believes is accurate. After disputing the IRS’s tax assessment, John decides to bring a legal action in the United States Tax Court challenging the tax amount. What is the authority of the US Tax Court and does it have authority to hear the matter of John’s tax assessment?

- **Resource Video:** <http://thebusinessprofessor.com/authority-for-judiciary-article-ii/>

- **Article IV** - Article IV courts are US Territorial Courts, such as those of Guam, Northern Mariana Islands, and the US Virgin Islands, established under the Territory Clause of Article IV.

- **Discussion:** Think about the formation of courts in these jurisdictions. These are not states and, therefore, Congress must act to establish courts with jurisdiction over these protectorates. How do you feel about territories of the United States that are not represented in the Federal Government, but are subject to federal jurisdiction?

- **Practice Question:** In the US Territory of Guam, Hanna is the victim of a crime when someone steals her automobile. What laws would be effected in this scenario and how would this situation differ from a similar occurrence in California?

- **Resource Video:** <http://thebusinessprofessor.com/article-iv-territorial-courts/>

State System

- The US Constitution, pursuant to the 10th Amendment, provides for both federal and state governments. While the US Constitution provides the authority for federal courts, a state's constitution provides the authority for state courts. Generally state constitutions follow a model that is very similar to that of the US Constitution and allow for judicial, legislative, and administrative courts.

- **Discussion:** Why do you think state constitutions follow a structure that closely resembles that of the US Constitution? Is there any requirement for state judiciaries to function similarly to federal courts?

2. What is the authority for Article III & Article I federal courts?

Article III Federal Courts

- US Supreme Court - Article III of the Constitution establishes the US Supreme Court as the highest court in the land. It has "original jurisdiction" over certain matters, but serves almost entirely as an appellate court. It provides appellate review of the decisions of the highest state court and decisions from all federal appellate courts.
- Federal Appellate Courts - These courts serve as the appellate courts for matters decided by judge or jury in the District Court. There are 13 federal appellate courts consisting of 11 enumerated US Circuit Courts of Appeal, the District of Columbia Circuit, and the Federal Circuit.
- Ancillary Federal Courts - These are Article III federal courts with special authority and vested with specific jurisdiction by Congress. These ancillary courts include: US Foreign Intelligence Surveillance Court of Review; US Foreign Intelligence Surveillance Court; US Court of International Trade, US Alien Terrorist Removal Court.
- District Courts - These are the Article III trial courts for the federal system. There are approximately 94 district courts spread throughout the United States. They do not follow state boundaries; rather, they are positioned within pre-established federal jurisdictions. There are also courts of limited jurisdiction, known as federal magistrate courts, which exist in support of the federal district courts.

- **Discussion:** Why do you think that there are such fewer federal trial and appellate courts than in the state court systems? How many cases does the US Supreme Court hear in a year? Does this number surprise you? Why or why not? What do you think is the reasoning behind the creation of special ancillary courts?
- **Practice Question:** Meredith is involved in a civil trial in the US District Court located in the state of Maryland. At the conclusion of the trial, she appeals the court's decision to the appropriate appellate court. Which Circuit Court of Appeals would be charged with reviewing Meredith's request for appeal?

- **Resource Video:** <http://thebusinessprofessor.com/authority-for-judicial-system-article-iii/>

Article I Federal Courts

Article I federal courts include “legislative courts” & “administrative courts”. Legislative courts are those created by Congress pursuant to authority granted under Article II to handle special jurisdictional matters. Administrative courts are those created to adjudicate disputes of a particular administrative agency.

- **Note:** Examples of legislative and administrative courts include: D.C. judiciary, D.C. Court of Appeals, D.C. Superior Court, US Court of Appeals for Armed Forces, (Several Military courts of Appeal), US Court of Appeals for Military Claims, Armed Services Board of Contract Appeals, Civilian Board of Contract Appeals, Board of Immigration Appeals, US Immigration Courts, Board of Patent Appeals and Interferences, Trademark Trial and Appeal Board, US Postal Service Board of Contract Appeals, US Court of Federal Claims, US Tax Court, US Bankruptcy Courts, Social Security Administration Office of Disability Adjudication and Review, US Merit Systems Protection Board, Board of Veterans’ Appeals, US Courts-Martial, Guantanamo Military Commissions, and US Court of Military Commission Review.
- **Practice Question:** Lawrence, a member of the US Army, is charged with deserting his unit at Fort Campbell, Kentucky. He is later apprehended by state police and extradited back to military control. The military decides to bring charges against him for the crime of desertion under the military code of justice. What is the authority for bringing criminal charges against Lawrence and who oversees the process?
- **Resource Video:** <http://thebusinessprofessor.com/article-i-federal-courts/>

Article IV Courts

These are territorial courts specially created to act as the court of general jurisdiction in select federal jurisdictions. These courts have jurisdictions similar to that of a federal district courts; however, they also exercise subject-matter jurisdiction over matters typically reserved to state and local courts in a jurisdiction. These courts are designated to a specific circuit court of appeals for all appeals from the trial court.

- **Example:** With regard to appellate matters, the Virgin Islands district court falls under the 3rd Judicial Circuit Court of Appeals, while the district courts of Guam and the Mariana Islands fall under the 9th Circuit Court of Appeals.
- **Discussion:** State governments generally create laws pursuant to its police power. The Federal Government generally creates laws pursuant to the Commerce Clause or Taxing and Spending Power under the US Constitution. How do you feel about the creation of federal courts to hear matters traditionally controlled under state law?

3. What types of courts exist in the state judicial system?

State governments establish courts pursuant to Articles III and I of their respective state constitutions. The general structure for the state court system is outlined below.

Article III State Courts

- *Supreme Court* - The State Supreme Court is generally the highest court in a state. In some states there is a different naming convention. In New York, for example, the highest court is the Court of Appeals. Nonetheless, the purpose of the highest state court is the same across all states. They review cases generally to ensure the correct or appropriate application of law - in accordance with the state's constitution. Cases generally go before the Supreme Court *via* a *Writ of Certiorari* or pursuant to request for appeal by a losing party. This process is similar to that of the federal system. Some state cases have automatic appeal rights to the state Supreme Court. This is the case for all capital murder cases.
- *Appellate Court* - Many state judicial systems have an intermediate court of review. Not every state is big enough to have an intermediate appeals court. As such, appeals must go directly to the State Supreme Court. The function of the intermediate state court of appeals is similar to that of the Federal Circuit Court of Appeals. It reviews the decisions of lower courts based on their interpretation and application of law to the facts of the case – as present in the record of trial.
- *Superior Court* - This is generally the naming convention for the highest level of trial court in the state. That is, the superior trial court is the court with general jurisdiction empowered by the state constitution to hear any matter of state law. It is the trial court for the most serious offenses (criminal and civil). It will hear any cases falling outside of the jurisdiction of subordinate trial courts. These courts generally employ juries as triers of fact.
- *Intermediate Trial Court* - Nearly all states have an intermediate trial court that has limited jurisdiction over certain types of cases. This court will generally hear criminal cases involving charges that have a specified limit in the potential sentence if found guilty. Further, it will generally hear civil lawsuits that have a specific limit in the dollar amount in dispute or in controversy. These courts often have special limitations, such as no right to jury trial and special court rules. The geographic jurisdiction of the court is generally broken down by county or district.
- *Courts of Limited or Special Jurisdiction* - Most states designate special courts to hear cases of a particular subject matter. This frees up the intermediate and superior trial courts to focus on criminal and civil trials that meet their jurisdictional requirements. Common examples of courts of limited jurisdiction include:
 - *Municipal Court* - Municipal courts are courts of limited jurisdiction to handle local ordinance violations. The geographic jurisdiction is generally limited to within the city or town limits.
 - *Example:* Common municipal court cases include citations (tickets) based on speeding or noise violations.
 - *Magistrate Court* (“Small Claims Court”) - This is a special court of limited jurisdiction to empowered to hear minor criminal offenses and small civil disputes. Magistrate court is important for small businesses. It handles much of the litigation between businesses and customers that falls within a jurisdictional limit (commonly \$10-20K or less). The benefits of the magistrate court are that it generally has very informal

court procedures and low court costs.

- *Probate Courts* - Probate courts handle matters involving death and estate administration. Specifically, the word probate signifies the process of administering an individual's estate. The court may also hear matters of child welfare and related family matters, such as guardianship, adoption, etc.
- *Family Courts* - Some states have a designated court to handle family law matters. The primary subject-matter jurisdiction for these courts includes divorce, annulments, and spousal and child support disputes.
- *Courts of Equity* - Some states designate special equity courts that operate based on principles of fairness. These courts apply "equitable maxims", rather than statutes, to reach a fair and just result. Most states have unified courts of law and equity and do not designate stand-alone courts of equity. Equity courts often hear civil disputes that do not involve the commission of a tort (such a mortgage default). They may act as a special form of mediator to certain disputes between individuals and businesses.
 - *Example:* States that have courts of equity include: Delaware, New Jersey, Mississippi, South Carolina, and Tennessee.
- *Business Courts* - States increasingly create a separate court or docket within the trial system to hear business law matters. These courts recognize the need to employ judges who are subject-matter experts in business principles.

Article I State Courts

All state constitutions allow for administrative state agencies to handle regulatory issues between citizens and the state government. These courts are structurally and operationally similar in nature to federal administrative courts. They fall under the state executive branch's authority. Examples of state administrative courts include: revenue (taxation), licensing, disability, employment, etc.

- **Discussion:** How do you feel about state's developing such extensive courts of special jurisdiction? Do these special courts provide any advantages or disadvantages for parties appearing before them?
- **Resource Video:** <http://thebusinessprofessor.com/state-supreme-courts/>

4. What is "Subject-Matter Jurisdiction"?

Subject-matter jurisdiction refers to the types of cases (subject matter of the case) that a court can hear (preside over). For example, a superior court in a state may not be able to hear a family, probate, or taxation matter. Similarly, a federal district court may not hear bankruptcy or immigration cases. Subject-matter jurisdiction is particularly important between federal and state courts. In some instances, a state may not be able to hear certain federal matters, and *vice versa*. For example, money laundering is a federal crime. A state generally cannot hear a case solely involving federal money-laundering charges, as it falls outside of its subject-matter jurisdiction. On the other hand, assault is a state law crime that is generally outside of the jurisdiction of the Federal District Court.

- *General Subject-Matter Jurisdiction* - Some state courts have general subject-matter jurisdiction. This means that the state court has the authority to hear any type of case involving state law.
 - *Note:* Federal District Courts are trial courts of general jurisdiction.
 - *Example:* The state superior court typically has authority to hear cases that are generally heard in lower-level courts. The reverse, however, is not true. Lower level courts (such as a municipal court) cannot hear cases that are outside of its limited, subject-matter jurisdiction.
- *Limited Subject-Matter Jurisdiction* - Often state courts divide jurisdiction based on the following:
 - the subject matter of a case,
 - the amount in controversy (or possible penalty for a crime), or
 - where individuals are located or reside.

Every state in the US has at least one court of general, subject-matter jurisdiction. Likewise, every state has some form of court with limited subject-matter jurisdiction.

- **Discussion:** As stated above, the state superior court typically has general, subject-matter jurisdiction within the state. Do you believe it is important to have state courts of general jurisdiction? Why are courts of limited jurisdiction necessary?
- **Practice Question:** Michelle hires Winston as a general contractor to build her home. Winston does a very sloppy job, which leads to Michelle suing him in state court for breach of contract and damages of \$25,000. She sues in an intermediate trial court with a jurisdictional limit of \$25,000. The court does not allow for a jury trial. Winston is not happy with the judge serving as trier of fact in the case. What may or should Winston do in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/subject-matter-jurisdiction-in-courts/>

5. What is the Federal Court's Subject-Matter Jurisdiction?

As previously discussed, if a federal court has subject-matter jurisdiction over a case, it means that the court may hear the case. There are generally two methods of establishing federal subject-matter jurisdiction in a case:

Federal Question Jurisdiction

- Federal-question jurisdiction is based upon, or arises out of, a federal law or the US Constitution. For a federal district court to have subject-matter jurisdiction, the parties must demonstrate that the case regards a dispute or charge based in federal law. For example, suing someone for trespass is a state-law tort generally tried in a state court. Suing someone under a federal law, such as discrimination under the Fair Housing Act, would be a federal court action. Special federal courts, such as legislative and administrative courts, have special subject-matter jurisdiction to the extent of the legislative or executive authority applicable to the court's subject matter. The court cannot hear matters beyond the scope of that jurisdiction. For example, a bankruptcy court cannot adjudicate a securities law dispute.

Federal Jurisdiction when the US is a Party

- Federal courts have exclusive subject-matter jurisdiction in civil or criminal lawsuits against the United States or its representatives. That is, any case in which the US Government is plaintiff or defendant, the matter can only be heard by a federal court. To illustrate, a federal district court would have subject-matter jurisdiction over a case in which a plaintiff sues the Federal Government for passing an allegedly discriminatory law. In such a action, the matter would also fall under federal-question jurisdiction, as the plaintiff is alleging that the action by the Federal Government is unconstitutional.

Suits Between States

- Federal courts have exclusive subject-matter jurisdictions over civil or criminal allegations between state governments. This most often arises when one state sues to enjoin (stop) another state from taking actions that unduly discriminate against another state or its citizens. For example, State A may sue State B in federal court contesting State B's higher sales tax rates on foreign citizens or businesses.

Diversity Suits between Citizens of Different States (Civil Cases)

- Federal courts have non-exclusive subject-matter jurisdiction in civil lawsuits between citizens of different states, if certain conditions are met. In this situation, allowing for federal subject-matter jurisdiction prevents one party from having an unfair advantage by being subject to another state's judiciary. It allows citizens of different states to go to trial in federal court, even if the claims are pursuant to state law. The special conditions for this type of jurisdiction are as follows:
 - *Diversity of Citizenship* - Parties must be from different states at the time of filing the action. Some federal diversity suits require "complete diversity," while others require "minimum diversity". In complete diversity cases, all plaintiffs must be citizens of different states from all defendants. In minimum diversity cases, only one plaintiff must be from a different state from one defendant. Minimum diversity is a common requirement in class actions.
 - *Jurisdictional Amount* - Diversity suits must involve a controversy between the plaintiff and defendant valued at \$75,000 or more. In cases with multiple plaintiffs, all plaintiffs' claims combined must amount to \$75,000 or more. For example, the court may aggregate 3 plaintiffs with \$25,000 claims to establish the \$75,000 amount in controversy requirement. If the dispute is for less than this amount, the federal court cannot hear the suit.

- **Discussion:** Do you think there is a valid justification for allowing individuals from different states to bring an action or remove an action to federal court? Does the federal court forum really mitigate any of the bias concerns with the jury? Do you think the amount in controversy of \$75,000 is justified? Should plaintiffs be able to aggregate their claims to reach the \$75,000 threshold? Does this create an issue if one of many plaintiffs happens to be located in the same state as the defendant?
- **Practice Question:** Milton enters into a contract to Cara to purchase a private jet. The jet is valued at \$7 million dollars in the contract. The terms of the contract state that Cara warrants that the aircraft meets all federal aviation

standards. Two months after the sale of the aircraft, Milton learns that the inspections records and mechanical function tests prescribed by the Federal Aviation Administration have been falsified. Milton is exploring his options for suing Cara in state and federal court. Cara is from Florida and Milton is from Mississippi. What subject-matter jurisdiction considerations exist for bringing an action against Cara in state or federal court?

- **Resource Video:** <http://thebusinessprofessor.com/federal-subject-matter-jurisdiction/>

6. What is the State Court's Subject-matter Jurisdiction?

General subject-matter jurisdiction means the state court may hear any type of case under state law. A state court of general jurisdiction has subject-matter jurisdiction in either of the following situations:

- an act violates a state criminal law and was committed within the state;
- a civil dispute involves a state law, or
- a citizen of the state is a party to a civil action.
 - *Example:* Tom is from Texas and Kay is from Kansas. Tom sues Kay in a Kansas court for a breach of contract that took place in Texas. Even though the breach of contract did not happen in Kansas, the court has subject-matter jurisdiction in the case based upon its personal jurisdiction over Kay as a citizen.

A state court with limited jurisdiction can only hear cases expressly allowed by the law creating the special court. In most states the state legislature will authorize special courts of limited jurisdiction. These courts are commonly limited by the type of case that it can hear or based upon the dollar amount in controversy.

- *Example:* Magistrate court in Georgia, for example, cannot hear a lawsuit alleging more than \$15,000 in damages because the amount exceeds the limits of its jurisdiction. South Carolina has a special circuit for family law cases.
- **Discussion:** Do you think it is important for a state to always have a court of general jurisdiction? Why do you think that states create courts of limited jurisdiction? Do these limited courts imply a lack of seriousness or professionalism in those courts? Does a court of general jurisdiction (particularly the judge) have the expertise to preside over all cases without a court of special jurisdiction?
- **Practice Question:** Lilly is from Texas. While in Arizona, she gets into a physical altercation with Mitchel. She is the aggressor and injures Mitchel very badly. Lilly leaves Arizona and returns to Texas. Mitchel presses criminal charges against Lilly in Arizona. Further, he seeks to sue her in civil court to recover damages for the injuries he suffered. What are the grounds for the Arizona court exercising subject-matter jurisdiction over the criminal and civil law actions?
- **Resource Video:** <http://thebusinessprofessor.com/state-subject-matter-jurisdiction/>

7. Can federal courts hear matters of state law? And vice versa?

Trial Courts

It depends. A state trial court may hear a case involving a federal question under certain circumstances. There are, however, certain types of cases that a state court cannot hear. Those cases involve a legal situation in which the applicable federal law preempts the entire area of law, such as immigration or bankruptcy. Likewise, a federal trial court may hear a state-law case under certain circumstances. For a federal court to hear a state matter and vice versa, courts must have subject-matter jurisdiction over some legal issue in the case. This generally occurs in two circumstances: 1) the case may involve a mixture of state and federal law, or 2) the case is a “diversity action”. If a case involving federal law also involves issues of state law, the federal court may adjudicate the state law issues arising in that case. Likewise, a state court hearing issues of state law case may apply federal law to adjudicate a federal law issue. Lastly, a federal court has subject-matter jurisdiction over diversity cases that involve only state law. The federal court will apply the substantive law of the state in which the court is located. The court will apply federal procedural law unless the federal procedural law would likely change the outcome of the case or is “outcome determinative”. In such event, the state procedural law will apply. These rules are known collectively as the “Erie Doctrine”.

- **Discussion:** Why do you think it is important to limit the ability of state courts to hear federal law issues and vice versa? Is there a good argument to allow greater ability of state and federal courts to hear issues solely involving the other’s law?
- **Practice Question:** Zora hires Isabelle as a contractor to design and manufacture a new baby product. Zora files and successfully prosecutes a utility patent on the product. In the contract with Isabelle, she agrees not to copy, trade, or otherwise employ the patented work. Isabelle later takes Zora’s design and begins producing a knock-off version of the product. Zora brings a legal action against Isabelle for patent infringement. Patent law is exclusively federal and preempts all state law. Zora also sues Isabelle breach of contract under New York Law. What are the subject-matter jurisdiction issues if Zora sues Isabelle in federal district court? What are the issues if Zora sues in state court?
- **Resource Video:** <http://thebusinessprofessor.com/can-state-courts-hear-federal-matters-and-vice-versa/>

Appellate Courts

Federal trial court decisions are appealed to the Federal Circuit Court of Appeals or *via* special writ to the US Supreme Court. Federal District Courts and Courts of Appeal cannot review decisions from state court cases. Also, state trial or appellate courts can never undertake appellate review of decisions from federal court cases. State trial court decisions are appealed to the state intermediate court of appeals or the state’s supreme court. There is, however, one exception to this rule. The US Supreme court may review decisions of state supreme courts. If the court’s decision appears to conflict with federal law, (such as a statute, treaty, or the US Constitution). US Supreme Court review of state supreme court decisions is most common when the state court upholds a state law that could potentially violate the appellant’s constitutional rights. In such a case, the US Supreme Court may issue a *writ of certiorari* or accept a request for appeal of the state Supreme Court’s decision by the losing party.

- **Discussion:** Why is it important that state appellate courts not hear appeals from federal trial courts? Why is it important to limit the ability of federal appellate courts from hearing appeals from state trial courts? Why is it

important the US Supreme Court be able to hear appeals from state supreme courts? Is there an argument for expanding the review authority of any of these courts?

- **Practice Question:** Nancy brings an action against the Georgia State Department of Revenue by suing the Commissioner Andrea. Andrea wins the civil lawsuit based upon an award of summary judgment. Nancy, unhappy with the result, believes that she lost the case because the court showed favor to Andrea as a state official. She does not believe that appealing the decision would do any good, so she files a request for appeal to the Federal Circuit court seeking to overturn the state court's decision. Is this appeal procedure possible? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/can-state-courts-hear-federal-matters-and-vice-versa-2/>

8. What is “Personal Jurisdiction”?

A court must have both subject-matter jurisdiction and personal jurisdiction in every case. While subject-matter jurisdiction regards the court's authority to hear a certain type of case, personal jurisdiction regards the authority for a court to exercise jurisdiction over an individual. That is, the court must have the legal authority to adjudicate the matter involving the specific individual. Determining whether a court has personal jurisdiction over an individual is different for criminal and civil cases.

- **Criminal Case** - In a criminal case, a court has personal jurisdiction over the defendant if the defendant committed the alleged criminal conduct within the court's geographic jurisdiction. A federal court will have personal jurisdiction over a defendant committing any criminal activity within the United States. A state court will have personal jurisdiction over a defendant committing any criminal activity within that state's borders.
- **Civil Case** - Establishing personal jurisdiction in civil cases requires that the court serve the defendant with a summons (or otherwise provide sufficient legal notice of the proceeding), also known as “service of process”. A summons, along with the complaint, gives a defendant legal notice of the allegations against her and directs her to appear before the court on a given date. The legal requirements for serving a summons on someone differ between state and federal courts and are discussed below.

In a criminal case, personal jurisdiction is generally not an issue. An individual would assert a defense to the alleged crime rather than assert a lack of personal jurisdiction. In a civil case, however, personal jurisdiction is a hotly debated topic. This is particularly true for businesses that place products into the market for sale. There is a great deal of uncertainty as to what amount of sales activity in a state will subject the business to personal jurisdiction in that state's courts.

- **Discussion:** Why are the requirements for personal jurisdiction different for criminal cases versus civil cases? Is there an argument for extending a state's personal jurisdiction over alleged criminal activity carried on outside of the state's jurisdiction? Would it be fair to subject
- **Practice Question:** Clarence lives in California. While he was visiting South Carolina, he was driving while intoxicated and crashed his vehicle. The wreck injured a bystander, Devon. Clarence, afraid that he would be arrested, quickly fled the scene of the accident. The next day he returned to California. What are the personal jurisdiction issues if the prosecutor's office in South Carolina seeks to bring criminal charges against Clarence for driving under the influence and leaving the scene of an accident? What are the personal jurisdiction issues if

Devon wishes to sue Clarence?

- **Resource Video:** <http://thebusinessprofessor.com/personal-jurisdiction-2/>

9. How does a federal court get personal jurisdiction over someone in a civil case?

Rule 4 of the Federal Rules of Civil Procedure lays out the process for a federal court establishing personal jurisdiction over a defendant. In summary, the federal court must employ the state law governing personal jurisdiction that is applicable in the state in which the federal court is located. The federal court adopting the state's procedural law must subject the defendant to the same procedures as if the case were in state court. That is, the federal court will use the state's procedural rules for serving process on individuals within the state's borders and may also use the state's long-arm statute to reach defendants outside of the state's geographic boundary. As discussed further below, the long-arm statute is a special statute allowing the state to serve a summons on a defendant who is not physically located in the state.

- *Note:* If the subject-matter of the case is exclusively federal, the Federal Rules of Civil Procedure allow the federal court to exercise personal jurisdiction over the defendant regardless of where she is located. That is, the federal court is not limited by the state's service of process rules. Federal procedure allows for service of process anywhere in the United States and its territories.
- **Discussion:** Why do you think that federal district courts use the procedural rules for service of process of the state in which the court is located? Is there an argument that federal courts should have their own uniform rules for service of process?
- **Practice Question:** Lindsay, a Florida resident, entered into a services contract with Rachel, a Georgia resident. Rachel later failed to perform and breached the agreement. As a result of Rachel's breach, Lindsay claims to have suffered damages in the amount of \$100,000. Lindsay plans to bring a civil action against Rachel in the Federal District court located in Georgia. At the time, Florida allowed process servers to deliver service of process, but Georgia required service of process to be carried out by the local Sheriff's office. Lindsay hired a Florida process server to deliver service of process to Rachel. What is the personal jurisdiction issue in this case?
- **Resource Video:** <http://thebusinessprofessor.com/federal-personal-jurisdiction/>

10. How does a state court get personal jurisdiction over someone in a civil case?

Service of process means providing an individual with a summons (or other authorized method of notification), which gives notice to the individual that she is being called before the court. Personal jurisdiction in state court is governed by the individual state's law concerning service of process. Service of process must generally take place (the summons must be delivered) while the defendant is physically present within that state. The exception to this rule is that every state has a law, known as a "long-arm statute", allowing service of process on defendants outside of the state.

- *Note:* There are limited circumstances where a state will allow a court to exercise jurisdiction over an individual without delivering a summons. For example, a court may exercise jurisdiction over an individual in a family matter (such a divorce), if that individual is a resident of the state and cannot be found after diligent search. Another situation is that a court may exercise jurisdiction over an individual's real estate that is located in the state

without delivering a summons to that individual if all attempts to locate the individual fail and notice is posted on the property.

- **Discussion:** Why do you think that states place such importance on delivering notice to establish personal jurisdiction? Do you feel like serving an individual with a summons while she is within the state justifies the court in exercising jurisdiction over that person? Do you think it is justifiable in any circumstance to exercise jurisdiction over someone without delivering a summons?
- **Practice Question:** Quinton decides to sue Maria for failing scratching his new car in the parking lot of the grocery store. Quinton files a court action and pays a process server to deliver the summons and complaint to Maria. The process server tries for weeks to locate Maria but is unsuccessful. Will Quinton be able to sue Maria if he cannot deliver the summons and complaint?
- **Resource Video:** <http://thebusinessprofessor.com/personal-jurisdiction-in-state-court/>

11. What is a state “Long-arm Statute”?

A state’s long-arm statute allows service of process on defendants who are physically located outside of the state. A state’s long-arm statute must, however, comply with the 14th Amendment’s Due Process protections. This means that, to pass constitutional muster, a state’s long-arm statute will only allow for service of process on individual outside of the state’s borders if the defendant has sufficient contact with the state to make it reasonable to call her into court there. More precisely, the defendant must have “minimum contacts with the state” sufficient to not offend notions of “fair play and substantial justice”. Examples of situations where a defendant has minimum contacts with the state to allow the state to serve process on a defendant *via* its long-arm statute include when: she is a resident of the state; she owns property in the state that is the subject of the controversy; or she committed the controversial activity in the state. A business entity is subject to jurisdiction if it carries on business regularly in the state or is organized in or registered to do business in the state. All of these situations involve a sufficient level of contact with the state so that service of process outside of the state’s geographic borders does not offend notions of fair play and substantial justice.

- **Note:** Recall, federal courts use the law of the state in which it is located for serving process on a defendant. This includes using the state’s long-arm statute when a defendant is not physically located within the state.
- **Discussion:** How much contact with a state do you feel is sufficient for a court to exercise jurisdiction over the person without offending the due process requirements of the US Constitution? Is there any situation where you believe a slight amount of contact with the state still justifies exercising jurisdiction? How do you feel about exercising jurisdiction over a business that regularly ships products to customers in a state but does not have a physical presence in the state and is not registered to do business?
- **Practice Question:** Elena lives in Vermont and has a small business that manufactures a product for pets and sells it to retail establishments throughout the United States. She takes orders on her website and ships her product through a third-party logistics company. Gary, one of her retailers in Montana, is not happy with the quality of her product and demands a refund. When Elena refuses to refund Gary’s money, he sues her in Montana court. The Montana long-arm statute allows for service of process on a civil defendant in any state if the defendant is a business entity and ships any products into the state of Montana. What constitutional argument could Elena make

to defend against being served with process and called into court in Montana?

- **Resource Video:** <http://thebusinessprofessor.com/state-long-arm-statute/>

12. What is “Venue”?

Venue is the physical location (within the state or federal circuit) where the trial is conducted. A state may contain more than one federal courthouse. Further, states generally have courthouses located in every county, district, or precinct within the state. Once the court establishes subject-matter jurisdiction over the type of case and personal jurisdiction over the defendant, there is a question as to the appropriate venue for the trial or hearing. The appropriate venue is generally the courthouse located in the county, district, or precinct that is most closely related to the matter in controversy. This could be the location where the controversial activity (such as the tort or breach of contract) took place. Alternatively, it could be the locale where the plaintiff or defendant resides. If the parties live in different towns, the place where the activity in controversy occurred or the defendant’s locality is generally the appropriate court.

A court may transfer venue to another court in the state if mutually requested by both parties or other equities require a transfer. The reasons for transferring the venue of a trial to another court in the state are to avoid one party having a home-field advantage or one party being subject to a biased jury pool. For example, one party’s home locality may be more likely to find in her favor at trial. Similarly, an individual accused of a horrible crime in a community may be subject to undue bias by prospective jurors.

- **Discussion:** Can you think of any famous trials in which venue was transferred to another court? Do you think that parties to a contract should be able to choose the venue where any controversies must be litigated?
- **Practice Question:** Beth is a resident of Sonoma County in Northern California. Samantha is a resident of San Diego County in Southern California. Last month, while visiting Disney Land, which is located in Orange County in Southern California, Samantha accidentally hit Beth with her car when she was crossing the parking lot. Beth suffered some injuries and decides to sue Samantha in the Sonoma County Superior Court for damages. What is the likely result if Samantha disputes venue for the court proceeding?
- **Resource Video:** <http://thebusinessprofessor.com/venue/>

13. Who are the primary players in the judicial system?

The legal system has a number of diverse contributors. Each plays a unique role in a quite intricate system. The primary players discussed in this chapter include:

- Judges
- Jurors
- Private and Public Lawyers (and their staff)

These individuals are primary members of the judicial system based upon an individual’s Constitutional rights. The 6th and 7th Amendments grant an individual charged with a crime or subject to a civil penalty of \$75 or more the right to trial by a jury of her peers. Articles I and III account for the authority to create a federal court system under the direction of judicial

officers or judges. Due Process rights allow an individual the right to representation in a judicial proceeding. The distinct roles played by judges, jurors, and attorneys are discussed individually in separate sections.

- **Resource Video:** <http://thebusinessprofessor.com/primary-players-in-judicial-system/>

14. What types of judges are part of the judiciary?

There are many types of judges in the legal system.

Federal System

- *Federal District Court Judges* - Judges for the federal trial court.
- *Federal Magistrate Judges* - Special federal court judges who hear certain pre-trial and post-trial matters.
- *Federal Circuit Court Judges* - Appellate judges on the appellate courts for all of the district courts within its geographic jurisdiction (judicial circuit).
- *US Supreme Court Justices* - Justices (judges) who sit on the highest appellate court in the US legal system.
- *Judges for Special Article I Courts:*
 - *Federal Administrative Judges* - Judges that preside over the various legislative (administrative) courts established by congress, such as the Tax Court.
 - *Specialty Court Judges* - Judges that preside over the various special courts designed by Congress under Congress, such as bankruptcy courts and courts-martial.

State Judicial System

- *Local Municipal Court Judges* - Judges presiding over municipal hearings to enforce city or municipal ordinances.
- *State Magistrate Judges* - Specialty court judges who preside over county or small claims courts. They also serve the function of granting warrants, holding probable cause hearings, and presiding over initial appearances.
- *Intermediate State Court Trial Judges* - Judges who preside over special trial courts of limited jurisdiction.
- *Superior Court Judges* - Judges who preside over trial courts of general jurisdiction.
- *State Appellate Court Judges* - Appellate judges who hear appeals from trial courts within its geographic jurisdiction.
- *State Supreme Court Justices* - Appellate judges (Justices) sitting in the highest appellate court in the state.

- *State Administrative Judges* - Judges presiding over the administrative agencies created by the state legislature.
- *Specialty Court Judges* - Judges presiding over special courts designated by the state constitution or legislature. Special court judges may include: family court judges, probate court judges, and masters in equity.

Some jurisdictions may have special names, designations, qualifications, etc., for judges presiding over a specific court.

- **Discussion:** How do you feel about the distinct roles of judges in different courts? Do you think should be distinct qualifications (education and training) for judges presiding over a particular court?
- **Practice Question:** Given what you known about the federal and state legal systems, what are the similarities and differences between the types of judges in the state and federal system?
- **Resource Video:** <http://thebusinessprofessor.com/types-of-judges-in-state-and-federal-judiciary/>

15. What are the duties of trial judges in the legal system?

The trial judge plays the following roles in the judicial process:

- *Applying Procedural Law* - The judge marshals the proceeding and presentation of evidence in accordance with procedural law. In this capacity, she observes and applies constitutional limitations and guarantees of due process of law. This includes applying procedural law, such as the admission of evidence at trial.
- *Applying Substantive Law* - The judge identifies applicable rules of law to apply in each case. In essence, the judge tells the jury what law to apply when trying the defendant's conduct. This is commonly known as instructing or "charging the jury".
- *Role as Fact-Finder* - In some cases, the parties are not entitled to a jury trial. As such, the trial judge may also serve as the finder of fact (the typical role of the jury). A judge often assumes this role in lower-level courts or when the defendant requests trial by judge alone. For example, the judge assumes the role of fact finder in traffic or small claims courts.
- *Applying Equity* - Equity is the inherent power of a judge to act in accordance with principles of fairness or justice when the law does not provide an adequate remedy through money damages. Equity allows the judge to order parties to take actions to achieve a fair and just result.

To give a practical explanation, the trial judge serves a role similar to a referee in a sports game.

- **Discussion:** Some analogies compare the trial judge to a referee in a sporting match. Why do you think this is an adequate or inadequate comparison? Why do you think that some defendants will request that a judge serve as fact finder in a given case?
- **Practice Question:** Lisa is a superior court judge in Alabama. In a criminal trial, the defendant requests a trial by

judge alone and agrees to forego her right to a jury trial. Lisa is concerned that serving as fact-finder in the case would cause issues for appeal and denies the defendant's request. During the trial, the defense counsel makes a motion to exclude from evidence a confession signed by the defendant. Lisa overrules the motion and allows introduction of the confession to the jury. At the end of the presentation of evidence, Lisa rejects the defense counsel's proposed jury instruction and delivers to the jury her own explanation of the substantive law to be applied to the facts. Explain how these activities fit within the core functions of a trial court judge.

- **Resource Video:** <http://thebusinessprofessor.com/trial-court-judges/>

16. What are the duties of appellate court judges or justices?

The duties of an appellate court judge are distinct from those of a trial judge. Specifically, the appellate court serves as legal reviewer of trial court decisions. It does not generally make determinations about the facts of the case, except in special circumstances (known as "de novo review"); rather, the court reviews the case based on the facts as found by the trial court and present in the trial record. That is, the appellate court accepts the jury's findings of fact as true. As an example, if the jury finds that an individual was driving the car that hit the plaintiff, the appellate court must assume that is true. The appellate court judges review the case for legal inadequacy and serve the following functions.

- **Resource Video:** <http://thebusinessprofessor.com/appellate-judges-justices/>

Application of the Law (Procedural and Substantive)

- In reviewing a case, the appellate judges determine if the law was applied correctly to the case. This process includes reviewing the application of procedural and substantive law. If the procedural law is found to have been applied incorrectly, the judges look to determine if the error was prejudicial to the losing party. If so, the case may be overturned in whole or in part and remanded to the trial court for further proceedings. If the substantive law is applied incorrectly, the case is generally overturned and remanded. The court's determination of whether the substantive law was applied correctly is generally based on the plain meaning of the statute and legislative intent in passing the statute. In making this assessment, the appellate judge will look at the legislative notes, prior appellate court opinions, or other indications of how and why the legislature passed the law. If the law, as applied, does not comply with the legislature's intent, the appellate court has the ability to overturn the decision (verdict) and remand the case for re-trial. The court may overturn the entire case or just the charge or cause of action negatively affected by the erroneous application of law.

- **Discussion:** Do you think a procedural error justifies overturning a case? How prejudicial do you believe a procedural error must be to justify overturning the case? Do you think that overturning part of a jury finding and upholding another part is fair and just? Should the case always be overturned in the event of a substantive error? Do you feel that the entire case should be overturned if the court finds a substantive error?
- **Practice Question:** Lisa is a superior court judge in Alabama. In a criminal trial, the Defendant request for a trial by judge alone and agrees to forego his right to a jury trial. Lisa is concerned that serving as fact-

finder in the case would cause issues for appeal and denies the Defendant's request. During the criminal trial, defense counsel makes a motion to exclude from evidence a confession signed by the defendant. Lisa overrules the motion and allows introduction of the confession to the jury at trial. At the end of presentation of evidence, Lisa instructs rejects defense counsel's proposed jury instruction and delivers to the jury her own explanation of the substantive law to be applied in the case. On appeal, what legal issues will the appellate court review in this situation?

Constitutionality of the Law

- Appellate judges are responsible for determining whether the law or government action, as applied, is consistent with and does not violate the Constitution. That is, they are charged with the power of interpreting laws and determining if the law is unconstitutional. Any law or government action that violates the constitutional rights of an individual is void and unenforceable. Additionally, if the law in question violates a superior law it will receive a limiting interpretation or be overturned entirely. Appellate judges' power to overturn the law is a critical piece of the checks and balances system. As a result, the legislators who passed the law must start over if they wish to pass another law to achieve their intended purpose.

- **Discussion:** What do you think of the role of the Supreme Court in reviewing the major cases and determining whether the law involved is constitutional. For example, consider The Affordable Care Act, Same-Sex marriage, Immigration Laws, Marijuana laws, etc. What has been or will be the role of the US Supreme Court in evaluating this law?
- **Practice Question:** The US Congress passes a law requiring all individuals in the United States to apply for a driver's license, regardless of whether the individual ever intends to drive a vehicle. Applying for the license takes time and costs money. Any individual who fails to apply for the license will face an income tax penalty. Proceeds from these penalties will be used to fund federal highway construction projects. Helen is not happy about the new law and files a federal court action against the director of the Federal Highway Administration (FHWA). The trial court grants summary judgment to the FHWA Commissioner; so, Helen appeals to the Circuit Court of Appeals. In this scenario, what legal issues will the appellate court review?

Developing the Common Law

- Appellate judges render decisions when reviewing a case. Along with these decisions, the court writes an opinion on how the law was or should have been applied in the case. The appellate judge's written opinion ultimately becomes part of the common law and serves as precedent for lower judges to apply in future cases. In this way, appellate judges are like legislators – interpreting and creating the manner in which the law should be applied.
- **Discussion:** The power of judicial review, arguably, makes the judiciary the most powerful branch of Government. How do you feel about the ability of the judiciary to develop law through the interpretation of the law as applied in a given case? Can you think of an example where judicial review overturned a lower court's decision?

- **Practice Question:** Adam lives in rural Louisiana. One day, he navigates his small fishing boat through a series of small creeks that eventually open up to a lake. While fishing on the lake, the local game warden approaches Adam and issues him a citation. Adam is now facing charges for trespass for unlawful entrance on a state-controlled lake and illegal fishing. The citation is based upon a Louisiana statute authorizing state-controlled wildlife areas and the restriction of those areas to public use. Adam, a savvy business student, begins researching the state statute and its legal history. He finds a state appellate court opinion stating that the Louisiana statute cannot lawfully prohibit access to the water resources that are accessible by a navigable waterway. Navigable waterways are controlled by federal law, and any state law in conflict is preempted. If Adam presents this case to the trial court, would it potentially have an effect upon the outcome of the trial? Why or why not?

17. How do cases arrive before the appellate courts?

The method by which a case arrives before an appellate court varies based upon the type of appellate court.

- *US Circuit Courts of Appeals* - The US Courts of Appeal hear cases appealed from the Federal District Courts. Like all appellate courts, the Courts of Appeal review cases to determine:
 - whether the correct law was applied, and
 - whether it was applied correctly, and
 - whether the law, as applied, violates rights provided by the US Constitution.

Generally, appeals derive from a request by the losing party at trial. In some cases, however, a party may make an interlocutory appeal, which is an appeal of a single issue before the case has been decided. This is only allowed, however, when the issue is extremely important or would effectively decide the case. The losing party generally requests permission to file an appeal with the Court of Appeals. The court will either grant the request or deny it – making final the decision on the appealed issue.

- **Discussion:** Do you think that interlocutory appeals should be allowed? What are some good arguments for allowing such appeals? Arguments against them?
- **Practice Question:** ABC, Inc., is facing a civil lawsuit in federal district court initiated by one of its employees for allegedly failing to provide the required disclosures about the company-sponsored retirement plans. The applicable federal law lays out numerous standards for plan disclosure and provides that a company that fails to comply will be subject to actual and statutory damages. ABC believes that the law is ambiguous and does not require the disclosures identified by the plaintiff. During trial, ABC moves for the court for a directed verdict in its favor. The court denies the motion. ABC knows that continuing to a jury trial will cost lots of money and that a jury is always likely to find in favor of an employee over an employer. Nonetheless, ABC does not want to settle the case and leave open the question of whether it must comply with this level of disclosure. What are ABC's options regarding appealing any outcome from the trial court?
- **Resource Video:** <http://thebusinessprofessor.com/appeal-to-us-federal-circuit-court/>

- *US Supreme Court* - The US Supreme Court accepts cases *via* two primary methods. The first method is the *Writ of Certiorari*. This is a written demand issued by the court for the case to be transferred to the court for review. Procedurally, 4 of 9 Justices must agree to accept the writ and review the case. The second method is pursuant to appeal by any party to a case. Generally, the court will only accept appeals of issues that have important and broad impact. Further, the issues on appeal generally involve issues of constitutionality. The Supreme Court may use this authority to review decisions by the highest court in any state or by any federal court. As the highest appellate court, decisions by US Supreme Court are final. That is, its decisions cannot be appealed further. Also, its decisions provide precedent for all inferior courts. This means that all lower courts (state and federal) must follow, interpret, and apply the law consistently with the interpretation of the Supreme Court. The court's interpretation of the law actually becomes part of the law and forms the common law surrounding the statute.

- **Discussion:** How do you feel about the US Supreme Court's ability to demand that any appellate case be transferred to the court for review? Is there are good argument that appeals to the Supreme Court should only happen pursuant to petition of the parties?
- **Practice Question:** Gerard, a citizen of State A, does not agree with a state statute allowing state agencies to ask employees about political affiliation as part of a job application. He believes that employers ask political affiliation questions as a subtext for discriminating based upon social belief and the expression of those beliefs. He files a federal action in the US District Court challenging the statute. The court defers action on the case and recommends immediate appeal based upon questions of constitutionality of the statute. At this point, Gerard is confident that his view will prevail in the Circuit Court, because a separate federal circuit court recently ruled on a similar issue in a way that is favorable to or recognizes Gerard's argument. Surprisingly, the local federal circuit rejects Gerard's arguments and holds the statute to be constitutional. Gerard immediately requests appeal to the US Supreme Court. What factors and procedures will affect the Supreme Court decision of whether or not to accept the case?
- **Resource Video:** <http://thebusinessprofessor.com/appeal-to-us-supreme-court/>

- *Appeals from Legislative and Administrative Courts* - In general, parties appearing before legislative courts have direct rights of appeal to Article III Courts (District or Circuit Courts). The ability to appeal, however, is not generally immediate. A party wishing to appeal a legislative court's decision must first appeal to the agency administrator or to an internal administrative board within the agency. Once this is complete, if this does not remedy the issue, the parties may appeal to the Federal District Court. The District Court will act as an appellate court for the matter in question. In certain cases, the parties may appeal directly to the Circuit Court and skip review by the District Court. The important thing to remember is that parties appearing before Article I courts must still have the ability to appeal the court's decision to an Article III court. Otherwise, cutting off access to an Article III court may be unconstitutional as a violation of due process rights.

- **Discussion:** Do you believe that the appeals procedure described above adequately protects the appellant's constitutional right to due process? How do you feel about the requirement of having to first appeal to an internal administrator or agency board before being able to appeal to an Article III court? Can

you think of any good reasons for adding this requirement?

- **Practice Question:** Meredith wants to file a civil action in federal court against her employer, ABC, Inc., for sex discrimination. She contends that ABC generally provides higher compensation to men than women for the same type of work and that she is a victim of this illegal treatment. She files a claim with the EEOC, the administrative agency charged with investigating claims of sex discrimination under federal law. She does not want to wait on the EEOC to undertake its investigation, so she immediately files a civil action against the employer in the federal district court. What will likely be the result of this situation?
- **Resource Video:** <http://thebusinessprofessor.com/appeal-from-administrative-courts/>

- *Appeals in the State Court System* - The appellate procedure in state court is similar to that of the federal system. Decisions from the trial court go to the intermediate court of appeals, unless the state does not have an intermediate court of appeals or state statute requires appeal directly to the state supreme court.

- **Discussion:** Do you think that state trial court decisions should ever be allowed to be appealed to a federal district court or a federal circuit court? Are there any good arguments for or against this hypothetical appellate process?
- **Practice Question:** Wallace is charged with the misdemeanor crime of public intoxication. He contends that he is not guilty, as his intoxication was from a prescribed medicine and was not voluntary. The prosecutor brings the case in an intermediate trial court of limited jurisdiction that does not allow for a jury trial. Wallace is aware that he can ask for a jury trial and the case will be removed to the state's superior courts. He decides to proceed to trial in the court of limited jurisdiction. Ultimately he is convicted and ordered to pay a fine. Wallace believes that he would have prevailed in the case if there had been a jury. What are Wallace's options at this point?
- **Resource Video:** <http://thebusinessprofessor.com/appeal-of-state-court-decisions/>

18. What is the role of “Jurors” in the judicial system?

The 6th and 7th Amendments to the Constitution guarantee the right to trial by jury in criminal and civil cases, with certain exceptions. The right to trial by a jury varies between criminal and civil cases.

- *Civil Cases* - The 6th and 7th Amendments do not guarantee a right to a jury trial in every trial. In civil cases, the right to a jury trial is linked to a dollar amount in controversy between the parties. States may have courts of special jurisdiction that have an amount-in-controversy limit and do not allow for a jury trial. If the parties want a jury trial, however, either party has the option of filing the case in a superior court of general jurisdiction, where a jury trial is an option. In this way, each party's access to a jury trial is not limited. Parties may also enter into contracts that forgo the right to a jury trial in the event of dispute.
- *Criminal Cases* - Due process requires that criminal cases in which a party faces potential imprisonment afford

her a jury trial. Very minor criminal infractions that involve a fine and no potential for incarceration often do not allow for a jury trial. For example, a citation for speeding may not entitle a party to a jury trial.

In criminal cases the defendant may elect to forgo a jury trial and have the judge act as fact finder. In civil cases, if the right to jury trial exists, both parties must consent to forgo the right to a jury trial.

- **Discussion:** Do you believe that every civil and criminal case should be entitled to a jury trial? Is there a good justification for tying the right to a jury trial to an amount in controversy or incarceration?
- **Practice Question:** Carla has a dispute with her electrician, Dan, over her bill for electrical work. Carla claims that Dan quoted a price of \$300 for the work and then increased the price to \$750 after the work was completed. She does not want to pay the higher amount. Dan ultimately sues Carla in the local magistrate's court, which does not allow for jury trials. What are Carla's options in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/right-to-jury-trial-under-6th-and-7th-amendments/>

19. How many jurors and juror votes are required to find someone guilty in a criminal case or liable in a civil case?

The number of jurors and the number of juror votes required for a finding of guilt or civil liability vary depending upon the type of case (criminal or civil) and the court (state or federal).

- *Number of Jurors* - Not all court cases involve a jury trial. When a jury trial is warranted, the number of jurors required is known as "*petit jury*". Rule 48 of FRCP states that, a "Court shall seat a jury of not fewer than six and not more than twelve members." Most cases do not have 12 jurors.
 - *Note:* Most states require that all murder cases have 12 jurors.
- *Unanimous Vote* - In criminal cases, most courts (state and federal) require unanimous vote by the jury to find the defendant guilty. Currently, courts in only two states allow for conviction of a defendant *via* non-unanimous voting, and those are generally reserved for minor charges.
 - *Note:* Federal military courts-martial, a special form of Article I federal court that enforces criminal actions, allows for a non-unanimous finding of guilty in certain cases.
- *Majority Vote* - In civil cases, many states have eliminated the unanimity requirement to find a defendant liable. This means that many states allow for a finding of civil liability with a simple majority vote by jurors. These statutes may require a minimum number of jurors on the jury.
- *Jury Findings* - In general, juries do not need to give reasons for their votes in a civil or criminal case. The jury will provide a simple verdict (guilty/not guilty or liable/not liable) and does not have to explain its reasoning in the matter. Some special verdicts, however, require jurors to answer a series of questions to ascertain their understanding of the law and procedure. Further, the jury may have to indicate whether they find aggravating circumstances, which may be a legal requirement for a certain finding. Even in these cases, the juror does not have to explain why they find facts to be convincing or no.

As previously stated, the specific rules applicable to jurors, juror votes, and findings will vary slightly depending upon the case and the court system.

- **Discussion:** How do you feel about the requirement in civil cases that a majority of jurors find liability? Are there good arguments for or against requiring unanimous jury findings in civil trials? What do you think about only requiring six jurors when determining guilt or innocence in criminal trial (other than capital trials)? Should jurors be required to give their reasoning behind finding guilt or innocence?
- **Practice Question:** Julie is a law clerk for a mid-sized legal firm. She is assigned to assist firm attorneys on a civil litigation matter in which her firm is defending its client in a contract dispute for \$2 million. The client is a large corporation with a corporate counsel who wants to be apprised of every step of the litigation. Her first assignment is to work on the *voir dire* questions used to identify biases in potential juror candidates. As part of the assignment, she is putting together a one-page explanation of the jury selection process for the client. She begins by laying out the total number of jurors required, votes required to establish liability, and any additional requirements of the jury. Help Julie write this first portion of the strategic plan.
- **Resource Video:** <http://thebusinessprofessor.com/jury-votes-required-for-finding-guilt-or-liability/>

20. What do attorneys do?

Areas of Practice - There are dozens of areas of law practice that are largely, if not completely, separate and unrelated. Very few attorneys are experts in more than a couple of legal areas. Below are some common areas of legal practice: Criminal Law, Civil Action (Tort Lawyers), Insurance Litigation, Secured Transactions, Administrative law, Contract law, Consumer Law, International shipping and trade, Immigration law, Intellectual Property law, Antitrust law, Securities law, Banking and Finance Law, Corporate Governments, Environmental law, Land and Property, Labor and Employment, Social Security & Disability, Elder Law, Estate Planning, Worker's Compensation, Family law, Human Rights, Election law, Sports law, etc.

Duties to Clients - Attorneys are counselors, advocates, and public servants. More specifically, they are fiduciaries and advocates for their clients' interests and officers of the court. The attorney's oath of office subjects the attorney to a professional code of ethics that governs all of her professional practice activities. The attorney is generally trained to navigate the legal system. This may involve working within the courtroom. Below are some universal truths about lawyers and those who practice in the courtroom.

- *Fiduciaries* - Attorneys have a duty of trust, confidentiality, and loyalty to their client. This means that, absent certain exceptions, an attorney cannot disclose confidences related to her by a client. This relationship requires a high degree of professional and ethical conduct. Lawyers are subject to sanction (or even disbarment) for failure to live up to these high ethical standards.
- *Court Representation* - Individuals may represent themselves or hire a licensed attorney to counsel and represent them before the court. Attorneys must be licensed by and admitted to a court's bar to represent clients before that body.
- *Officers of the Court* - Attorneys are officers of the court and are required to seek justice and to try cases on the

merits only. While attorneys represent their clients, they have ethical obligations to the court to promote and seek justice. The system is not designed to be a battle of wits, but rather a presentation of evidence for a just decision.

Not all attorneys practice law in a courtroom; however, these standards apply equally to attorneys who provide legal services outside of the courtroom.

- **Discussion:** Do you think that the majority of the public is aware of all of the specialties that exist in legal practice? Why do you think that there are so many specialty areas of legal practice? Do all of these specialties call into question the professional competence of general practitioners? Do you find any conflict of interest for attorneys who are expected to be officers of the court as well as zealous advocates for their clients?
- **Practice Question:** Grace has her own legal practice where represents corporations in contract law matters. She primarily works with investment banks to develop and memorialize corporate funding arrangements. One of her biggest clients, ABC, Inc., approaches her about suing a competitor, 123, Inc., in state court for anti-competitive behavior. Grace has very little experience in this area, but she decides to undertake some due diligence in order to adequately advise the client on the situation. From her investigation, she learns that there are really no grounds for a lawsuit against 123. More troubling, however, is Grace learns that ABC has been involved in an on-going scheme that could be considered fraudulent to its shareholders. Grace brings this matter to the attention of the CEO of ABC. The CEO tells her to ignore the shareholder matters and, if she wants to continue representing ABC in other matters, to initiate litigation against 123 immediately. What are the duties and ethical considerations that constrain Grace in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/what-do-attorneys-do/>

21. Who are some of the other players in the court system?

The court system can be large and complicated. To run properly, it requires a number of individuals to carry out specific functions. Some of the primary actors are as follows:

- **Process Servers** - Process servers deliver legal documents (serve process) to individuals being called into court. Some jurisdictions allow private parties to serve process for the court. Other jurisdictions require police authorities to serve process.
- **Clerks of Court** - Clerks of court run the office that manages all publicly filed court documents for that jurisdiction. All court documents are first filed with the Clerk of Court. The Clerk of Court may also manage the process for service of process.
- **Court Reporter** - The court reporter records and transcribes the official record of the court. This record is used in appellate review.
- **Bailiff** - The bailiff controls security in the courtroom and carries out the orders of the court. This includes executing contempt orders.
- **Paralegals & Law Clerks** - Paralegals and law clerks carry out many of the administrative tasks that support the court and trial process. This includes conducting research for attorneys, companies, government bodies, judges, or

justices.

- *Staff Attorneys* - Legislative and administrative bodies employ staff attorneys. These attorneys research issues and serve as the primary architects and scribes of laws proposed by the bodies they serve. For example, staff attorneys write the majority of the laws proposed by members of the legislative branch.
- *Prosecutors & Public Defendants* - These are the government attorneys employed to represent the government in prosecuting alleged crimes and representing the defendants subjected to prosecution.
- *Law Professors* - These legal scholars and practice experts train attorneys and act as contributors to the body of legal thought. Researching professors write about specific areas of law and provide analysis and insight for use by practitioners, legislators, and the court.
- *Law Journals* - Law journals review, edit, and publish works of original thought that add to the intellectual body of law. These published works serve as influential sources for use by practitioners, legislators, and the court.
- *Bar Associations* - Bar associations are federal, state, and local groups of attorneys. These organizations can be very influential in shaping the development of law and the legal system through advisory votes and committee proposals.

The above list of contributors to the court system is by-no-means exhaustive.

- ***Practice Question:*** Derrick is a new business manager who oversees the corporate collections group. As part of his role, he has to be aware of all legal actions by the corporation for outstanding debts. Derrick recalls some of what he learned in school about the legal process, but is very confused by the whole process. He tries to read legal material online, but realizes he does not have enough time to fully educate himself on the process. He assigns his intern (you) to explain the whole litigation process in two pages. He specifically wants you to begin by explaining the role of everyone involved in the process. Write a memo explaining the role of everyone involved in the litigation process.
- ***Resource Video:*** <http://thebusinessprofessor.com/players-judicial-system/>

22. What are the theoretical (political) views toward judicial review?

As previously discussed, appellate courts have the power of judicial review. This includes the power to review laws passed by the legislative body or actions by the executive and to declare them to be unconstitutional and void. Two primary views exist regarding the role of the judiciary in executing its authority:

- *Judicial Restraint* - Proponents of judicial restraint believe that the judiciary's power of review should not be used except in unusual cases. They specifically believe that review of laws that has the effect of expanding or limiting the understanding of constitutional rights are too important to be decided by courts unless absolutely necessary. As such, any case that requires analysis of and interpretation as to the extent of rights afforded under the Constitution are to be avoided if there is another legal basis for a decision. Proponents of judicial restraint also believe that litigation is not the appropriate technique for bringing about social, political, and economic change. That is, social, political, and economic change should only result from the passage of laws by the legislative

branch of the federal or state government.

- *Judicial Activism* - Proponents of judicial activism support the use of the judiciary's power of review. They believe that judicial interpretation of laws is the appropriate vehicle for developing legal standards and should be used whenever justified by the needs of society or public sentiment. Proponents of judicial activism also believe that constitutional issues must be decided within the context of contemporary society. They adopt the view that the meaning of the Constitution is relative to the collective beliefs, sentiments, and values of society at the time in which the law is being interpreted.

These views of the role of appellate courts have become largely a political issue.

- **Discussion:** What are the major arguments in favor of or against judicial restraint? Judicial Activism? How do these points of view align with the beliefs of major political parties within the United States?
- **Practice Question:** ABC Corporation spends a great deal of money each year lobbying politicians. It contributes tens of millions of dollars of shareholder money to political action committees that support particular political candidates that support policies favorable to ABC. ABC tasks you with researching political candidates to identify which candidates actively endorse the view of judicial restraint? Why do you think this information is relevant and valuable to ABC?
- **Resource Video:** <http://thebusinessprofessor.com/judicial-restraint-vs-activism/>

TOPIC 4: ADMINISTRATIVE LAW

Overview

Administrative law concerns the methods by which administrative agencies of the federal and state governments promulgate and enforce regulations. Regulations provide the body of rules surrounding statutory law. This chapter will review the constitutional authority for the creation and functions of administrative agencies. It will explore the nature and organization of agencies, as well as the process by which agencies promulgate and enforce regulations. It will lay out the judiciary's role in reviewing administrative agency action and court decisions. Lastly, it will examine the effects of regulations on business practice.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

- [Administrative Agency](#)
 - [Executive](#)
 - [Independent](#)
 - [Functions of Agencies](#)
 - [Legislative](#)
 - [Executive](#)
 - [Judicial](#)
 - [Constitutional Authority for Agencies](#)
 - [Agency Organization](#)
 - [Appointing Agency Personnel](#)
 - [Creating Regulations](#)
 - [Judicial Review of Agency Rulemaking](#)
 - [Judicial Review of Administrative Court](#)
 - [Advantages of Agencies](#)
 - [Disadvantages of Agencies](#)
-

TOPIC 4: ADMINISTRATIVE LAW - QUESTIONS & ANSWERS

1. What are “Administrative Agencies”?

Federal administrative agencies are bodies impliedly authorized by the US Constitution and created by Congress to enforce statutes and develop regulations in furtherance of those statutes. That is, administrative agencies assist the legislative branch developing and the executive branch in executing laws. Administrative agencies include departments, agencies, commissions, bureaus, boards, government corporations, and committees. Most administrative agencies fall under the control of the executive branch. There are, however, a few administrative agencies that are directly under the control of Congress, such as the Congressional Budget Office and the Library of Congress. The authority of the President over an administrative agency depends upon the genesis of the agency and whether it is an “executive agency” or “independent agency”.

- *Executive Agencies* - The US Constitution establishes the executive branch of the federal government and allows the President to establish employ agencies to carry out the executive function. Executive agencies include all of the departments under the President’s authority. The heads of the executive agencies are cabinet members who report directly to and are closely controlled by the President. The President nominates individuals to these positions and the Senate must approve these nominations by a simple majority vote. The President has complete discretion in removing these individuals from their positions.
 - *Example:* Examples of Executive Agencies include: Department of Defense (DOD); Department of Justice (DOJ); Department of State (DOS); Department of the Treasury (DOT); Department of Homeland Security (DOHS); Department of Health and Human Services (DHHS); Department of Energy (DOE); Internal Revenue Service (IRS).
- *Independent Agencies* - Independent agencies, as the name implies, operate with a degree of independence or autonomy from the executive branch. These agencies are not part of the President’s cabinet; rather, they exist independently pursuant to congressional statute. Congress will pass what is known as an “enabling statute”, that establishes an administrative agency and outlines the extent of the agency’s authority.
 - *Example:* Independent federal agencies include the: Central Intelligence Agency (CIA); Federal Communications Commission (FCC); Federal Energy Regulatory Commission (FERC); Social Security Administration (SSA); Federal Reserve Board of Governors (Federal Reserve); Federal Trade Commission (FTC); General Services Administration (GSA); International Trade Commission (ITC); Environmental Protection Agency (EPA); National Labor Relations Board (NLRB); Securities and Exchange Commission (SEC); Commodities Futures Trading Commission (CFTC); United States Postal Service (USPS); National Aeronautics and Space Administration (NASA); Federal Election Commission (FEC); National Transportation Safety Board (NTSB); National Science Foundation (NSF); Small Business Administration (SBA); Nuclear Regulatory Commission (NRC).

Executive and independent agencies carry on similar functions; however, an independent agency generally has more of a regulatory function, where an executive agency plays more of an enforcement role.

- **Discussion:** How do you feel about the role of agencies in the development and execution of laws? Do you find

surprising the breadth and number of agencies?

- **Practice Question:** Thomas is listening to a heated political discussion at the office water cooler. One colleague is expressing her frustration at the current state of the regulations surrounding an area of business practice. She is blaming the President for not taking steps to ease the regulatory burden. The other colleague is defending the President and arguing that the bureaucracy is a result of Congress' shortcomings. What information would you need to determine which colleague is more accurate (or at least informed) in her statement?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-administrative-agencies/>

2. What are the functions of agencies?

Administrative agencies serve “executive”, “quasi-legislative”, and “quasi-judicial” functions. As part of the regulatory process, Congress passes statutes to establish new law. The statutes, along with direction in the form of an “enabling statute”, are then turned over to administrative agencies to develop rules and regulations that further the objectives of the statutes. As such, while Congress dictates the objectives and substantive laws, the administrative agency assumes the regulatory activity of developing procedural rules for enforcing the law. This is the quasi-legislative, agency function. The statutes themselves are broad in nature, while the rules and regulations developed by administrative agencies are more specific. Disputes between the agency and those subject to regulation often arise when enforcing the substantive statutes and procedural regulations. As such, the agency may develop a tribunal or administrative law body that adjudicates these disputes. This is the quasi-judicial, agency function. Lastly, the agency carries out an executive function by carrying out or enforcing the statutory laws.

- **Resource Video:** <http://thebusinessprofessor.com/function-of-administrative-agencies/>

Quasi-Legislative Functions

A primary charge of administrative agencies is to develop and issue regulations that have the impact of laws. Administrative rules are internal, procedural, interpretative, or legislative. Legislative rules are the most important, as they generally have the force of law and add to the statutory law. Unlike statutory lawmaking, issuing regulations entails several procedural steps. Agencies begin by developing proposed regulations. The proposed regulations are then published to the public with a request for public comment. Some agencies also issue guidelines to supplement the issued regulations. These guidelines provide explanations or interpretations of the statutes and regulations and also explain the agency's responsibility for enforcing the statutes and regulations. They will outline how individuals should proceed to comply with the regulations and will identify conduct that fails to comply with the regulations. Conduct that fails to comply with the statutes and regulations is illegal and may be enforced through agency procedure or civil or criminal law.

- **Discussion:** What do you think about the ability of agencies to create regulations that have the force and effect of law? Is congressional or executive approval of these regulations a sufficient check on the quasi-legislative power of the agencies?
- **Practice Question:** Congress passes a statute that charges the Securities and Exchange Commission (SEC) with enacting regulations that allow for faster and easier private offerings of securities for sale by private companies.

The statute provides the primary objectives but leaves it up to the SEC to develop the procedural rules. What is the process the SEC should undertake in carrying out this charge?

Quasi-Judicial Functions

Administrative agencies often create tribunals (similar to courts) to adjudicate disputes arising under the agency's regulations. Congress, through statute, may direct that certain types of disputes undergo an administrative process ("exhaust all administrative remedies") before a party has standing to bring an action in a state or federal court challenging the agency's action. If Congress fails to specifically address the topic, the Administrative Procedures Act controls the quasi-judicial process. This act generally requires that individuals with disputes concerning federal regulations exhaust all administrative remedies prior to taking judicial action.

An administrative court functions similarly to an Article III court. The court undertakes a fact-finding process and applies those facts to the applicable law. The court may resolve a dispute and hand down fines or sanctions for improper conduct. This process may include issuing cease and desist orders directing individuals to stop carrying on a certain activity and desist from any further activity that runs afoul of the regulations. Administrative courts do not employ juries. All fact finding and decision making are carried out by (an) administrative law judge(s). As such, administrative courts cannot authorize or order detention of individuals. Often agencies will seek to settle disputes with individuals by entering into a consent order providing a resolution of the dispute. This avoids employing the administrative court to resolve the dispute. The administrative court then approves the order to officially resolve the issue. A notable advantage of this process is that consent orders give up the right to judicial review. As such, the parties cannot subsequently file a legal action contesting the administrative decision. Further, there is no admission of guilt in a consent order.

- **Discussion:** How do you feel about agencies creating internal court systems or adjudicative processes? Can you see any Constitutional issues with forcing individuals to adjudicate certain matters before an administrative court (without a jury)?
- **Practice Question:** Dolores has a farm chemical business in Iowa that produces and sells liquid fertilizer to farmers across the country. Her business operations require the mixing and testing of all sorts of chemicals. The Environmental Protection Agency (EPA), which is charged with enforcing federal environmental statutes, inspects Dolores's job site and finds evidence of soil contamination. The EPA undertakes an investigation that includes extensive soil sampling. The EPA determines that Dolores's business is discharging too many chemicals into the soil and seeks to fine Dolores and cause her to cease certain operational activities. Dolores contests the pollution assessment based upon acceptable levels of foreign particulates in soil. The EPA offers a settlement to Dolores that allows her to avoid fines by permanently ceasing certain activities. What are Dolores's options in this situation?

Executive Functions

Administrative agencies perform executive functions by enforcing the regulations they pass. That is, the agency investigates complaints and identifies conduct that it deems in violation of regulations. Enforcement is partially handled through administrative courts that address the dispute and render a decision. In addition to investigating conduct potentially in violation of the regulations, the administrative agency monitors compliance and works to educate and advise lawmakers in the passing and execution of laws. The extent of investigation and advisory activities is as follows:

- *Investigation* - Agencies often investigate activities that are the subject of agency regulations. It will gather and compile information about the company's activity and investigate any areas of concern. The agency may have limited subpoena authority. In the process, they identify practices that may be illegal. It is a crime to make any false or fraudulent statement in any matter within the jurisdiction of a federal agency. As such, companies are required to be forthcoming in reporting activity to the regulatory agency.
 - *Advising* - Agencies evaluate common practices and issue public advisory opinions. These opinions explain how the agency views a particular type of conduct. These opinions serve to educate the public and help individuals and companies avoid disputes with the agency. The agencies also develop proposals and make reports to the President or to Congress. These reports keep Congress and the President informed of agency activity and aid them in the development and execution of laws.
- **Discussion:** Do you believe that agencies have sufficient authority in enforcing their regulations and decisions? If no, what enforcement authority should agencies possess?
 - **Practice Question:** Dolores has a farm chemical business in Iowa that produces and sells liquid fertilizer to farmers across the country. Her business operations require the mixing and testing of all sorts of chemicals. The Environmental Protection Agency (EPA), which is charged with enforcing federal environmental statutes, inspects Dolores's job site and finds evidence of soil contamination. The EPA undertakes an investigation that includes extensive soil sampling. What are Dolores's obligations with regard to allowing (or facilitating) the EPA investigation?

3. What authority exists for creating and vesting authority in administrative agencies?

The Constitution is silent with regard to the creation of administrative agencies. Congress passes statutes authorizing the creation of administrative agencies. The statutes are known as, "enabling statutes". Congress's authority to create agencies is inferred from its role as legislator. The ability of the executive branch to oversee the operations of administrative agencies is inferred from its responsibility to execute the laws of the United States. The authority to vest quasi-legislative and quasi-judicial authority in the administrative agencies has come under attack at various points in history. The US Supreme Court has reviewed these allocations in a number of situations and generally deemed the allocation of authority valid.

- *Delegation of Legislative Functions* - One of the earliest challenges to the authority of Congress to delegate quasi-legislative responsibilities to administrative agencies came in *Wayman v. Southard*. In this case, the Supreme Court held that administering a statute requires the ability to delegate the responsibility of filling in details to subordinate officials. This based the legislative authority of agencies on the President's authority to execute the statutory law. In 1935, the US Supreme Court reviewed the authority of Congress to delegate authority to the President, which is then delegated to the President's cabinet. The Court recognized that such a delegation is valid if Congress provides sufficient statutory instruction to guide (and limit) the President in the execution of such authority. Since that time, a few attempted delegations of power to the Executive has been overturned as too broad, while many others have been found to be constitutionally valid.
- *Delegation of Judicial Functions* - In 1935, in *Humphrey's Executor v. United States*, the Supreme Court held that administrative agencies may carry out quasi-judicial and quasi-legislative functions in the execution of laws as

agents of the legislative and judicial branches. Congress's grant of authority to administrative agencies to issue sanctions to individuals was pursuant of the agency's regulatory function. In 1909, the Supreme Court in *Oceanic Steam Navigation Co. v. Stranahan*, upheld this practice as constitutional.

Congress maintains the authority to control and limit agency authority. Further, Congress can pass statutes that criminalize activities regulated by agencies. Enforcement of such statutes would necessarily be the role of the executive branch, while determination of challenges to these statutes would be the role of the judicial branch.

- **Discussion:** Are you convinced that the legislative and executive functions of agencies are contemplated within the constitutional authority granted the executive and legislative branches?
- **Practice Question:** Darian owns a payday and title loan agency. He makes loans to individuals secured by a lien on the borrowers paychecks or vehicle title. He recently expanded his operations to include making unsecured student and training loans in exchange for a percentage of future wages post graduation. His operations are generally regulated by the Consumer Financial Protection Bureau (CFPB). The agency investigates Darian's new business practice and seeks to levy on fine on his business for failing to make the required consumer disclosures. What are Darian's options for challenging the authority of the CFPB to regulate his business activity?
- **Resource Video:** <http://thebusinessprofessor.com/authority-for-administrative-agency-functions/>

4. How are administrative agencies organized?

Executive and Quasi-Legislative Staff Members

Administrative agencies are organized differently depending upon whether it is an executive or independent agency.

- **Executive Agencies** - An executive agency falls under the supervision of a member of the President's cabinet. As such, a single individual (director or secretary) sits at the head of the agency. The director will generally act as the senior executive administering the agency. The director will appoint subordinate officers and authorize the hiring of agency staff.
- **Independent Agencies** - Independent agencies generally have a controlling board or commission that governs the agency. The board will generally consist of 5 to 7 members, one of whom is the chair. The chairperson has the power to appoint staff for the agency. The agency board will serve a high-level governance function. It will appoint or elect an executive director for administration as the chief operating official of the agency. The executive director supervises administrative functions, such as personnel matters and budgeting.

Outside of the leadership and governance structure, the operational structure of most agencies is similar. The agency secretary keeps board-meeting minutes and is in charge of all agency publication requirements. The structure of the agency may be centralized or it may have various regional offices. Regulatory administrative agencies generally have regional offices that investigate alleged violations of the law. Agencies may also establish advisory councils. The advisory councils are made up of agency outsiders who are selected because of their expertise. They provide a level of interaction between the regulators and those being regulated.

Quasi-Judicial Staff Members

The quasi-judicial staff within an administrative agency generally consists of numerous administrative law judges and their support personnel.

- *Fact Finders* - Administrative law judges perform the adjudicative, fact-finding functions in disputes between the agency and those regulated. As such, the quasi-judicial staff members have a separate reporting structure from the rest of the agency. This separation serves to ensure that the quasi-judicial function is carried out in an impartial manner. Like Article III judges, administrative judges have immunity from liability for damages based on their decisions.
- *Appeals or Request for Review* - Once the administrative law judge makes a decision in a dispute, a party unhappy with the decision may appeal the decision either to an internal board established to hear appeals, the agency's governing board, or the cabinet-level official. Many state administrative law judges are not organized separately from the administrative agency. The administrative law judge is an employee of the agency. This relationship gives rise to a perception of bias. Other states establish an Office of Administrative Hearings that provides impartial administrative law judges to preside over administrative hearings.

The organization of the judicial staff will vary slightly between administrative agencies, but the primary role of administrative law personnel remains constant.

- **Discussion:** Why do you think the organizational structure varies between executive and legislative agencies? Do you see any reporting issues with housing administrative courts within the agency?
- **Practice Question:** Describe the difference in organization between an executive and independent agency. Also explain how this organization affects the authority of the President to exercise authority over agency operations?
- **Resource Video:** <http://thebusinessprofessor.com/how-are-administrative-agencies-organized/>

5. How are key agency personnel appointed and removed?

In both executive and independent administrative agencies, the President has the authority to nominate the governing personnel (directors, secretaries, boards, commissioners, etc.) for appointment and to remove those individuals.

Appointment of Administrative Agency Officials

Following nomination for appointment by the President, the Senate must vote to confirm the nominee. Congress cannot take part in the appointment process outside of providing advice about the nomination during the confirmation hearing. To keep the key personnel somewhat independent of the President, the individuals generally serve staggered terms that are longer than the President's 4-year term. This prevents the sitting President from appointing all of the leadership of an agency at one time. Further, federal statutes often require that the governing board or commission of independent agencies be bipartisan, with a certain number of individuals coming from outside of the President's political party.

Removal of Administrative Agency Officials

The President generally has the authority to remove key leaders from administrative agencies. While the President's

authority to remove individuals from executive agencies is unlimited, there may be any number of limitations on the ability to remove members of independent agencies. For instance, Congress may pass a statute limiting this authority. These statutes normally require proof of incapacity, neglect of duty, malfeasance, or good cause before the President can remove an official. This is particularly true if the agency primarily serves a regulatory function. Congress may also reserve the ability to vote to remove an independent administrative official. This authority is limited by the function of the agency. If the independent agency exercises any executive powers, such as enforcement or statutes, Congress cannot take part in removing the agent. If Congress wants to remove an agency official acting in an executive capacity (any of the heads of executive agencies), it must initiate impeachment proceedings.

- **Discussion:** What do you think about the requirement for bipartisan representation on administrative boards? Do you agree with the broad authority of the President to remove members of executive agencies? Do you think Congress should have greater authority in this regard? Conversely, do you think statutes limiting the President's removal authority are excessive?
- **Practice Question:** David is an executive member of a federal administrative agency. He was nominated by the President and confirmed by the Senate. What information about the agency and David's position is required to determine the process or procedure for removing David from his position?
- **Resource Video:** <http://thebusinessprofessor.com/appointing-and-removing-agency-personnel/>

6. What is the administrative agency process for creating regulations?

The quasi-legislative process by which administrative agencies create regulations is "formal", "informal" or "hybrid". Formal rulemaking generally proceeds as follows:

- **Public Announcement** - The agency develops a proposed regulation and announces the rule or regulation to the public.
- **Public Comment** - Following the announcement of the new regulations, the administrative agency allows for public comment on the regulation. Individuals may write letters, enter comments on the website, and speak at an open public forum regarding the proposed regulation. At the public hearing, interested parties are allowed to present evidence in support of, or in opposition to, a proposed rule or regulation.
- **Final Rulemaking** - The agency will take public comment and incorporate those comments into a final draft of the regulation. If the proposed regulation garners much public interest, Congress will seek a report or explanation of actions from the agency.

The informal rulemaking process does not require a hearing. The hybrid procedure requires a hearing, but the process is less detailed than the formal process.

- **Discussion:** Do you believe the process of public announcement, comment period, and final rulemaking is effective in notifying the public and gauging public sentiment?
- **Practice Question:** Gene is very upset by a proposed federal regulation passed by the Federal Communications

Commission (FCC) that will impact cable and Internet distribution. What are Gene's options for voicing her opinion about the proposed regulation?

- **Resource Video:** <http://thebusinessprofessor.com/process-for-creating-administrative-regulations/>

7. What is the judiciary's authority to review agency rule making?

Individuals may challenge an administrative action in an Article III court. Generally, a judicial challenge to administrative rulemaking must be a challenge to the procedures followed by the agency. Per administrative procedure, the agency must propose rules within the express grant of authority from the legislature. Exceeding the scope of authority may result in a court finding the proposal void. Once the court decides that a rule of an agency is authorized and constitutional, it will not address the wisdom or effectiveness of the rule. The court will review the constitutionality of the delegation of authority based upon the following:

- *Definiteness* - The delegation of authority to the administrative agency by Congress must be set forth with sufficient clarity so that all concerned, especially reviewing courts, will be able to determine the extent of the agency's authority.
- *Limited* - An executive or legislative delegation of authority must be limited. The delegating authority must provide in the enabling statute or the agency's charge that its power is limited - though it does not have to specifically outline those limitations. These authorities must take steps to implement procedural safeguards to prevent any arbitrary or abusive practices by the agency.

Regardless of the purpose of effect, courts will hold that an agency exceeds its authority if an analysis of legislative intent confirms that the agency has gone beyond that intent.

- **Discussion:** Do you think it is a good idea to limit judicial review of administrative rulemaking to the procedural aspects of the rulemaking process?
- **Practice Question:** Tammy is angry about new regulations from the Federal Trade Commission that limit the importation of products that contain specific technologies. She sells a product that employs the regulated technology and she wants to contest the agency's new rules. During the rulemaking process, she voiced her dissent to the regulations. Now that the regulations are in effect, what can Tammy do to challenge the FTC's rulemaking?
- **Resource Video:** <http://thebusinessprofessor.com/authority-to-review-agency-rulemaking/>

8. What is the judiciary's authority to review administrative court decisions?

The judiciary has power to review agency decisions pursuant to either the procedures written into the delegating statute or pursuant to the Administrative Procedures Act (APA).

- *Note:* The APA is a federal act, but state administrative agencies often follow similar procedures.

- *Review Under the APA* - The Federal Administrative Procedure Act provides for review of administrative court decisions except where statutes preclude judicial review or the agency is vested with sole discretion in a matter. An agency is vested with sole discretion in matters that do not affect a citizen's constitutional rights.
- *Standing* - To establish standing to challenge an administrative court's decision, the plaintiff must have been harmed or suffered a loss pursuant to the administrative court's ruling. Evidence of loss may be economic or limit an individual's established rights.
- *Exhaustion of Remedies* - The judiciary will generally only intervene in an administrative court's decision when the individual seeking review has exhausted all available administrative remedies and procedures available. This means that the individual must first pursue appeal options within the agency. Requiring that all administrative actions be final ensures that the court does not interrupt the administrative process. Courts do, however, retain the authority to intervene before the exhaustion of administrative remedies if seeking such remedies would be useless or the harm is immediate and severe.
- *Issues of Jurisdiction* - In some situations, an injured party will file a court action challenging an administrative action. In such situations, judicial resolution of the claim requires further resolution of issues specifically tasked to the administrative agency under the enabling statute. In such a case, the court will suspend the legal action until the administrative agency resolves these issues.
- *Review of Facts* - When an individual seeks review of the administrative court's decision, the trial court will generally accept any facts in the administrative record that are supported by "substantial evidence". The standard for substantial evidence is that there must be material evidence from which a reasonable person might reach the same conclusion as did the agency. "De novo" review is when the court disregards the agency's findings of fact and takes evidence anew.
- *Standard of Review (arbitrary & capricious)* - The court will review the administrative decision based upon the procedures established by Congress, the record from the administrative hearing, and the reasons and basis for the administrative court's decision. The court will review the agency's decision to determine if it is "arbitrary and capricious". That is, there must be a finding of fact that:
 - 1) there is substantial evidence to support the agency's decision, and
 - 2) the reasoning applied by the agency is based upon applying the facts to the state of the law.

There are limited situations which allow a party to directly challenge an administrative court's decision without first exhausting all administrative procedures. These exceptions may be linked to exigency or when administrative review would be useless.

- **Discussion:** Do you think the requirement that a party exhaust all administrative remedies prior to judicial review is appropriate? Are there any negative consequences to this approach? Do you find any issue with the fact-finding process or the court's acceptance of facts presented to the administrative agency?
- **Practice Question:** John owns a chemical fertilizer business located in Montana. The Environmental Protection

Agency (EPA) inspected John's operations and determined that his product does not meet EPA guidelines for a specific chemical compound content. The EPA issues a cease and desist order from further selling the product and levies a fine on John's business. What are John's options for challenging the EPA's actions?

- **Resource Video:** <http://thebusinessprofessor.com/authority-to-review-administrative-court-decisions/> ; <http://thebusinessprofessor.com/review-under-the-federal-arbitration-act/>

9. What are the advantages of administrative agencies?

Delegating regulatory and executive authority to administrative agencies has numerous advantages:

- *Exactness* - Congress cannot effectively pass statutes that are sufficiently detailed to regulate an entire subject matter. While laws provide a general outline for regulation, the agency rules and regulations make the statutory law more exact. More specifically, the agencies fill any gaps that exist in the statutory law.
- *Expertise* - Administrative agencies generally employ officials who are subject-matter experts in the given areas of regulation. As such, they are often more efficient and effective in developing rules and regulations to govern conduct in the specific area. Their expertise also provides thoroughness and consistency in the development and enforcement of business regulations. Lastly, employing such individuals to make quasi-judicial decisions about disputes avoids relying on individuals who are unfamiliar with the subject.
- *Public Protection* - Agencies often exist to regulate an area of conduct in a manner that protects the public interest. Individuals and businesses do not always act in accord with the public interest.

All of these advantages relate to efficiency, effectiveness, and the public interest. While administrative procedures are often burdensome, agencies allow for the administration of an extremely large and complex system of regulations.

- **Discussion:** Do you believe that the above-cited attributes are truly characteristics of administrative agencies?
- **Resource Video:** <http://thebusinessprofessor.com/advantages-of-administrative-agencies/>

10. What are the disadvantages of administrative agencies and regulations?

While administrative agencies provide the above-stated benefits, there are numerous disadvantages to relying on the agencies in the rule-making and adjudicative process. Foremost among the disadvantages, administrative agencies are famous for adding a degree of bureaucracy to regulated activities. Complying with additional regulations and the procedures raises the cost of doing business. These higher costs are born by the government, businesses, and consumers.

- **Discussion:** Can you think of any examples of private action (business activity) where administrative regulations add considerable burdens to the process.
- **Resource Video:** <http://thebusinessprofessor.com/disadvantages-of-administrative-regulations/>

TOPIC 5: CRIMINAL LAW & PROCEDURE

Overview

The chapter introduces the concept of criminal law and the procedures for enforcing those laws. It will explore the Constitutional authority of the government to pass criminal laws, the enforcement methods, and identifies specific types of criminal laws. It breaks down criminal conduct into the basic elements necessary to demonstrate criminal liability. It explores the process and procedure for enforcing criminal laws and the Constitutional limitations on the government that serve to protect individual rights. Lastly, it explores numerous federal and state criminal statutes that routinely affect business practices.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• Criminal Law • Elements of a Crime - Actus Reus - Mens Rea - Strict Liability • Felony & Misdemeanor • Processing Criminal Charges • Arrest • Miranda Rights • Initiating Criminal Charge • Initial Appearance & Arraignment • 4th Amendment (Due Process) • 5th Amendment - Grand Jury - Double Jeopardy	• 6th Amendment • Crimes Against Property • Fraud • Business Fraud • Fraud - Good Faith • Conspiracy • Obstruction of Justice • False Statement • Aiding and Abetting • White-Collar Crime • Worker Endangerment • Foreign Corrupt Practices Act (FCPA) - Bribes & Kickbacks	• False Claims Act • Racketeering Influence & Corrupt Organizations Act (RICO) • Sarbanes-Oxley • Cyber Crime • Defenses to Crimes • Criminal Punishment- Types • Criminal Punishment - Theories • Federal Sentencing Guidelines

TOPIC 5: CRIMINAL LAW & PROCEDURE - QUESTIONS & ANSWERS

1. What is “criminal law”?

Criminal law is public law passed by the federal, state, or local government. It restricts or requires affirmative conduct of its citizens under the threat of prosecution. These prohibitions may be in the form of a statute, common law rule, regulatory rule or decision, or local ordinance. Criminal laws prohibit conduct that is either considered, “*malum in se*” or “*malum prohibitum*”.

- *Malum in se* - means that conduct is inherently wrong without regard to a statute proscribing the conduct.
 - *Example:* Most people consider murder and theft to be innately wrong or evil without regard to a government’s prohibition of the conduct.
- *Malum prohibitum* - means that conduct is not necessarily wrong or evil, but it is made illegal based upon a law.
 - *Example:* A public company’s failure to adequately disclose corporate information to the public is made illegal by statute. Without such a statute, it may not be considered inherently wrong.

The authority for each type of law may differ, but generally criminal laws are enforced by the government and exist to protect the health, safety, and welfare of citizens. This includes protecting the property and rights of those citizens. Failing to comply with criminal laws can result in fines or imprisonment.

- **Discussion:** Do you generally believe that criminal laws are effective at curbing prohibited conduct? Do they effectively protect the health, safety, and welfare of citizens? Does a criminal penalty ever violate the purpose of protecting citizens? With the prison population at record levels in the US, is there a need to reform the criminal punishment system? If so, what are some alternatives that may achieve a similar purpose to the penalty of imprisonment?
- **Practice Question:** Explain the primary differences between criminal law and civil law?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-criminal-law/>

2. What are the elements of a crime?

Every crime is composed of certain elements. Common among all crimes are the physical and mental characteristic of the defendant in failing to comply with the criminal law.

- *Actus Reus* - *Actus Reus* is a latin phrase meaning, “guilty act”. This element simply means that the individual committed the act proscribed by the statute. In some cases a threat to act or a failure to act constitutes the crime. In any event, the defendant must be responsible for that action or inaction.

- *Example:* If an individual is involuntarily intoxicated, this may negate the *actus reus*. If someone slips drugs in a person's drink unknowingly, it may excuse the voluntary act required to find a person guilty of a criminal offense. That is, she may not have the control over her physical actions necessary to satisfy the *actus reus*. The act of voluntary intoxication, however, will not excuse the *actus reus*. Voluntarily drinking or taking medications is a sufficient act.
- *Mens Rea* - *Mens rea* is a latin phrase meaning a "guilty mind". This generally means that there must be some mental intent to commit the act that is wrongful under the law.
 - "General intent" crimes simply require that the individual intend to do the act that constitutes a crime, without specific intent as to the results of the harmful action.
 - *Criminal Negligence* - If an actor intends a physical act that is negligent under the circumstances, she may be criminally liable for the harm resulting from the action. Generally, the action must pose a foreseeable risk of harm and the actor's failure to observe due care brings about that harm.
 - *Example:* Bob is driving while texting on his phone. He takes his eyes off of the road and accidentally strikes a pedestrian who is killed. In this instance, he may be criminally negligent.
 - *Strict Liability Crimes* - This type of crime does not require a defendant's *mens rea*. That is, if an individual undertakes an action, regardless of whether there was intent, she is criminally liable.
 - *Example:* An individual who has sexual intercourse with someone under the legal age of consent may be convicted of statutory rape. It does not matter if the defendant believed that the other person was above the legal age of consent. A strict liability crime looks solely at the action and not the intent of the parties.
 - "Specific intent" crimes require that the individual have the intent to achieve that harmful result or be indifferent or reckless with regard to the probable results of her conduct. The specific intent requirement is generally satisfied if the defendant acts recklessly with regard to the potential harm that could result from her actions or inactions.
 - *Intentional Crime* - The actor intends the physical act and the likely result of that act constituting a crime.
 - *Example:* Tom intentionally provides false information to a bank when applying for a line of credit. When the bank learns of the false information, it presses charges against Tom for fraud. If Tom is able to demonstrate that he did not know that the information was false, it will negate the specific intent required for a charge of fraud.
 - *Criminal Recklessness* - An actor may be criminally liable for undertaking an action without regard for the potential harm to persons or property. Generally, the actor must understand the substantial risk and consciously disregard it.
 - *Example:* Merrick is anxious to try out his new bow and arrow. He walks outside and

fires an arrow straight up into the air. Merrick lives in the city and the area is densely populated. He knows that it is a substantial risk that the arrow will strike someone, but he disregards this risk. He will likely be criminally reckless if that arrow strikes someone.

In some instances, a guilty act may constitute more than one crime. This may be the case when one crime is a “lesser-included offense” of another crime. That is, less than all of the elements required for one crime may meet all of the elements of another crime. For example, theft may be a lesser-included crime of burglary. A general intent crime may be a lesser-included offense of a specific intent crime.

- **Discussion:** Do you think the mental element of a crime is important? If a person causes harm without intent, is there less reason to subject that individual to criminal punishment?
- **Practice Question:** Donald is driving down the road listening to his favorite heavy metal songs. He gets so excited that he does not realize that he is traveling 20 mph over the speed limit. A police officer witnesses the speeding, stops Donald’s car, and issues him a citation. Donald goes home and looks up the citation under state law. The statute indicates that speeding is a strict liability crime. What does this mean for Donald? Does it matter that Donald’s excessive speed was accidental? Would it matter if Donald were temporarily disoriented when driving due to a carbon monoxide leak in his car that caused him to lose the ability to effectively control his automobile?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-criminal-intent/>

3. What are the classifications of criminal conduct?

Criminal conduct is generally classified by the level of severity and the potential punishment from breaking the law. The two primary classifications of crimes are as follow:

- **Misdemeanor** - A misdemeanor is crime of lesser significance that is punishable by a fine or a joint sentence of less than one year.
- **Felonies** - Felonies are more serious crimes that are punishable by fine or imprisonment in a penitentiary for a period of one year or more.

Historically, the common law identified “treason” as a class of serious offense that was separate from a felony. Also, today, many jurisdictions identify a less severe form of criminal act, known as an “infraction”. The infraction is generally a minor violation of an ordinance or regulation.

- **Discussion:** Do you believe that laws are always classified appropriately? Do you believe that criminal conduct is generally classified too leniently or too harshly? Do you believe that the misclassification of crimes has a negative impact on society?
- **Practice Question:** Clark is a college student at City College. He is at a house party drinking alcohol when the police arrive to break up the party. Clark is cited for underage drinking. Angry at the occurrence, Clark gets into an argument with a police officer and punches him. Clark is arrested and taken to jail. What is the likely classification of each of Clark’s criminal acts? Why?

- **Resource Video:** <http://thebusinessprofessor.com/misdemeanor-vs-felony-criminal-charges/>

CRIMINAL LAW PROCESS

4. What is the process for initiating and processing criminal charges against a defendant?

The general process for initiating criminal charges against an accused is as follows:

- *Arrest* - An arrest is the first step of the prosecutorial process. It involves the physical detention of an individual. If the defendant is an organization, the arrest may be carried out through injunctions against continued business operations. The arrest takes place pursuant to some form of legal authority. This may include the arresting individual witnessing criminal activity or pursuant to an arrest warrant.
- *Initial Appearance* - Once an individual is arrested, she has a right to be informed of the charges against her. As such, the defendant must go before a judicial officer within a statutory period (generally 72 hours) to receive notice of the charges.
- *Bringing Charges* - To bring formal charges against someone, the case is handed over to the prosecuting officer of the court. The prosecuting attorney may have any number of titles (solicitor, district attorney, etc.). This prosecuting officer orchestrates the process for bringing charges against a defendant in the name of the people of that jurisdiction. For example, the charges may read, “US v. John Smith” or “State of Georgia v. John Smith”. Who has the decision-making authority to bringing charges against the defendant depends upon the classification of the alleged criminal conduct. A prosecutor must file an “information” with the court to begin prosecution of a misdemeanor. The prosecutor must submit the matter to a grand jury to bring felony charges against a defendant. The grand jury decides to bring felony charges against a defendant, this is known as handing down an “indictment.”
- *Arraignment* - The arraignment is the first appearance by the defendant before the court to answer the criminal charges. At the arraignment, the court will review the defendant’s rights and accept the defendant’s plea. The plea will either be guilty, not guilty, or *nolo contendere* (no contest). If the defendant pleads guilty (or no contest), the court will set a trial date for sentencing. If the defendant pleads not guilty, the court will set the matter for trial.
- *Trial Burden* - To convict a defendant of a crime, the Government bears the burden of proof and the burden of persuasion. Burden of proof means that the Government must demonstrate sufficient evidence to demonstrate each element of the charged offense. The burden of persuasion means that evidence must be sufficient to convince a jury that the defendant is guilty beyond a reasonable doubt.

Each step of the criminal process may vary slightly among jurisdictions. Prosecution of a violation of a criminal law is carried out in an Article III court (judicial branch court). Article I courts (administrative courts) do not prosecute violations of criminal law.

- *Note:* States establish a special court, “juvenile court”, to handle criminal infractions by adolescents.

- **Discussion:** Of the major steps in the criminal process, do you think any procedural step is more important in

terms of observing a defendant's due process rights? Can you think of situations or examples of how a defendant's rights could be infringed upon in each of the steps?

- **Practice Question:** Laura receives notice from the state's criminal law division that she has been indicted for illegally trading in corporate securities. The criminal detective advises Laura to report to the local police station where she will be processed for arrest and detention. On the way to the police station, Laura calls her attorney and asks about the process that she will face if the government continues with the charges against her. If you are Laura's attorney, explain to Laura the process that she can expect.
- **Resource Video:** <http://thebusinessprofessor.com/process-for-bringing-criminal-charges/>

5. What is the process for executing an arrest?

Law enforcement officers generally carry out arrests. There must be "probable cause" for a government official to make an arrest. This may include observance of the criminal activity or based upon reliable evidence. If an officer does not witness the illegal conduct or have immediate evidence in her possession regarding the commission of the crime, she must generally seek an arrest warrant prior to arresting a suspect. A judicial officer (generally a magistrate judge) must hear evidence and make a determination as to whether probable cause exists to arrest someone. If the magistrate determines that probable cause exists, she will issue an arrest warrant that empowers the police to arrest the individual. The police must execute the arrest warrant within the terms of the authority granted by the judicial officer.

- **Discussion:** Why do you think a judicially issued warrant is required to make an arrest if the officer does not witness the criminal conduct? Why is a warrant not required when the officer witnesses the criminal conduct? Do officers ever make arrests without personally witnessing criminal conduct? How close in time must the criminal conduct be to the arrest to justify an arrest without a warrant? Do officers ever exceed their authority when making an arrest? What should be the repercussions of making an arrest without a warrant when a valid warrant should be required?
- **Practice Question:** Jane witnesses Frederick committing a crime. She chases after Frederick, but he is too fast and escapes. What process must Jane follow in order to effectuate an arrest of Frederick?
- **Resource Video:** <http://thebusinessprofessor.com/process-for-arresting-a-suspect/>

Once an individual is under arrest, the government agent (collectively referred to as "police officer" or "officer") will generally make the individual aware of her constitutional rights against self-incrimination. A "*Miranda* warning" is a written or verbal statement to the arrested individual substantially as follows, "You have the right to remain silent. Anything you say can and will be used against you in a court of law. You have the right to an attorney. If you cannot afford an attorney, one will be provided to you at no cost." Once the police officer delivers the *Miranda* warning, anything that the defendant says in response to questions from the officer may be used in court. If the officer fails to advise the defendant of her rights, any statements made by the defendant pursuant to interrogation are not admissible at trial. There are, however, a number of exceptions to this rule:

- **Unsolicited Statements** - If a defendant makes unsolicited statements to the officer, those are admissible at trial. This means that the defendant made statements voluntarily and without being interrogated.

- *Public Safety Exception* - If there are exigent circumstances where public safety is at risk, this can justify government questioning prior to reading the *Miranda* warning. In such a situation, any statements made by the individual could be used against her in court.
- *Other Evidence Sufficient of Conviction Rule* - If there is sufficient evidence to convict an individual without the use of the individual's statements in violation of the *Miranda* rights, failing to appropriately deliver the *Miranda* warning and using subsequent statements in court will not disrupt the conviction.
- *Unequivocally and Assertively Request Counsel* - If an individual does not request the presence of an attorney during interrogation, the Government does not have to immediately supply the individual with counsel. The request for counsel must be unequivocal.

The limited exceptions to the requirement to inform an accused of her *Miranda* rights are subject to some degree of controversy.

- **Discussion:** What purpose do you think reading the *Miranda* rights serves? How effective is reading the *Miranda* rights in achieving this purpose? Do officers often fail to read an individual her *Miranda* rights following arrest? Can you think of a situation in which it may be a good tactic for the officer to not read the *Miranda* rights?
- **Practice Question:** Gwen is a police officer. She receives a call that there is a violent crime in process and that an individual is injured. The only other information she receives is the address of the alleged incident. Gwen arrives on the scene and notices Thomas sitting on the curb with his head hung down. Gwen jumps out of the car and yells to Thomas, "There has been a violent crime reported. Have you seen anything suspicious?" Thomas looks up and say, "I'm sorry. I didn't mean to hurt her." Gwen, realizing that Thomas is the alleged perpetrator replies, "Where is she?" Thomas replies, "I left her in the kitchen." Gwen immediately handcuffs Thomas and radios in for assistance. She then rushes into the house and finds the victim on the floor. When the ambulance arrives, Gwen drives Thomas to the police station. She does not inform him of his *Miranda* rights. During the drive Thomas laments out loud about having hit the victim with a frying pan. Will Thomas' statement made while sitting on the curb be used against him? What about the statements made while riding in the police car?
- **Resource Video:** <http://thebusinessprofessor.com/exceptions-to-reading-miranda-rights/>

6. How does the government initiate criminal charges?

If criminal conduct constitutes a misdemeanor, the prosecutor will file a document called an "information" with the court. This document attests that there is sufficient evidence to bring charges against the defendant. If the alleged criminal conduct constitutes a felony, the prosecutor must submit the case to a "grand jury" to seek an indictment. A grand jury is a group of citizens chosen at random to serve this judicial function. The grand jury must consist of at least 16 citizens who live in the court's jurisdiction. The grand jury will hear evidence and vote on whether to send a case to trial. To issue an indictment, a majority of the grand jury must vote that a crime has been committed and that there is sufficient evidence to warrant the accused standing trial. The grand jury does not determine guilty or innocence; rather, it determines whether probable cause exists to believe the accused committed the alleged crime. The grand jury has broad investigatory power, such as the authority to subpoena business records or witnesses to testify. Grand jury proceedings are kept confidential to protect the accused. To issue an indictment, the court will issue a "true bill". If the grand jury declines to indict, it will

issue a “no true bill”. If an indictment is issued, the indicted person is still presumed to be innocent until convicted by a court of law.

- **Discussion:** Should a grand jury be the final decision maker in determining whether to initiate a prosecution? Should public sentiment or a prosecutor’s sentiment about an accused have any bearing on whether the grand jury hands down an indictment? Why do you think grand jury proceedings are closed to the public and confidential? How do you feel about that fact that the grand jury is often used as an investigatory tool for its ability to solicit testimony and subpoena witnesses and information?
- **Practice Question:** Darla calls the police and reports that a suspicious man is outside of her house and trespassing on her property. She provides a description of the individual. Justin, a police officer, arrives and detains Bill for trespass. The Officer Justin is aware of several burglaries in the neighborhood and has suspicions about Bill. He takes Bill to the police station. Justin then calls witnesses to the prior burglaries who pick Bill out of a suspect line up as the perpetrator. What would be the process for initiating misdemeanor charges against Bill for trespass? What would be the process for initiating felony charges for burglary?
- **Resource Video:** <http://thebusinessprofessor.com/initiating-criminal-charges/>

7. What is the “initial appearance” and the “arraignment”?

Initial Appearance

The initial appearance is the first court proceeding for a defendant. Generally, the first appearance will take place within 24-72 hours of arrest. The judge will review whether probable cause exists to detain the individual on the subject charges. During the initial appearance, the judge will review the defendant’s rights. It is a restatement of the *Miranda* warning as well as reassurance of other certain constitutional rights afforded the defendant, including:

- the right to remain silent
- the right to be represented by counsel (and appointment of counsel if indigent);
- the right to know all charges against her;
- the right to a preliminary hearing;
- the right to seek pre-trial release (if the Judge so grants);

This process helps ensure that the defendant’s 5th Amendment right against self-incrimination is preserved.

Arraignment

The arraignment is the judicial proceeding that officially starts the trial process. At the arraignment the court will officially inform the defendant of the charges against her. She will be asked to respond to the charges in the form of a plea of guilty, not guilty, or no contest. In some cases, the initial appearance and arraignment will take place at the same time. This is particularly true when there is no formal arrest. Often, white-collar crimes do not involve a traditional arrest. If the grand jury hands down an indictment, the defendant will voluntarily appear before the court for a combined initial appearance and arraignment.

- **Discussion:** Why do you think the arraignment is necessary? Should a defendant be informed of the charges against her at the initial appearance, rather than at the arraignment? Should a party be able to forgo arraignment by entering in a plea by other methods?
- **Practice Question:** On Friday night, Charles was arrested on Friday night for assault after getting into a fight at a bar. At what point is Charles first informed of the charges against him? When is Charles first required to respond to those charges against him?
- **Resource Video:** <http://thebusinessprofessor.com/arraignment-and-initial-appearance/>

CONSTITUTIONAL PROTECTIONS IN CRIMINAL LAW PROCESS

As previously discussed, the Constitution establishes individual rights and serves to protect those rights against intrusion by the government. Below are numerous specific protections afforded individuals as part of the criminal law process.

8. What protections does the 4th Amendment provide to individuals subject to criminal charges?

Protection of Individual Rights

The 4th Amendment protects individuals against “unreasonable search and seizure”. More specifically, the police must obtain a court order before searching the individual’s body or any physical location where the defendant has an expectation of privacy. To obtain a search order, the government must demonstrate to a judicial official (generally a magistrate judge) that there is probable cause to believe that the suspect or private location contains evidence of a crime. There are certain limitations to the requirement that the government secure a search warrant before searching private property. The most common exceptions include:

- “*Exigent circumstances*” - This doctrine allows the government to proceed with a search of premises if there is a risk of harm to individuals or the destruction of evidence.
- “*Grab area*” - Officers may search any place that is in the immediate grab area of a suspect at the time of arrest. The grab area can be interpreted very broadly to include any place in the reach of a suspect at any point during the arrest.
- “*US Entry/Exit*” - The Federal Government also allows for warrantless searches at the border for individuals entering the United States. As such, there is no expectation of privacy for vehicles entering and leaving the country.

Special rules apply to electronic forms of surveillance, such as audio and visual recordings. Electronic surveillance generally requires a search warrant if surveilling a space where an expectation of privacy exists.

Protection of Businesses

The expectation of privacy applies to businesses as well as individuals. That is, the government must obtain a search warrant prior to searching business premises. This extends to administrative and civil enforcement actions as well. The more heavily regulated the business industry, the less it is afforded privacy protections against search. Many businesses have no expectation of privacy when the business is heavily regulated or closely connected to receipt of government funds

for operation.

- *Example:* If the owner objects, a building inspector may need a warrant to inspect whether a building meets code. A public university, government funded research laboratory, or public utility may have limited rights to privacy.

Exclusion of Unlawfully Obtained Evidence

The 4th Amendment protection against warrantless searches is enforced through criminal procedural law. If the government violates an individual's 4th Amendment rights by conducting an unlawful search and seizure, the evidence uncovered in the search is not admissible at trial against the accused. This is known as the "exclusionary rule". This rule exists to prevent the government, which has an interest in using seized evidence for prosecution of criminal law offenders, from infringing upon a defendant's constitutional rights in pursuit of criminal law enforcement. There are exceptions to the exclusionary rule for unlawful searches. For example, if the government relied in good faith on a search warrant from the court that was later deemed invalid, the evidence uncovered in the search may still be used in a prosecution. This is known as the "good faith exception". Further, if evidence is uncovered in an unlawful search that would have been inevitably discovered without the unlawful search, it may be used in a prosecution. This is known as the "inevitable discovery exception".

- *Note:* If the government searches beyond the authorization of the search warrant, any evidence uncovered in the search may be excluded.

- **Discussion:** Do you think the 4th Amendment protects individual rights or is a hindrance on maintaining law and order? Why do you think that there is less 4th Amendment protection for businesses than individuals? Is the exclusionary rule sufficient repercussion to dissuade conduct by officials that violates an individual's 4th Amendment rights?

- **Practice Question:** Perry is suspected of dealing illegal narcotics from his home. A private informant testifies to a magistrate that he witnessed Perry selling drugs from his home. The magistrate issues a search warrant for the home, but does not include the automobile on the premises. The police raid and search Perry's home but do not find any narcotics. One of the officers finds the keys to Perry's car and searches the trunk. Below the spare tire is a large amount of illegal narcotics. Perry is charged with possession of the narcotics with intent to distribute. At trial, what defense will Perry likely raise to introduction of the drugs as evidence?

- **Resource Video:** <http://thebusinessprofessor.com/4th-amendment-search-and-seizure-protections/>

9. What protections does the 5th Amendment provide to individuals subject to criminal charges?

The 5th Amendment provides several procedural, due process rights to citizens. In addition to the right to due process of law, the 5th Amendment includes the following notable protections.

- *Right to Grand Jury* - The 5th Amendment provides that anyone tried of a capital or infamous crime must receive a presentment or indictment by a grand jury.
- *Protection Against Self-incrimination* - The 5th Amendment protects against compulsory self incrimination. It protects the accused from being compelled to testify against herself. It does not protect against being compelled to

produce evidence. For example, a business executive can be made to produce documents. It only protects testimony that is related to an assertion of fact or the disclosure of information. The protection against compulsory self-incrimination does not apply to business entities. The only entity (quasi-entity) protected is the sole proprietorship, because the entity and individual are one in the same.

- *Protection Against Double jeopardy* - No “person shall be subject for the same offense to be twice put in jeopardy of life or limb.” If an illegal activity violates both federal and state laws, double jeopardy does not prohibit two trials, one in federal court and the other in the state court system.

Procedural due process rights apply to civil, administrative, and criminal proceedings. The basic premise is that individuals enjoy 5th Amendment protections from government infringement of their rights (including rights to property).

- **Discussion:** Why do you think the 5th Amendment includes a right to a grand jury? Do you think that an individual accused of a crime should have to testify? Do you think that this protection should apply to the criminal investigation stage as well as during formal trial? How do you feel about the fact that the 5th Amendment does not prohibit the Federal Government and a state government from prosecuting an individual for committing a single crime?
- **Practice Question:** Donna is charged with participating in a bank robbery orchestrated by Alice. Eric, the prosecutor, decides to pursue separate trials against Donna and Alice. Eric wants to call Alice as a witness to testify against Donna and vice versa. Can Donna be compelled to testify in trial against Alice?
- **Resource Video:** <http://thebusinessprofessor.com/5th-amendment-criminal-law-protections/>

10. What protections does the 6th Amendment provide to individuals subject to criminal charges?

The 6th Amendment provides numerous procedural protections for someone who is subject to the prosecutorial process. These protections include:

- *Speedy and Public Trial* - An individual, upon being charged with a crime, may request an expedited trial before a jury of her peers. This right prevents unduly long detention without proceeding with prosecution.
- *Trial by Jury* - The 6th and 7th Amendments to the US Constitution allow for trial by jury. This right does not extend to administrative hearings, certain Article I hearings, juvenile proceedings, and certain misdemeanor cases.
- *Informed of Charges* - The 6th Amendment ensures that individuals will be fully informed of the nature and extent of charges brought against them. If the Government fails to give notice of charges arising out of the same allegedly criminal conduct, the right to later bring those charges may be forfeited.
- *Confront One's Accuser* - Anyone accused of a crime has a right to confront (and cross-examine in court) anyone accusing her of the charged criminal activity.
- *Right of Subpoena* - The court provides any defendant with the opportunity to subpoena witnesses to give testimony or evidence at trial if those witnesses or evidence are relevant to the charged criminal conduct.

- *Right to Counsel* - Defendants have the right to be represented by a licensed attorney in any case that has the possibility of imprisonment. If an individual cannot afford an attorney, the government will provide the defendant with a free public attorney.

The rights afforded under the 6th Amendment have been interpreted broadly to ensure adequate protection of a criminal defendant's rights.

- **Discussion:** Do you believe that all of the above protections are warranted for individuals accused of crimes? Why is it important to allow a defendant the option of electing to have a speedy trial? Is there any justification for denying the right to jury trial in certain administrative and juvenile cases? How does the right to be informed of charges against a defendant have the effect of protecting against multiple prosecutions for a single course of conduct? Do you believe that a defendant should always have the right to confront her accuser (such as in rape or molestation cases)? How broad should the right of subpoena be and should it balance the rights of those subpoenaed against those of the defendant? Is it, and if so, why is it important to afford a defendant the right to legal counsel throughout the prosecution process (beginning at the point of arrest)?
- **Practice Question:** Bernard was arrested on charges of conspiracy to commit murder. His accomplice, Abby, was also arrested but skipped bail and left the country. Without Abby, the prosecution will have a difficult time proving conspiracy against Bernard. The prosecution seeks to delay Bernard's trial until international police are able to locate and detain Alice. What 6th Amendment rights can Bernard assert to aid in his defense?
- **Resource Video:** <http://thebusinessprofessor.com/6th-amendment-protections-criminal-law/>

11. What protections does the 8th Amendment provide to individuals subject to criminal charges?

The 8th Amendment prohibits the Federal Government from imposing "excessive bail, excessive fines, and cruel and unusual punishment" on individuals pursuant to criminal prosecution. These protections have been extended to state governments as well. The prohibition against cruel and unusual punishment has been the subject to extensive interpretation over the years. This has particularly been the case with regard to capital punishment. Generally, the standard for what constitutes cruel and unusual punishment has become increasingly broad.

- **Discussion:** Why do you think the trend toward what constitutes cruel and unusual punishment is toward greater protection of defendants? What do you think is the justification behind prohibiting excessive bail for defendants? What about excessive fines?
- **Practice Question:** Nancy is convicted of check fraud. The judge sentences Nancy to 100 hours of hard labor to be carried out during the hottest hours of the day. Are there any arguments against the constitutionality of this sentence?
- **Resource Video:** <http://thebusinessprofessor.com/criminal-law-protections-of-the-8th-amendment/>

12. What are some common crimes involving the property of others?

Each state adopts its own criminal statutes. Some of the more common types of named criminal offenses against someone else's property include:

- *Larceny* - Larceny is the unlawful taking (theft) of personal property with the intent to permanently deprive the rightful owner of it.
- *Robbery* - Robbery is theft through violence or threat.
- *Burglary* - Burglary is theft by breaking into a building (sometimes at night) with intent to commit a felony therein.
- *Extortion* - This is the unlawful obtaining of another's property through coercion, such as the threat of violence.
- *Embezzlement* - This is the theft of money by an individual entrusted to hold it.
- *Fraud, False Pretenses, and Theft by Deception* - Fraud, False Pretenses, and Theft by Deception involve deceiving someone to unlawfully take possession of her property. While fraud generally involves deception, false pretenses and theft by deception requires a knowingly false representation.

There are many statutory and common-law charges involving the property of others. These above-mentioned examples, however, are generally uniform across jurisdictions.

- **Discussion:** How do you feel about the premise of revoking an individual's liberty for actions that harm the possessions or property of others? Does the individual's intent when carrying out these actions influence your opinion?
- **Practice Question:** What is the difference between larceny, robbery and burglary? What is the difference between extortion and embezzlement? What is the difference between fraud and theft by deception?
- **Resource Video:** <http://thebusinessprofessor.com/crimes-against-property-of-others/>

13. What type of activity constitutes fraud?

The elements of the crime of fraud vary between jurisdictions. Consistent with the federal fraud statute, fraud is the unlawful taking of another's property through the following types of knowing and willful conduct:

- falsifying, concealing, or covering up any trick, scheme, or device;
- making any material false fictitious, or fraudulent statement or representation about a material fact; or
- making or using any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry.

Related charges, commonly known as "false pretenses" and "theft by deception" generally constitute the following types of conduct:

- intentionally creating or reinforcing an impression that is false;
- failing to correct an impression that is false and that the person does not believe to be true if there is a confidential or fiduciary relationship between the parties;
- preventing another from acquiring information that is relevant to a transaction; and
- failing to disclose a known lien or other legal impediment to property being transferred.

Note: The elements of the above charges are generally common among most jurisdictions, with slight variations in the language or wording.

- **Discussion:** Fraud generally entails wrongfully obtaining resources or benefits from another person by deceptive means. In your opinion, does the fact that the individual voluntarily provides the resources or benefits to the fraudster in any way mitigate or lessen the reprehensible nature of the actions?
- **Practice Question:** Doreen is seeking to borrow funds to run her business. She approaches several wealthy individuals in town and pitches the virtues of her business. She goes further than over representing the strength of her business. She lies about the incomes generated over the past several months. Convinced by her presentation and the business's strong performance, several individuals make loans to the business of \$10,000 or more. Doreen continues operations and uses the funds to pay herself a substantial salary. Ultimately, the business fails and shuts down. Has Doreen committed a crime? If so, what?
- **Resource Video:** <http://thebusinessprofessor.com/activity-constituting-fraud/>

14. How does “good faith” affect fraud?

Fraud requires knowing and willful conduct carried out with the intent to defraud someone. As such, good faith in one's actions is a defense to the allegations. The defense is that the defendant acted in good faith and did not have the necessary intent to defraud anyone. It does not matter that a person's statement or belief is wrong, there is no action for fraud unless intent to deceive is present. Further, an individual's lack of due care in making a statement is not relevant in determining fraud.

- **Discussion:** How do you feel about the mental intent requirement for a charge of fraud? Do you think a person should be able to escape a criminal fraud charge if she is reckless in her actions? What if she recognizes that her assertions are extremely unlikely, but she leads a customer or client to believe that the unlikely result is reasonably certain?
- **Practice Question:** Mitchell owns a baseball card of Mickey Mantle. He believes that the card is an original rookie card. He offers to sell the card to Amy for \$1,500. Amy buys the card. No long afterward, she has the card inspected and learns that it is simply a reproduction of the original card and is not worth any money. She is angry at Mitchell and asks your opinion on whether she should report the incident to the police. Has Mitchell committed fraud? Why or why not?

- **Resource Video:** <http://thebusinessprofessor.com/good-faith-as-a-defense-to-fraud-charge/>

15. What are some common types of business fraud?

Many examples of business fraud include a scheme or plan designed to take from a person the tangible right of honest services. Below are some common examples of fraud in the business context:

- *Mail or Wire Fraud* - It is illegal to use the US postal service or electronic means of interstate communication to carry out a scheme to defraud. This is a very broad statute, as it includes any fraudulent conduct employing mail or wire transmission. “To mail” means a communication is sent or received through use of the US Postal Service or any interstate carrier. “Wire transmission” includes the use of radio, television, telephone, Internet, or other wired form of communication.
- *Securities Fraud* - Federal laws defining securities fraud are the Securities Acts of 1933 and the Securities Exchange Act of 1934. Section 17 of the 1933 Act covers fraudulent activity in the issuance of securities. Section 10 and Rule 10(b)(5) of the 1934 Act cover fraud in the purchase or sale of a security.
- *Insurance Fraud* - This is a common state-law crime in which an insured makes a fraudulent claim for benefits under an insurance policy. For example, intentionally setting fire to the building of a failing business to collect the insurance proceeds is insurance fraud.
- *Healthcare Fraud* - Healthcare fraud generally involves making fraudulent claims for payment or reimbursement of healthcare expenses. The common offenders are healthcare providers who make fraudulent claims for reimbursement for services never performed or unnecessary. The prosecution usually falls under the False Claims Act.
- *Tax Fraud* - Tax fraud is the knowing concealment of transactions or property ownership in an attempt to illegally avoid paying federal, state, or local taxes.

- **Discussion:** Do you think there should be varying degrees of fraud? When does an individual’s conscious decision to do a poor job or cut corners amount to a plan or scheme to defraud the individual paying for the services? Could an intentional misstatement about quality of services or effectiveness of a product amount to fraud? Could it be fraud if an individual misrepresents (or lies about) a work process in order to get hired or win a contract?
- **Practice Question:** Javier opens a personal wealth investment business. He represents to clients that he can generate above-average returns on their investment with minimal risk. He claims to have insider information on many new business ventures that makes them a certain success. He makes up fake disclosure documents for business that do not exist or have no connection with Javier. In reality, Javier is running a *Ponzi* scheme in which he takes money from investors and uses the funds to pay returns to other investors. He also spends much of the remaining funds soliciting new investors through email and direct-mail advertisements. What crimes, if any, has Javier committed? Why?
- **Resource Video:** <http://thebusinessprofessor.com/common-types-of-business-fraud/>

16. What is the crime of “Conspiracy”?

Conspiracy involves an agreement between individuals to commit a crime. Conspiracy is a separate charge or crime than the crime agreed to by the parties. In a conspiracy, each member becomes the agent of the other member(s). Each person in the conspiracy does not have to know all of the details. Each person simply needs to understand that the plan is illegal and knowingly and willfully join in that plan on one occasion. The conspiracy or conspired act does not have to be successful. The formal elements of a conspiracy charge are as follows:

- *Multiple People* - There must be 2 or more persons.
- *Mutual Understanding* - In some way or manner, these people must come to a mutual understanding to try to accomplish a common and unlawful plan.
- *Willfulness* - The defendant must willfully become a member of the conspiracy.
- *Overt Act* - During the existence of the conspiracy, one of the conspirators must knowingly commit at least one of the “overt acts” described in the indictment (formal charge).
- *Purposeful Act* - The overt act was knowingly committed in an effort to carry out or accomplish some objective of the conspiracy.

The essence of a conspiracy offense is the making of an agreement followed by the commission of any overt act in furtherance of that agreement. While direct evidence is preferable, circumstantial evidence may be used to prove a conspiracy.

- **Discussion:** Do you think a person should be liable for conspiracy to commit a crime if they were not involved in the planning of the crime? What if conspirators solicit a third party to commit an illegal act that is part of the conspiracy, but the third party does not know about or agree upon the conspired scheme? How much evidence do you think must be present to demonstrate alleged conspirators have arrived at a mutual understanding?
- **Practice Question:** Sarah, Jane, and Tommy need money to support their drug habits. They devise a plan to break into April’s house and rob her. As soon as they begin planning, Sarah realizes that this is a very bad idea. She tells Tommy and Jane that she made a mistake and she wants no part of the plan. Tommy and Jane, undeterred by Sarah backing out, go to April’s house to determine the best way to break in. A neighbor notices them creeping around the house and calls the police. The police arrest Tommy, Jane, and Sarah and charge them all with conspiracy. Will Sarah, Jane, and Tommy be found guilty of conspiracy? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/conspiracy-as-a-criminal-charge/>

17. What is the crime of “Obstruction of Justice”?

Obstruction of justice is an intentional act carried out with the intent to obstruct the legislative or judicial process. This charge seeks to protect legislative, judicial, and administrative proceedings.

- **Discussion:** How do you feel about charging a friend or family member of an accused individual for harboring (hiding) that individual to prevent her arrest? What if a friend or family member withholds or fails to give to authorities any information that implicates a family member in a crime? What if a friend or family member specifically lies when questioned by authorities to prevent an arrest?
- **Practice Question:** Barry witnesses a masked individual pull a pistol on two unsuspecting tourists and demand their valuables. He then watches the perpetrator run away down the street. At the end of the street, the perpetrator throws his weapon in the trashcan and continues to flee. Barry walks to the end of the street and removes the robber's weapon from the trashcan. He likes the gun and decides to keep it for himself. When the police arrive on the scene, they question everyone in the area, including Barry. Barry refuses to answer the police questions and does not mention the weapon he found. Has Barry committed a crime?
- **Resource Video:** <http://thebusinessprofessor.com/obstruction-of-justice-as-a-criminal-charge/>

18. What is the crime of providing a “False Statement”?

False Statement to a Bank

This involves presenting financial information to a bank when requesting a loan. It is a federal crime for anyone to willfully make a false statement to a federally insured financial institution. Lending institutions rely upon a company's financial statements in extending credit or granting a loan. An individual must intentionally make the false statement to the financial institution in order to secure some form of financial rights (such as a loan or guarantee). The statement must relate to a material fact or consideration that the individual knows to be false. A fact is material if it is an important consideration in the determination of whether or not to extend a financial benefit.

False Statement to a Federal Agency

The US Code makes it a federal crime for an individual to willfully and knowingly make a false or fraudulent statement to a department or agency of the United States. The false statement must be material in nature. Making a materially false statement to another person with knowledge that it will be transmitted to a federal agency is also a crime.

- **Note:** Federal appellate courts recognize the “exculpatory no” exception for simple denials made in response to government questioning as part of a criminal investigation. This type of reaction to government questioning will not lead to charges of making a false statement.
- **Discussion:** How does a false statement to a financial institution compare to a false statement to a governmental agency? Does criminal liability for a false statement to a governmental agency implicate the 1st Amendment?
- **Practice Question:** Donnie needs capital to run his business. He goes to the local bank and talks with a loan officer. As part of the loan application process, Donnie must submit his business's financial history. Donnie makes up some financial statements with false information about the business's operations and sales. The bank relies on these statements in loaning \$30,000 to Donnie's business. Donnie's business takes off and is successful. He is easily able to repay the loan. Has Donnie committed a crime?

- **Resource Video:** <http://thebusinessprofessor.com/false-statement-as-a-criminal-charge/>

19. What is “Aiding and Abetting” criminal activity?

Aiding and abetting involves providing assistance to someone accused of a crime. The assistance must relate to the criminal activity, such as assistance preparing to commit the crime, covering up the criminal activity, or evading law enforcement. This charge can be very similar to conspiracy. Under state law, the crime of aiding and abetting is often referred to as “accessory”. An individual can be an accessory before or after the commission of the crime. “Accessory before the fact” means that the individual helps in preparation of the criminal activity. “Accessory after the fact” means that the individual helps conceal or cover up the crime.

- **Discussion:** When should offering general support to an individual who commits a crime constitute accessory? Is a person an accessory if she knowingly provides the accused with a weapon or tools to commit a crime? What if the third party simply provides information to the accused that is useful in committing the crime? What if a person allows the accused to stay with them after learning that there is a warrant for the accused’s arrest?
- **Practice Question:** Hank commits a violent crime and is on the run from the police. Prior to committing the crime, he expressed to his friend, Joanna, that he needed a handgun to rob someone. Joanna, ever the loyal friend, helps him acquire the gun. After the crime is committed, Hank flees and asks his mother Edith for help in leaving the state. Edith allows Hank to take her vehicle and flee the state. Has Joanna or Edith committed crimes?
- **Resource Video:** <http://thebusinessprofessor.com/aiding-and-abetting-or-conspiracy-to-a-crime/>

WHITE COLLAR AND BUSINESS CRIMES

20. What is a “White-collar Crime”?

White-collar crime characterizes crimes by criminals of high socioeconomic status or individuals who hold high-ranking, professional positions, such as corporate executives. More broadly, it includes any offense that occurs in a business or professional setting. These crimes can either be for personal gain or with the purpose of harming or benefiting the business.

- **Note:** Unlike individuals, corporations cannot be put into jail. Corporations can, however, be fined and face other criminal penalties, such as involuntary dissolution.
- **Example:** White-collar crimes includes: embezzling money, making electronic advances to fictitious employee, and accepting kickbacks from suppliers.
- **Discussion:** Do you feel like white-collar crimes are punished as regularly or severely as non-white-collar crimes? How do you feel about the inability to incarcerate a business entity, when these entities receive many of the same rights and procedural protections of human beings?

- **Practice Question:** Gina is the Chief Financial Officer of ABC, Inc. In her role, she approves all major expenditures of corporate funds. She authorizes the use of corporate funds to pay for her vacation to the Bahamas with her family. She uses the funds for travel, lodging, gambling, and dining. She is able to conceal the expenditures by acting as disbursing and approval authority. Do Gina's actions constitute white-collar crime?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-white-collar-crime/>

21. What are crimes directed at conduct endangering workers?

In some instances, a corporate official may be charged with a crime for conduct committed in furtherance of her job duties. Particularly, conduct by business officials that endanger workers may be criminal in nature.

- **Note:** The Occupational Safety and Health Administration (OSHA) or equivalent state agencies may investigate businesses for violation of health and safety standards. If an agency uncovers potentially criminal conduct, it can turn the investigation over to state or federal authorities for investigation and potential prosecution.
- **Example:** Examples of such criminal actions include when a business official: commits an assault and battery of an employee or makes decisions that recklessly endanger or company workers. If a company official orders extremely dangerous process, such as handling dangerous chemicals, or fails to institute adequate safety precautions, she may face criminal liability if a worker is injured or killed.
- **Discussion:** If you have read the famous book by Upton Sinclair, "The Jungle", you are aware of the harsh working conditions that workers in the United States faced at the turn of the 20th Century. Do you think that criminalizing decision making by corporate executives helped to curb these harsh employer practices? Do you think the criminal penalties against businesses are sufficient to deter these practices?
- **Practice Question:** Earl is a movie director. He is known for the action sequences in his documentary films. He hires, Faith, a recent film graduate to work on his movie set. As part of a film, Earl wants to film a chase sequence on a railroad track. Earl mounts a camera on the bumper of a vehicle and instructs Faith to maneuver it during the action scene. During the scene, Faith is bounced from the vehicle and severely injured. Has Earl committed a crime against Faith?
- **Resource Video:** <http://thebusinessprofessor.com/crimes-for-conduct-endangering-workers/>

22. What is bribery and other illegal payments (kickbacks)?

Offering, receiving, or soliciting something of value for the purpose of influencing the action of an official in the discharge of her public or legal duties is illegal in both the domestic and international contexts. Under federal law, this sort of activity is prohibited by the *Foreign Corrupt Practices Act*, which specifically serves to prevent kickbacks to facilitate business transactions.

- **Note:** There is an exception under the FCPA that allows payment to individuals to undertake their procedural or routine tasks when such payments are customary in a country.

- **Discussion:** Do you think businesses should be prevented from paying government officials for official action that helps or favors the business? Should these prohibitions apply outside of the United States as well? Does it change your opinion if the act of paying officials in a particular foreign country is so common that it is expected? Should there be an exception when bidding for contracts against foreign companies that are openly paying officials?
- **Practice Question:** Sean owns a company and seeks to sell goods to the Brazilian government, specifically the development department. Sean knows that the Brazilian market is difficult to break into for foreigners. Sean, with the purpose of improving his chances of winning the contract, buys very lavish gifts and has them delivered to the home of the director of the development department. Has Sean committed a crime?
- **Resource Video:** <http://thebusinessprofessor.com/bribery-or-illegal-kickbacks-as-a-crime/>

23. What is the “Racketeer Influenced and Corrupt Organizations Act” (RICO)?

This law imposes criminal and civil liability upon those businesspersons who engage in certain prohibited activities that directly affect interstate commerce. The law is commonly used to impose criminal sanctions and forfeiture of resources used in furtherance of the criminal enterprise. Elements of a RICO action include:

- *Involvement in an Enterprise* - This may include using or investing income from prohibited activities to acquire an interest in or to operate an enterprise; acquiring or maintaining an interest in or control of an enterprise; or conducting or participating in the conduct of an enterprise while being employed by or associated with it.
- *Pattern of Racketeering* - Racketeering is defined as “any act or threat” involving a specified state crime or any “act” subject to indictment under various federal statutes. There must be some pattern of or recurring activity constituting racketeering.

The law makes it unlawful for any person employed by or associated with any enterprise to conduct or participate in a violation of the law. The law foresees two separate entities — person and the enterprise. Generally, employment alone is insufficient to hold someone liable under RICO.

- **Discussion:** Do you think this statute goes to far by allowing the government to charge individuals who are not directly involved in the criminal activity? Is the ability to reach those facilitating a criminal activity (and their assets) necessary to the administration of justice?
- **Practice Question:** Gloria makes a living by illegally importing cocaine into Florida from Colombia, SA. She does not have any hands on the process. Rather, she hires every part of the activity. Once the drugs arrive, she hires Terry to pack them in the trunk of a car and sends them to a distributor in New York. She hires Robert to drive the vehicle carrying the drugs. On the way, Robert is stopped and arrested by North Carolina police officers. The Federal Bureau of Investigation gets involved and traces the scheme back to Gloria. How can the FBI potentially charge Gloria for her involvement in drug trafficking?
- **Resource Video:** <http://thebusinessprofessor.com/racketeer-influenced-and-corrupt-organization-act-rico/>

24. What is the “False Claims Act”?

The False Claims Act (FCA) is a federal law that provides criminal and civil sanctions for those who commit fraud against the US Government. It is well known for authorizing a special type of civil action, “Qui Tam” or “Whistleblowing”, which allows a civil plaintiff to bring an action against a company on behalf of the Federal Government. The criminal and civil provisions of the FCA prohibit the following conduct:

- Knowingly presenting, or causing to be presented a false claim for payment or approval;
- Knowingly making, using, or causing to be made or used, a false record or statement material to a false or fraudulent claim;
- Conspiring to commit any violation of the False Claims Act;
- Falsely certifying the type or amount of property to be used by the Government;
- Certifying receipt of property on a document without completely knowing that the information is true;
- Knowingly buying Government property from an unauthorized officer of the Government, and;
- Knowingly making, using, or causing to be made or used a false record to avoid, or decrease an obligation to pay or transmit property to the Government; and
- Retaliation based upon reporting any of the above infractions.

The unique aspect of the FCA is that it allows individuals reporting criminal fraud against the government and those bringing Qui Tam actions to receive a portion of the proceeds recovered by the government.

- **Discussion:** What do you think is the justification for allowing civilians to bring an action on behalf of the government? What do you think about awarding a whistleblowing civilian a portion of the civil damages recovered against a company? What is the reasoning behind allowing these types of actions?
- **Practice Question:** Ron works in the manufacturing services unit for ABC, Inc. ABC has a large contract with the Federal Government to manufacture steel storage containers. The contract allows ABC to charge the government for all materials used in manufacturing and for the labor costs. Ron noticed that ABC was routinely ordering shipments of steel fittings at \$25,000 each as part of the materials order for the government contract. In reality, ABC was only using a small portion of the fittings on the contract, and was selling the remaining units to third parties. Ron decides to inform the government that it is being routinely over charged by ABC. Has ABC committed a crime? What rights and protections does Ron have in reporting ABC’s conduct?
- **Resource Video:** <http://thebusinessprofessor.com/the-false-claims-act/>

25. What is the “Sarbanes-Oxley Act”?

The Sarbanes-Oxley Act (SOX) is a set of federal laws addressing criminal and unethical conduct of public company

boards and management. It also addresses the accounting and auditing practice of firms servicing these public companies. The criminal sanctions under the statute are as follows:

- *Title VIII & XI* - This portion of SOX contains the "*Corporate and Criminal Fraud Accountability Act of 2002*". It provides criminal charges for the creation or destruction of fraudulent corporate records. It generally addresses fraud through the uses of corporate records and provides established ranges of criminal penalty. It also establishes protections against retaliation for those reporting such activity.
- *Title IX* - This portion of SOX is called the "*White Collar Crime Penalty Enhancement Act of 2002*". It provides criminal charges for illegal and unethical conduct by officers and managers that harms the public. It specifically requires corporate managers to certify that records are true and accurate.

SOX was passed in the wake of numerous corporate scandals that rocked the financial markets, such as World Com, TyCo, Enron & Arthur Andersen.

- **Discussion:** Do you think that additional government regulation of corporate practices in the form of criminal penalties helps to curve unethical conduct? Do any positive effects outweigh the negative consequences to the business (such as increased costs, bureaucracy, etc.)?
- **Practice Question:** Derek is CFO of ABC, Inc. After years of declining profits, Derek devises a method for improving the appearance of ABC's balance sheet. Derek creates a group of limited liability companies that are owned by ABC. ABC transfers corporate debt to these entities, which is reported off of the main balance sheet and in the footnotes of the financial statements. Derek knows that this form of disclosure is likely to convince investors that ABC has a strong financial position. Has Derek committed a crime?
- **Resource Video:** <http://thebusinessprofessor.com/sarbanes-oxley-act/>

26. What is a "Cyber Crime"?

Federal law provides that a person who intentionally accesses a computer without authorization or exceeds authorized access to obtain classified, restricted, or protected data, or attempts to do so, is subject to criminal prosecution.

- *Example:* Types of cybercriminal conduct include: hacking, cyber terrorism, destruction of data, unlawful appropriation of data or services.
- **Discussion:** Do you think it should be a crime for individuals like Edward Snowden to disclose governmental data? Do you think it should be a crime to access the back-end database on someone's private website? At the opposite end of the spectrum, if someone walks away from a public computer and fails to log out of her email account, do you think it should be criminal to read that person's emails? What if you were to send an email (even as a joke) from that person's email account?
- **Practice Question:** Clarence has his own business website that he hosts on a personal server. He manages the site personally with Wordpress. Alice is aware of Clarence's website setup and wants to play a joke on him. She guesses his password and logs into his website server. She then changes the title to read, "Alice is Amazing".

Clarence is outraged by Alice's joke. Has Alice committed a crime?

- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-cyber-crime/>

DEFENSES TO CHARGES OF CRIMINAL CONDUCT

27. What defenses exist to criminal conduct?

Common defenses to criminal conduct include:

- *Negating Mental Capacity* - Certain conditions of the defendant may negate the mental capacity to commit a crime.
 - *Examples:* Defenses commonly negating capacity include mental incompetence, insanity, involuntary intoxication, and infancy.
- *Negating Intent* - Certain conditions may negate the requisite intent (*men rea*) required by a particular crime.
 - *Example:* A mistake of fact or voluntary intoxication may negate the mental intent required to find guilt for a particular crime.
- *Other General Defenses* - These defenses constitute defenses to certain criminal charges. Common examples include:
 - *Duress* - This means applying undue pressure (often pursuant to a position of power or authority over an individual) to coerce activity deemed to be criminal conduct.
 - *Example:* Holding a gun to someone to make them steal would be an example of duress.
 - *Necessity* - Necessity is when an individual had no choice but to break the law in order to avoid significant harm. There must not be another reasonable manner of avoiding the harm and the harm avoided must be greater than the harm caused by breaking the law.
 - *Example:* Hank sees an individual planting a bomb in a public park. The individual runs off. Hank pulls out his concealed weapon and fires it into the air multiple times. This act causes all the bystanders to flee running. His act of firing the weapon was criminal, but it was done out of necessity.
 - *Entrapment* - This involves the wrongful solicitation and inducement to commit criminal activity by a government official (particularly the police).
 - *Example:* I am a police officer. I tell Adam that he can make some extra money by helping me transport drugs from Florida to New York. I provide Adam with a vehicle loaded with illegal drugs. I then arrest Adam for carrying out the plan. I have entrapped him.

- *Justifiable Use of Force* - Individuals may generally use a certain level of force to protect themselves and their property. The use of force is generally limited to the ability to respond with a reasonable amount of force given the situation.
 - *Example:* Thomas is walking down the street when he is attacked by two men. Fearing for his physical safety, Thomas uses a can of mace to spray and disorient his attackers. Thomas has not battered his assailants, as his use of force was justified in defense of his safety.

The availability or applicability of any defense depends upon the type and nature of the criminal charges.

- **Discussion:** What is your impression of defenses to criminal activity? Do you believe most defenses posed in criminal actions are valid or are they overused hindrances to the execution of justice? Can you think of any famous criminal cases where one of the defenses earned an acquittal for a defendant?
- **Practice Question:** Geoffrey is walking home from a party and is stopped by the police. The police are concerned that Geoffrey is intoxicated and administer a field sobriety test, which Geoffrey fails. The police charge Geoffrey for public intoxication. Geoffrey contends that he did not drink or take drugs that night. A blood test shows that Geoffrey has alcohol in his system. Unbeknownst to Geoffrey, someone at the party had spiked the punch bowl from which Geoffrey was drinking. What defenses might Geoffrey employ at trial?
- **Resource Video:** <http://thebusinessprofessor.com/common-defenses-to-criminal-conduct/>

THEORIES OF CRIMINAL PUNISHMENT

28. What types of punishment exist for criminal activity?

Criminal statutes carry numerous forms of punishment or sanction for criminal conduct including:

- *Fines* - These are monetary penalties placed on someone convicted of criminal activity.
- *Incarceration* - This includes the physical detention of an individual.
- *Other Loss of Rights or Privileges* - Other losses of rights or privileges pursuant to criminal conduct include:
 - the right to vote,
 - the right to own a firearm, and
 - the privilege of driving.

These punishments are not exclusive. Criminal conduct may carry multiple punishments.

- **Discussion:** Do you believe that criminal punishments are fair across all crimes in the United States? More

specifically, are the criminal sanctions for white-collar crimes just in comparison to criminal sanctions for the sale for illegal drugs?

- **Practice Question:** Victor is charged with domestic abuse of his wife. The police have evidence that Victor physically attacked his wife on multiple occasions. The charges are a felony in Victor's state. If convicted, what are the possible penalties Victor could face for this illegal conduct?
- **Resource Video:** <http://thebusinessprofessor.com/types-of-punishment-for-criminal-activity/>

29. What are the theories for criminal punishment?

Numerous theories or philosophies exist for imposing some form of sanction upon criminal conduct, including:

- **Retribution** – Retribution theory states that an individual should suffer or incur some harm for her conduct.
- **Deterrence** – Deterrence theory states that imposing sanctions on conduct will prohibit that type of conduct. Individual deterrence says that imposing sanctions will prevent an individual from undertaking that conduct. General deterrence focuses on the signaling effect that punishing a criminal has on the population. Those who are aware of the sanctions inflicted upon an individual will be less likely to undertake that conduct.
- **Incapacitation** – Incapacitation theory says that society should be protected against individuals who commit a crime for a specific period of time.
- **Rehabilitation** – This theory states that an individual receives sanctions with the purpose of allowing the individual time to mentally process her actions. This may include training to help the individual understand the wrongfulness of the conduct and, hopefully, reform and refrain from committing further criminal conduct.
- **Restoration** – This theory states that the victim deserves to be made whole (or as close as possible) from the criminal activity. The cost of making the victim whole should be borne by the criminal. This may include providing the victim with the sanctity of mind that this type of conduct will not happen again.

Legislators and judicial figures do not have to state their reasoning when passing criminal statutes or handing down criminal sentences.

- **Discussion:** Which, if any, of these philosophical justifications for criminal punishment convince you? Why or why not?
- **Practice Question:** The Oregon legislature is revisiting the state statutes concerning penalties for specific crimes. The legislature has asked you to testify as an expert regarding theories of criminal punishment. In a concise paragraph, provide an explanation of the primary theories supporting punishment for criminal infractions.
- **Resource Video:** <http://thebusinessprofessor.com/theories-behind-criminal-punishment/>

30. What are the “Federal Sentencing Guidelines”?

In 1980, a federal sentencing commission developed sentencing guidelines for federal crimes. Initially they were mandatory for federal courts, but later became discretionary. The federal guidelines are still very influential in the sentencing process. Some states have model guidelines for use in state-law, criminal cases.

- Note: Business entities are subject to punishment under the federal sentencing guidelines as well.
- **Discussion:** Do you believe courts should employ standard sentencing guidelines? Why or why not?
- **Practice Question:** Tommy is convicted under a federal money-laundering statute. He is awaiting sentencing. What role does the Federal Sentencing Guidelines play in the court sentencing Tommy for his illegal conduct?
- **Resource Video:** <http://thebusinessprofessor.com/federal-sentencing-guidelines/>

TOPIC 6: CIVIL LITIGATION PROCEDURE

Overview

This chapter introduces the concept of civil litigation (“suing someone” or “bringing a lawsuit”). More specifically, it explores the methods and procedure for enforcing one’s rights in a civil lawsuit. It introduces the individuals involved in a civil trial and provides a detailed explanation of the mechanics of a proceeding. It explains the authority for a court to adjudicate certain types of actions and explains what elements must be present for a court to legally subject individuals to its authority. Lastly, the chapter will explore the post-trial stages and the remedies and enforcement mechanisms available to the litigating parties.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• <u>Civil Action or Lawsuit</u>	• <u>Minimum Contacts</u>	• <u>Frivolous Case</u>
• <u>Parties to Litigation</u>	• <u>Class Action</u>	• <u>Jury Selection (<i>Voir Dire</i>)</u>
- <u>Plaintiff</u>	• <u>Pleadings</u>	• <u>Trial Process</u>
- <u>Defendant</u>	• Default Judgment	• <u>Burden of Proof</u>
- <u>Counter Claim</u>	• <u>Discovery</u>	• <u>Verdict</u>
• <u>Third-Party Defendant</u>	• <u>Scope of Discovery</u>	• <u>Joint and Several Liability</u>
• <u>Standing</u>	• <u>Motions</u>	• <u>Appeal</u>
• <u>Personal Jurisdiction</u>		• <u>Enforce a Judgment</u>
- <u>Service of Process</u>		• <u>Res Judicata</u>
- <u>Long-Arm Statute</u>		
-

TOPIC 6: CIVIL LITIGATION & PROCEDURE - QUESTIONS & ANSWERS

1. What is a “civil lawsuit” or “civil action”?

A civil lawsuit is a private legal action between two or more parties addressing a legally recognizable dispute. A civil lawsuit can be grounded in tort, contract, property, or family law. One or more of the parties have allegedly suffered a harm or loss as a result of the actions or inactions of the other party. Those parties are seeking resolution of the legal dispute and an enforceable remedy from the court.

- **Discussion:** Why do you think the government provides a method by which individuals can settle disputes among themselves? Do you think litigation is an effective method of achieving these objectives?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-civil-lawsuit/>

2. Who are the “parties” to a lawsuit?

A lawsuit involves (or may involve) the following parties:

- **Plaintiff** - The plaintiff is the party (individual or business) who files the action claiming that she has suffered a wrong at the hands of the defendant. Basically, the plaintiff is the individual suing or bringing a civil action against someone else.
 - **Discussion:** Compare the plaintiff in a civil case to the prosecutor in a criminal case. Note: In criminal law, there is no plaintiff. The State (represented by the district attorney, a prosecutor) brings charges against a criminal defendant.
- **Defendant** – The defendant is the party being sued in the civil action. More specifically, a defendant is a party named by the plaintiff in the formal complaint filed with the court. Often times, the plaintiff will name multiple defendants. In some cases, each defendant’s conduct may subject her to potential liability independently of other defendants. In other cases, the collective actions of multiple individuals may subject them to liability collectively.
 - **Discussion:** Compare the defendant in a civil case to the defendant in a criminal case. Note, in criminal law the person being prosecuted is also called the defendant.
- **Counterclaim** – A counterclaim is a claim by a named defendant against the plaintiff. The defendant alleges that the plaintiff is responsible for some loss or harm she has suffered. A counterclaim by the defendant against the plaintiff does not have to be related in any way to the claims alleged by the plaintiff against the defendant. This all happens within the same court case. In this situation, the defendant or “counter-plaintiff” is the one bringing the counterclaim against the original plaintiff or “counter-defendant”.

- **Discussion:** What do you think is the benefit for the defendant of allowing him or her to make any claims back against the plaintiff in the legal action? Are there any advantages to the original plaintiff?

- *Third-party Defendants* – A third-party defendant is a party who is not initially named as a defendant in the plaintiff's complaint but is added to the case by a defendant. Basically, a defendant makes a claim against a third party alleging that she should be brought into the litigation as a co-defendant.

- **Discussion:** Why do you think that the rules of court procedure allow a defendant to add co-defendants to the lawsuit?

- **Practice Question:** David decides to sue Mary for destroying his lawn by pouring plant killer in a pattern spelling an offensive word. Mary was present at the time, but it was actually Mark who poured the chemical on David's lawn. Mary was involved in the incident because she was angry at David for backing out of his agreement to sell her his car. What options exist for Mary in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/parties-litigation/>

3. What is “standing” to sue in a civil trial?

Standing is the requirement that a person have a legally recognizable interest in a dispute before the court. In summary, to seek redress before the court, a person must suffer a loss or harm caused by the defendant(s). This rule seeks to ascertain that there is indeed an adversarial relationship between the plaintiff and defendant.

To have standing, a plaintiff must demonstrate two things to the court:

- *Legal Wrong* - The complaint, as written, must demonstrate a legal controversy. That is, there must be a legal wrong that took place. A legal wrong is an action that is prohibited by law and, if proven, may allow the plaintiff redress.
- *Personal Stake* - The plaintiff must show that she has a personal stake in the dispute or controversy with the named defendant. This means that she must be the one wronged. For example, a plaintiff cannot generally sue someone for harming another person who is not closely related to her. While she may be negatively affected, she is not the individual directly suffering the harm. Her harm is incidental.

Standing does not depend upon the validity or merits of the case. It only depends upon the relationship and nature of the controversy between the parties. Standing is determined at the time of filing the action. It does not matter if the plaintiff suffers harm at some time well after the dispute arises. She must have suffered the harm prior to the commencement of the action.

- **Discussion:** During the economic meltdown of 2007, many people suffered financially as a result of actions of others. Should those generally affected by the poor economy be able to sue those who played a major role in the downturn? Would granting standing to such people open the court to an unmanageable flood of cases?
- **Practice Question:** Angel is a big fan of Kim, a professional celebrity. Ryanne is a musician and celebrity who speaks ill of Kim on social media. Angel is so offended by Ryanne's conduct that she initiates a lawsuit against her for defamation. What is Ryanne's primary defense against Angel's action?
- **Resource Video:** <http://thebusinessprofessor.com/standing-sue/>

4. What is "personal jurisdiction" in a civil suit?

Personal jurisdiction means that the court has authority not only over the subject matter of the case but also over the parties to the case. This is also known as "*in personam* jurisdiction", or jurisdiction over the person. In some instances a court cannot establish jurisdiction over a person, but it can establish jurisdiction over real or personal property located within its geographical boundaries. This is known as "*in rem* jurisdiction". In practice a court obtains personal jurisdiction over the plaintiff when she files the legal action. By filing a lawsuit in a court, the plaintiff voluntarily submits to or grants the court personal jurisdiction over her. The plaintiff must generally allege in the complaint the grounds for the court's exercise of personal jurisdiction over the defendant. Otherwise, the defendant may voluntarily agree to be subject to the court's jurisdiction. Of course, the defendant is free to contest a court's personal jurisdiction. In fact, court procedure allows a defendant to appear before the court with the sole purpose of contesting personal jurisdiction without being subjected to jurisdiction in the process.

- **Note:** Personal jurisdiction, in this discussion, applies to civil cases. In criminal cases, a court only has personal jurisdiction over a party who commits a crime in that state. Other states will often extradite individuals charged with crimes to the state in which charges are filed.

- **Resource Video:** <http://thebusinessprofessor.com/personal-jurisdiction/>

Service of Process

The primary method of obtaining personal jurisdiction over a defendant is through service of process. This means that the court must deliver notice of the litigation (a summons) to the defendant. The summons provides notice to the defendant to appear in court. The plaintiff must also include a copy of the complaint at the time of delivering the summons. In some circumstances, a plaintiff may serve process on a defendant without personally delivering a summons. If, for example, a defendant is known to be in an area but cannot be found, court procedure may allow for the effective delivery of notice by other methods. This may include delivery to the last known address, delivery to immediate family members, and publication in a newspaper of general circulation.

- **Discussion:** A recent state case allowed for service of process *via* Facebook message. Do you believe that service of process should be delivered personally to a defendant? Or do you support alternative methods of notification, such as electronic posting? Do you think alternative methods of providing notice of litigation affect an

individual's due process rights?

The Long-Arm Statute

In order to serve the summons on the defendant, she must generally be within the state at the time of delivery. There is, however, a common exception that allows a court to serve process on a defendant located outside of the state's boundaries. This is known as the "long-arm statute". Limitations on the long-arm statute are as follows:

- *Due Process* - Serving process on a defendant is subject to the constitutional right to due process of law. As such, a state's long-arm statute must meet constitutional due process requirements.
- *Minimum Contacts* - To meet constitutional standards, the long-arm statute can only be used to serve process on a defendant who is located outside of the state if she has "minimum contacts" with the state. Minimum contacts means that the defendant has sufficient contact with the state to not "offend the notions of fair play and substantial justice".

What is Minimum Contacts?

A court may be able to legally serve a summons on a defendant who is out-of-state if one of the following are met:

- *Resident of State* - The defendant is a resident of the same state as the court.
- *Instate Activity* - The defendant committed the action within the state that is the subject of the litigation. The defendant may have committed a tort or entered into the business deal that was the subject of the litigation.
- *Owns Property* - The defendant may own property located in the state that is the subject of the litigation. This is known as "*in rem*" jurisdiction. This would include a lawsuit challenging property ownership rights.
- *Voluntary Submission* - The defendant may voluntarily submit to personal jurisdiction in the court. She can do this by written waiver or by just showing up to court and not contesting jurisdiction.
- *Presence in the State* - Remember, the court may serve process on a defendant if she is present in the state for any reason. The primary exception is that a party can appear in court for the purpose of contesting personal jurisdiction and not subject herself to the court's authority by doing so.
- *Registered in the State* - A business is subject to jurisdiction in its state of incorporation or any state in which the defendant business is registered.

- **Discussion:** Suppose a defendant technically committed the tort in a state, but really has very little contact or ties with the state otherwise. For example, Dave builds a product in Georgia and ships it to California. The product is defective and hurts the purchaser. Dave technically caused harm in California, but does not otherwise have any contacts with the state. Is this sufficient minimum contacts for the California court to exercise jurisdiction over Dave?
- **Practice Question:** Claire lives in Georgia and purchases a pair of shoes online from Waylon's Shoe Sales.

Waylon's is located in California. Waylon's only has physical locations in California, but he sells *via* the Internet throughout the United States. He does, however, routinely employ sales agents to attend trade shows and make sales calls in every state. When Claire's shoes arrive, she wears them out to diner. On the way out of the house, the heel of the shoe breaks and Claire falls to the ground. She suffers a torn ligament in her knee. She plans on suing Waylon's in Georgia's superior court for negligent manufacture of the product. What personal jurisdiction issues exist in this case?

5. What is a “class action” lawsuit?

A class action is a special type of lawsuit in which one or more plaintiffs file suit on their own behalf and on behalf of all other persons who have a similar claim against the defendant. The individuals represented by the lead plaintiff(s) are known as a “class” of plaintiffs. This type of lawsuit is popular when many individuals suffer the same type of harm by the defendant's conduct. Frequently, it involves matters in which no one member of the class has suffered a sufficient loss or harm to justify bringing the lawsuit alone. Basically, the damage suffered by one person is not enough to support the expense of litigation. Class status allows plaintiffs to aggregate their claims into one trial. It also avoids multiple legal actions involving the same issue. It provides advantages to the class of plaintiffs when the cost of litigation high and the issues are complex.

- **Discussion:** Do you think that class actions are valuable or detrimental to US society? Do you think that class actions have an impact on corporate behavior with regard to consumers?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-class-action-lawsuit/>

Requirements for a Class Action

The requirements for a plaintiff to bring a class action against a defendant are as follows:

- **Certify the Class** - The primary hurdle for the plaintiff is to “certify” all potential plaintiffs as a class. To certify a class, the plaintiff(s) must present evidence of the following:
 - **Numerosity** - The class is so numerous that joinder of class members in a trial outside of a class action is impracticable;
 - **Commonality** - There must be questions of law or fact common to the class;
 - **Typicality** - The claims (harms suffered) or defenses of the class representatives are typical of those of the class;
 - **Adequacy** - The class representatives will fairly and adequately protect the interests of the class; and
 - Any of the following:
 - **Risk of Inconsistency** - Hearing separate actions risks either inconsistent adjudications and standards or any one action would be dispositive of cases by other parties;
 - **Defendant's Obstinacy** - The defendant fails to act on any grounds or causes of actions by the

defendants, or

- *Note:* Denying the class does not give rise to immediate appeal. The case must be tried to a result first. This procedural requirement places a significant hurdle in the way of individuals trying to get certified as a class.

- **Discussion:** In recent years, Wal-Mart was the subject of a class action lawsuit for gender discrimination in hiring, promotion, and salary. The court denied class status to the plaintiff on the grounds that all plaintiffs did not suffer the same type of harm. Gender discrimination in hiring is not sufficiently similar to discrimination in promotion and salary so that the plaintiffs are representative of all class members. Do you believe that the requirement that each plaintiff be representative of all class members should be construed more strictly or loosely?
- **Resource Video:** <http://thebusinessprofessor.com/class-action-lawsuit-certify-a-class/>

- *Notice to Opt-Out* - Once certified, the lead plaintiff must give notice of the litigation to all prospective members of the class who can be found through reasonable efforts. Once identified, the prospective members are then given the option of opting out of the litigation. Opting out means that they will not be included in the class of plaintiffs. In most cases, this reserves the ability of the potential class member to bring her own legal action against the defendant.

- **Discussion:** You may have gotten notice in the mail or *via* an email that you are a potential class action member. They are common with purchases of electronics, lending practices, and communications or data usage agreements. Do you believe that failing to opt out of such actions is in your best interest? Were you satisfied with the result from the class action suit?

- *Cost of Litigation* - The lead plaintiffs in the class action must generally pay all of the costs associated with bringing the suit. This includes the heavy fee associated with notifying all potential class members. This makes it prohibitively expensive for one individual or a small group of plaintiffs to serve as plaintiffs for the class. Aggregating the claims among a group of lead plaintiffs, however, makes the action more affordable. Further, if the class action is successful, the plaintiffs paying the cost of litigation may recoup those expenses from any judgment rendered.

- **Discussion:** Do you believe that plaintiff's attorneys should be able to pay the costs of certifying the class? Why or why not?

- *State or Federal Court* - Plaintiffs may be able to bring a class action in state or federal court. State class action suits must demonstrate the court's subject-matter jurisdiction over the case and personal jurisdiction over the defendants. For the court to have subject-matter jurisdiction over the class action, a cause of action claimed against the defendants (such as fraud) must arise under state law. The court has personal jurisdiction over all

defendants when they all have minimum contacts with the state. Issues arise when there are multiple defendants from different states and they have very little contact with the state of litigation. A class action in federal court avoids the issue of personal jurisdiction, but the plaintiffs must still demonstrate that the court has subject-matter jurisdiction. If the parties are not suing the defendant based upon a federal law, then there must be diversity between the plaintiffs and defendants. Generally two federal statutes allow for class actions involving “complete diversity” and “minimum diversity”.

- *Complete diversity* - This requires that all plaintiffs be from different states than all defendants. This is difficult to achieve when the plaintiff class is very large and some class members are located in the same state as the defendant.
- *Minimum diversity* - This allows for the diversity action in federal court when only one plaintiff is diverse from one defendant. In both complete and minimum diversity situations, the amount in controversy must be at least \$75K. In some situations, all claims can be aggregated to meet the \$75K amount. In other situations, a single plaintiff must have a claim of \$75K in order to meet the statutory amount in controversy requirement.

- **Practice Question:** Save-Mart is national retailer of consumer products. A large group of female employees seek to bring a class action against Save-Mart for discriminatory practices in the hiring, promotion, compensation, benefits, scheduling, and firing of female employees. Most of these employees received minimum wage during their period of employment, which averaged 6-8 months. Four women from California will serve as the representative plaintiffs. What issues exist here for the plaintiffs in bringing the class action?
- **Resource Video:** <http://thebusinessprofessor.com/class-action-procedural-requirements/>

6. What are “pleadings” in a civil lawsuit?

Pleadings are the legal documents that parties use to communicate their grievances and responses to each other and to the court. In summary, they are used to start the litigation process. The pleadings consist of the following documents:

- *Summons* - The summons is the document notifying a defendant of the pending litigation and directing her to respond or appear before the court on a given date.
 - *Note:* Recall that service of process (delivery of the summons) is the basis for a court exercising personal jurisdiction over a defendant.
- *Complaint* - The complaint lays out the plaintiff’s legal grievances or causes of action against the defendant. It must state legally recognized causes of action and be specific enough to allow the defendant to adequately respond (answer) to those allegations. Generally, the complaint lays out the following:
 - identification of plaintiff and defendant,
 - the basis for the court’s subject-matter jurisdiction,

- the basis for service of process (court's personal jurisdiction),
 - the cause(s) of action against the defendant(s), and
 - the request for damages (or other legal or equitable remedy).
- *Answer* - The answer is the defendant's response to the complaint. The defendant will generally address every point in the complaint in one of the three following ways:
 - *Admit* - Admit the truth of an individual point in the allegation,
 - *Deny* - Deny the truth of the allegation, or
 - *Lack of Information* - Claim a lack sufficient knowledge to admit or deny the allegation.

The defendant may present a counterclaim against the plaintiff. This generally happens within the defendant's answer to the plaintiff's complaint. The parties may also include motions requesting action from the court outside of the complaint and answer.

Default & Default Judgments

Under state and federal law, a defendant has a stated period of time to respond to the plaintiff's complaint. Most jurisdictions allow 30 days to respond. Many jurisdictions also allow an extended period of time to answer the complaint if the defendant is willing to accept service of the summons and complaint by some method other than personal delivery. For example, the statute may allow for 60 days to respond if the defendant accepts service of process through the mail. If the defendant fails to respond within the allowed period of time, the court will deem the defendant in default. This generally results in the court rendering a default judgment in favor of the plaintiff. Subject to the court's review and discretion, the default judgment will award the defendant the legal or equitable remedies sought in the complaint. A defendant who defaults may be able to later petition the court to set aside the entry of default and judgment. To do so, however, the defendant must provide the court with a justifiable reason for setting aside the default and letting the defendant answer the complaint.

- **Discussion:** Do you believe that holding a defendant in default is a justifiable action for failure to respond to the initial pleadings? If not, what would be another manner of compelling a response from the defendant?
- **Practice Question:** Olivia receives a summons and complaint from a process server. The documents indicate that Matthew is suing Olivia for breach of contract. Olivia is annoyed by the situation. She replies to the complaint in a long letter that describes a tort that Matthew committed against her several years ago. She fails to address any of Matthew's allegations against her for breach of contract. If this is the only response that Olivia makes to the summons and complaint, what is the likely result?
- **Resource Video:** <http://thebusinessprofessor.com/court-pleadings/>

7. What is "discovery" in a civil lawsuit and how is it used?

Discovery is the process of identifying and obtaining any information or evidence that is relevant and material to the dispute. The rules of procedure for federal and state court litigation allow a party to obtain any such evidence from the other party or third parties. The purpose behind discovery is to allow the parties to obtain the necessary information to resolve or litigate the dispute. The outcome of a case should be based upon all of the facts and evidence available. Several methods exist for requesting information between the parties:

- *Interrogatories* – Interrogatories are a series of written statements in question format and directed to the other party. The court will permit a limited number of relevant questions that directly relate to or will potentially lead to relevant evidence. The questions are generally presented in a yes/no or admit/deny format. The party receiving the interrogatories must answer these questions within a statutory period of time. A failure to answer the questions may result in the court deeming the interrogatory statements to be true.
- *Request for production* – Each party may request that one party produce any documents or other physical evidence that are relevant to the dispute or are likely to lead to relevant evidence. The party receiving the request for production must generally make the listed documents or evidence available for the other party's review.
 - *Note:* The request to produce documents can be directed to third parties who are not otherwise involved in the litigation.
- *Depositions* – A deposition is a formal interview of an individual taken when that person is sworn to an oath of truth (under oath). The court will permit parties to depose the other party and any third parties who may have relevant information or evidence. Depositions serve the purpose of formally recording an individual's testimony prior to trial. It can prevent an individual from intentionally or inadvertently modifying her testimony at trial.
- *Request for Admission* – A request for admission is a statement of facts presented to the other party. It seeks to identify and establish the facts that are not in dispute. This is made to save time and money.

Through these court-approved methods, parties to a civil suit have extensive authority to uncover evidence this is material to the litigation. The authority to demand evidence becomes controversial when the evidence demanded in some way discloses private or personal information of third parties.

- **Discussion:** Do you believe that this combination of discovery methods is effective in producing evidence relevant to a civil dispute? Can you think of other methods that could make the discovery process more effective?
- **Practice Question:** Carter sues Justin for defamation. Carter claims that Justin is spreading malicious lies about him that have harmed his career. What information and records might Carter seek to obtain from Justin? What methods might Carter employ to obtain those records?
- **Resource Video:** <http://thebusinessprofessor.com/steps-discovery-process/>

8. What is the “scope of discovery” in a civil lawsuit?

A party is permitted to seek evidence that is relevant to the dispute. Basically, the evidence requested through discovery

must have a tendency to lead to evidence that may be relevant and admissible at trial. This standard is construed very broadly. If one party fails to produce requested discovery, the other party generally files a motion with the court to mandate its production. Parties are free to contest any discovery request before the court. The court will determine whether the request is valid and the extent of the required disclosure. Failure to produce discovery can lead to sanctions from the court. In severe cases, it can lead to the court deeming certain allegations to be true and not subject to dispute.

- *Note:* A very hot topic in the field of discovery is E-discovery or electronic discovery. E-discovery concerns files stored electronically on computers, servers, hard drives, or in the cloud. Today, records are very easily destroyed and hidden. Individuals who are adept at scouring computer files to identify relevant information are very valuable.
- **Discussion:** Do you think the power of the court to order discovery in a civil suit is too limited or too broad? What are the justifications for allowing each party such broad discovery power? Are you convinced by these reasons?
- **Practice Question:** Amy is suing Michael's business for breach of contract. Amy requests all sorts of records of Michael's business activities. She also includes a request for production of his personal bank account statements. Will Michael have to surrender his personal bank account records to Amy?
- **Resource Video:** <http://thebusinessprofessor.com/scope-of-discovery-in-a-civil-lawsuit/>

9. What are “motions” and how are they used in a civil lawsuit?

A motion is a method by which a party asks the court to do something. That is, the party moves the court to take action. Motions are most often used to ask the court for some form of procedural action. Below are examples of common motions:

- *Motion to Compel Production* – This is a request to the court to force the other side to produce the requested information (discovery). It is extremely common for parties to litigation to ignore or not fully comply with the other party's discovery requests. The motion to compel is the procedural remedy available to the requesting party.
- *Statute of Limitations* - This is a request to the court to bar the other party from bringing a particular cause of action against the defendant. Basically, it argues that the statutory time period allowed for bringing the specific legal action has passed. Successfully demonstrating that the statute of limitations has passed effectively wins that claim for the defendant.
- *Judgment on the Pleadings* - This is a request by the defendant to the court to rule in her favor based upon the information in the pleadings. It states that, even if all pleadings are true, the defendant is entitled to judgment as a matter of law. At this point, neither party has presented any facts, but the defendant claims that the plaintiff has failed to allege sufficient facts to state a cause of action. Basically, the defendant claims that all of the facts, as alleged, do not establish a legal claim under the existing law.
- *Directed Verdict/Summary Judgment* - This is a request to the court by a defendant to rule in her favor based upon the plaintiff's presentation or the entire presentation of evidence. The request for directed verdict comes at the close of the plaintiff's presentation of evidence. The court will grant the motion if the plaintiff has failed to

present sufficient evidence to show that the defendant could be liable under the law. If granted, the defendant does not have to present a defense because the plaintiff did not show the minimal amount of evidence necessary to demonstrate liability. A motion for summary judgment is based upon the same grounds, but is made at the close of all evidence.

A motion can take many forms and can be for any purpose. In business cases, motions litigation is often the most intense aspect of a trial. The result of motions litigation will often be the determining factor as to whether parties continue on with litigation, dismiss the action, or settle the lawsuit.

- **Discussion:** Why do you think motion litigation is so important in business cases?
- **Practice Question:** Zara decides to sue ABC, Inc., in state superior court. ABC receives a summons and complaint containing lots of allegations. ABC believes that all of the allegations made by Zara, even if true, do not state a valid cause of action under state law. What process should ABC take in responding to these allegations?
- **Resource Video:** <http://thebusinessprofessor.com/motions/>

10. What is a “frivolous case” and how are such cases regulated?

A frivolous case is a civil lawsuit that lacks any factual merit. Basically, the plaintiff is suing the defendant based upon facts that do not amount to a cause of action. A frivolous case is based upon conjecture or false information. Any party can move to dismiss a frivolous suit or the judge can dismiss it unilaterally. Generally, the rules of procedure in civil trials seek to prohibit the filing of frivolous cases. Specifically, Rule 11 of the Federal Rules of Civil Procedure requires an attorney to sign an attestation that the case is filed in good faith. The attorney’s signature says that the facts and claims in pleading are meritorious and, to her knowledge, not for an improper purpose.

- **Discussion:** The idea of a frivolous case relates closely to the question of whether society in the United States is over litigious. What do you think? Is it better to allow frivolous suits or potentially block a valid dispute from resolution through the court system?
- **Practice Question:** Lydia walks into the office of attorney Greg. Lydia states that she has been in a car accident. She states that she is not injured and does not feel any pain. Greg immediately sends Lydia to a doctor, chiropractor, and physical therapist. He sends a letter to the other driver’s insurance company asking for \$100,000 in damages for pain and suffering. When the insurance company refuses to settle, Greg files a complaint to start a legal action against the driver and his insurance company. Greg signs an affidavit that all of the allegations are substantiated by facts known to him. Could Gregg potentially be subject to sanction by the court for filing a frivolous claim?
- **Resource Video:** <http://thebusinessprofessor.com/frivolous-cases/>

11. What is the process for selecting a jury (“jury selection”) in a civil case?

Individuals called to serve jury duty are referred to as the “jury pool”. The jury pool is a cross-section of the population

and each member is randomly chosen from government records. Jurors fill out a questionnaire and submit to a background check as part of this process. This procedure seeks to expose any biases or prior conduct that might disqualify the potential juror from service. For example, an individual who has previously been convicted of a felony may not serve on the jury. Once the final pool is selected, these individuals are eligible for selection to serve on a “trial jury” for any case in the court’s jurisdiction.

The trial jury is selected through a process known as “*voir dire*”. In this process, the plaintiff and defendant (through their counsel) ask questions to evaluate the jurors. The purpose of the questions is to identify any biases that may prejudice the juror’s ability to be fair and impartial in the execution of her duties. If the questions reveal any biases that disqualify the juror from service, the juror is stricken “for cause” from the jury pool. This is a procedural process to narrow the jury pool down to a group of eligible, non-biased individuals. Then, each party is given the ability to strike a limited number of jurors from the pool for any non-discriminatory reason. These are known as “preemptory challenges”. This allows the party to strike potential jurors that they simply do not want on the jury. The only limitation is that the preemptory challenge cannot be used to eliminate a potential juror based upon any protected classification (race, religion, gender, etc.).

- **Discussion:** Do you believe that the jury selection process is fair? Why or why not?
- **Practice Question:** Martin is defense counsel in a civil case against his client. During the jury selection process, Martin identifies a number of jurors who appear to have biases that would prejudice his client. He also gets the sense that a couple of the jurors do like him or his client. What are Martin’s options with regard to choosing jurors?
- **Resource Video:** <http://thebusinessprofessor.com/selecting-jury/>

12. What is the general process or steps involved in a civil trial?

A civil trial begins with the pleadings. Following the pleadings, the parties will generally submit a number of motions to the court for various reasons. This is generally known as pretrial matters. After the pre-trial matters conclude, the trial process begins. A jury trial begins with the parties selecting a jury through the *voir dire* process. Once the jury is selected, the trial commences. The judge opens the case by going on the record and announcing the case and the parties to the dispute. The pleadings become part of the official record of trial. The parties are then given the opportunity to make an opening statement to the jury. The plaintiff goes first and the defendant is given the opportunity to follow. Often, the defendant will defer delivering the opening statement until after the plaintiff has delivered her entire case.

Following the opening statement, the plaintiff will present all of the evidence and witnesses to support her case. Once the plaintiff completes her presentation of evidence, the Defendant will move the court for a directed verdict. If the motion is denied, the defendant is allowed to present evidence in rebuttal of the plaintiff’s case. Once the defendant completes her presentation of evidence, the jurisdiction may allow the plaintiff a chance to rebut the defendant’s case with any additional presentation of evidence. At the conclusion of the plaintiff’s “rebuttal”, the defendant is allowed to the opportunity to rebut the plaintiff’s rebuttal. This is known as the “surrebuttal”. At the conclusion of the surrebuttal, all parties rest. At this point, the defendant will again move the court for summary judgment based upon the presentation of all evidence. If the motion is denied, the court will then allow the parties to make a closing statement to the jury. After closing statements, the presentation of evidence is closed. The remainder of the case belongs to the judge and jury.

- **Discussion:** Which steps in the trial do you feel are most important or determinative of guilt or innocence?
- **Practice Question:** The company that you work for is being sued. You are going to be called to testify at trial. You do some research on the trial process. In a concise paragraph, explain the process for a civil action in a manner that anyone can understand it.
- **Resource Video:** <http://thebusinessprofessor.com/steps-trial-process/>

13. What is the “burden of proof” in a civil trial?

The burden of proof in a trial refers to the responsibility of a party to produce evidence in support of her allegations. The burden of persuasion refers to the strength of that evidence. The burden of proof in a civil trial is a finding of liability by either a “preponderance of the greater weight of evidence” or by “clear and convincing evidence”.

- *A preponderance of the greater weight of evidence* - Concerns how convincing is the available evidence. The jury should focus on the credibility and accuracy.
- *Clear and convincing evidence* - Is a slightly higher standard of proof than a preponderance of the evidence. It focuses on the greater likelihood or belief that the evidence is truthful and the fact finder’s belief in its truth.

In either case, the plaintiff must present evidence sufficient to meet this standard in order to demonstrate liability.

- **Discussion:** Compare the burden of proof in a civil trial to the burden of proof in a criminal trial? Why do you think the standard of proof is far lower in a civil trial than in a criminal trial?
- **Practice Question:** Donte is charged with criminal assault. Also, the alleged victim is suing Donte in civil court to recover damages. Donte is acquitted in criminal court. Is it possible that Donte will still be held liable in civil court?
- **Resource Video:** <http://thebusinessprofessor.com/burden-of-proof-in-a-civil-trial/>

14. How is a civil trial decided?

At the conclusion of all evidence and arguments, the judge instructs the jury on the applicable law to apply to the facts. This is known as “charging the jury”. The jury charge explains the state of the law to the jury. The jury will use this law when determining liability. Following the jury instruction by the judge, the jury will recess to deliberate about the facts and apply them to the applicable law. The jury must find that the facts demonstrate each element required by the statute consistent with the burden of proof. The jury must be persuaded that the facts have merit. After deliberation, the jury will return with a verdict of liable or not liable on all of the plaintiff’s claims. If the jury find’s liability, there may be a separate presentation of evidence by the parties regarding damages. The jury will deliberate to determine damages to award based upon the finding of liability. The jury will then deliver the verdict to the judge. The judge, if satisfied that all procedural requirements are met, will enter a judgment on the verdict. The losing party will generally move the court for a directed verdict in contrast to the jury’s findings, known as a “*judgment non obstante veredicto*”. This is also known a “judgment

notwithstanding the verdict” or (“JNOV”). Judges rarely grant JNOV motions. At the same time, the losing party will generally request permission from the court to file an appeal to the appellate court. If done in a timely manner, requests to appeal are routinely granted. The trial process is now closed. The appellate court will review the losing party’s request for appeal (along with the record of trial). If the appeal is denied, the case is closed. If the appeal is granted, the appellate process begins.

- **Discussion:** Do you think this is a fair and just manner of determining a party’s liability? Why do you think the judge has the authority to override the jury’s verdict? Why do you think the judge rarely exercises this authority?
- **Practice Question:** Todd is being sued by Nancy. The judge provides a clear description of the law to the jury, including all of the elements necessary to find Todd liable. The jury ultimately finds Todd liable to Nancy. After the jury announces its verdict, what are Todd’s options?
- **Resource Video:** <http://thebusinessprofessor.com/how-is-a-civil-trial-decided/>

15. What is “joint and several liability”?

Joint and several liability is a manner of apportioning liability among multiple parties. It will only apply when there is more than one tortfeasor. Parties that are jointly liable are assessed a certain amount of damages. Joint and severally liable individuals are all liable to the plaintiff, but the entire award of damages may be recovered from any defendant.

- **Note:** Joint and several liability is a windfall for plaintiffs who can seek recovery from one party and allow that party to seek any level of contribution from a joint tortfeasor.
- **Example:** Ann is a huge fan of Justin, the singer. She follows him all over the country and is somewhat of a stalker. She calls hotels when he is in town in an attempt to identify where he will be staying. She calls the hotel and learns that Justin will be staying on the third floor. She asks to rent the room next to him. When Justin arrives, she secretly records him singing in his room and posts it to YouTube. This severely hurts Justin’s career when folks learn that his singing is actually auto tune and he cannot carry a note. Justin sues Ann and the hotel. The court awards joint liability of \$1 million against Ann and the hotel. If the court awards joint and several liability, Justin can recover the \$2 million against the hotel or Ann. The hotel or Ann would then have to work to seek \$1 million contribution from the other.

- **Discussion:** How do you feel about the doctrine of joint and several liability? Is this fair to the defendants? Why or why not?
- **Practice Question:** Carrie and Doug are being sued by Edith. Carrie is rich, while Doug is of modest means. Edith is worried that, if she receives a verdict against Carrie and Doug, she will not be able to recover against Doug. Under what situation would Edith be able to recover the entire verdict, despite Doug’s lack of assets?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-joint-and-several-liability/>

16. What is the process and procedure for appealing (“appeal”) the verdict in a civil trial?

The losing party in a case must file a request or notice of appeal with the trial court. This request allows the party to undertake the appeals procedure with the immediate appellate court. The request for appeal will generally include the grounds for appeal (allegations as to how the law was incorrectly applied or that the law is unconstitutional) and the record of trial. The appellate court will review and either grant or deny the request. If the court grants the appeal, the parties are allowed to file a brief in support of their position regarding the issues presented on appeal. The appellate hearing generally consists of 3-5 judges sitting together (“*en banc*”) to hear the parties’ arguments. In rare cases, all of the appellate judges will sit to hear a case. At the appellate hearing, counsel for each party is allowed to present an oral argument in support of her client’s position. The appellate court will take the briefs and arguments under consideration and deliberate on the case. The judges will then render an opinion as to the application of the law in the case and, sometimes, the constitutionality of the law. The appellate court’s written opinion about these matters becomes a part of the common law and serves as “precedent” for the future application of that law by subordinate courts. If the court finds that the trial court erred in the application of law, the trial court’s decision (or part of the decision) will be reversed and remanded for further action. The parties apposing the appellate court’s decision may request immediate appeal to the higher appellate court (generally the State or US Supreme Court). If the appeal is granted, the appellate procedure repeats itself. If the case is remanded to the trial court and the parties do not immediately appeal the appellate court’s decision, they may then re-litigate the issues that are remanded. At that point, the process repeats itself.

- **Discussion:** How do you feel about the system for requesting appeal of a trial court decision? Why do you think appellate procedure limits the information considered by the appellate court to the information in the the record of trial? Do you think the appellate court should review the evidence again (such as hearing testimony from witnesses).
- **Practice Question:** Mark is suing his former employer in state court for discriminatory firing. He loses his case at trial and immediately appeals to the state appellate court. What is the general process for requesting appeal? What will the court look for in deciding whether or not to grant an appeal? Under what situations could Mark appeal to the state and US Supreme Court?
- **Resource Video:** <http://thebusinessprofessor.com/appeal-case/>

17. How does a party enforce a civil judgment?

Collecting on a judgment can be a difficult process. There are three primary methods by which a party may enforce a court’s judgment.

- **Encumbrance** - A judgment holder may file a lien on property of the debtor, such as the real property registered to the debtor. The process requires an order from the court that the judgment be attached to available real property. The lien is then filed with the registrar of deeds in the county where the court is located. Holding a lien on the defendant’s property clouds title and makes it difficult for the debtor to sell or borrow money against it. Further, the lienholder can file a foreclosure action to sell the property to collect the judgment.
- **Execution** - Execution is the method by which a court’s judgment is enforced through the executive branch. Generally, a court official, such as a sheriff or marshal, seizes some property of the debtor, sells it at public auction, and applies the proceeds to the creditor’s claim. The responsibility for identifying property of the debtor upon which to execute is the responsibility of the judgment holder. If the sheriff is unable to identify or locate any

property of the debtor, there can be no execution and sale of the property.

- *Note:* The court may hold a special proceeding to inquire about the assets of the debtor.
- *Garnishment* - Garnishment is similar in nature to execution but involves a defendant's employee wages. It entails having a portion of the debtor's wages paid to the court, which is then released to the judgment holder. This process requires an order of garnishment from the court that the judgment holder can provide to the debtor's employer. The employer is legally obligated to withhold the ordered funds or risk contempt of court.

These methods vary in degree of effectiveness. Encumbering property does not immediately ensure payment. Executing on property and selling it is only available if the defendant owns property. Garnishment of wages provides greater certainty of payment but only if the debtor is employed.

- **Discussion:** Do you believe that the above methods of enforcing payment of a debt are fair? Do you believe these methods go far enough to protect the rights of the debtor?
- **Practice Question:** Diane has a civil judgment against Pete. Pete has refused to pay the judgment, leaving Diane with no other option but to pursue alternative methods of collecting the debt. What are some methods Diane may employ in collecting on her judgment against Pete?
- **Resource Video:** <http://thebusinessprofessor.com/enforcing-judgment/>

18. What is “*res judicata*” in civil trials?

Res Judicata is a legal expression meaning that the legal dispute between the parties is decided. This principle prevents successive lawsuits involving the same facts or occurrence. A plaintiff may not sue the defendant for the same conduct under the same or a separate cause of action. The separate cause of action should have been raised during the initial trial. It brings the dispute to a conclusion.

- **Discussion:** Compare the principle or *res judicata* to the principle of double jeopardy in criminal cases. How are they similar? Different?
- **Practice Question:** Tom is suing Isabelle for assault. Isabelle allegedly approached Tom in a public restaurant and slapped him in the face. The jury returns a verdict of not liable on the grounds that Isabelle was temporarily incapacitated by rage at seeing her boyfriend having dinner with another woman. Tom is outraged by the verdict and seeks to sue Isabelle a second time for battery. Can Tom sue Isabelle for battery after losing the first trial alleging assault?
- **Resource Video:** <http://thebusinessprofessor.com/res-judicata/>

TOPIC 7: ALTERNATIVE DISPUTE RESOLUTION

Overview

This chapter explores the resolution of disputes between individuals. More specifically, it explores the methods that individuals use to resolve disputes without resorting to civil litigation. Alternative dispute resolution includes any method or procedure for achieving this purpose; however, there are two commonly recognized processes - arbitration and mediation. Employing these resolution methods may be mandatory or voluntary. Further, these methods may not be exclusive. That is, the parties may employ mediation, arbitration, and litigation, all within the realm of a single dispute. This chapter will explore the procedures and general legal principles applicable to these processes.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• Settlement • Alternative Dispute Resolution (ADR) • Advantages of ADR • Mediation - Advantages & Disadvantages • Voluntary & Mandatory Mediation • Mediation Procedures	• Challenging a Mediation • Arbitration - Advantages & Disadvantages • Voluntary and Mandatory Arbitration • Arbitration Procedures - Award • Federal Arbitration Act	• Challenging an Arbitration - Voluntary - Mandatory - FAA Review • Enforcing Arbitration Awards
-

TOPIC 7: ALTERNATIVE DISPUTE RESOLUTION - QUESTIONS & ANSWERS

1. What is “settlement” of a legal dispute?

Settlement means that the parties to a legal dispute work out their differences and enter into an agreement to resolve the situation. The benefit of a settlement is that the parties maintain control over the outcome of the dispute. The parties are not subjected to a ruling, judgment, or award of a third-party decision maker. Businesses often settle legal disputes to avoid the high cost of litigation, maintain privacy, and to preserve the professional relationship with the other party. Also, juries tend to show favor to individual plaintiffs to the detriment of businesses. Individuals, on the other hand, settle disputes to avoid the long, tenuous litigation process and to make certain of some level of recovery. Achieving a settlement is a core objective of mediation, which is discussed in a separate section.

- **Discussion:** Can you think of any other benefits of privately settling a matter, as apposed to pursuing litigation? Can you think of any situations where the above benefits of settlement are undesirable? Hint: Think about situations where you want to get your message or reason for dispute out to the public.
- **Resource Video:** <http://thebusinessprofessor.com/settlements/>

2. What is “Alternative Dispute Resolution” (ADR)?

ADR, as the name implies, is an alternative to resorting to litigation to resolve a legal dispute between parties. The most common forms of ADR are:

- *Mediation*
- *Arbitration*

Since ADR is an alternative to litigation, disputing parties do not have to begin a lawsuit prior to using any form of ADR. Also, filing a lawsuit does not preclude the use of ADR in conjunction with the litigation. Some courts, such a family court, often encourage or require parties to undertake some form of ADR prior to moving forward with litigation.

- **Resources Video:** <http://thebusinessprofessor.com/what-is-alternative-dispute-resolution-2/>

3. What are the advantages of using ADR to resolve disputes?

The effective use of ADR offers several distinct advantages:

- *Costs* - ADR may reduce the costs associated with litigation for the disputing parties. This is probably the most common reason for including an ADR clause in a contract or agreeing separately to submit a dispute to ADR.
- *No Jury* - Businesses generally prefer ADR to litigation because it avoids allowing a jury to decide a dispute.

ADR, unlike a jury trial, generally involves the use of one or more knowledgeable professionals to either decide or assist in resolving the dispute. This is far more practical than letting a random group of jurors resolve the issue.

- *Privacy* - Another reason to use ADR is that it is a private process; whereas, litigation and court records are open to the public. Individuals concerned with public knowledge of the dispute harming the company's brand or reputation strongly prefer the use of ADR to resolve disputes.
- *Business Relationship* - ADR can preserve the on-going business relationship between the parties, where litigation often destroys the relationship.

- **Discussion:** Can you think of any other benefits to ADR over litigation? Should businesses include ADR clauses in all contracts? Should individuals dealing with businesses agree to an ADR clause or should they attempt to eliminate ADR clauses? Why?
- **Practice Question:** Ryan runs a consulting business. All of his clients enter into an agreement to mediate any disputes arising under the agreement. If the mediation does not work, the client agrees to submit the dispute to arbitration. What are the advantages to the business of pursuing all available ADR methods rather than pursuing litigation?
- **Resources Video:** <http://thebusinessprofessor.com/what-are-the-advantages-of-alternative-dispute-resolution/>

MEDIATION

4. What is “Mediation”?

Mediation is the process by which parties to a legal dispute employ a third party, called a “mediator”, to assist in resolving the dispute. The mediator is an unbiased and disinterested third party. She generally has undergone special training in dispute resolution and possesses in-depth knowledge of the subject matter of the dispute. In most instances, a mediator is a licensed attorney who has mediator training. This is important, as the mediator should understand the legal principles that will apply to the dispute and be able to explain those legal principles to the parties. The mediator can honestly communicate with each party the process and possible results if the parties cannot resolve the dispute and decide to move forward with litigation. Mutual understanding of the parties is important in resolution of the dispute.

- *Note:* The mediator is not a decision maker; rather, she is a facilitator helping to bring the parties together toward a negotiated settlement. As such, she cannot deliver a binding decision on a matter. The parties must ultimately agree or refuse to settle the dispute.

- **Resources Video:** <http://thebusinessprofessor.com/mediation/>

5. What are the advantages and disadvantages of mediation?

There are numerous advantages and a few disadvantages to mediating a dispute, as follows:

- *Control* - Recall that mediation allows the parties to retain control over the dispute. They are free to refuse to negotiate, and they are not required to find a resolution to the dispute. The voluntary nature of negotiation in the mediation process allows the parties to decide to pursue litigation or some other form of ADR. The level of control retained by the parties can also be seen as a disadvantage. Neither party can be certain that the mediation will result in a settlement. This lack of certainty can frustrate the parties with the process.
- *Costs* - There is significant cost savings associated with mediation. While the parties generally share the responsibility of paying the mediator, it avoids court fees, some legal fees, and other expenses associated with going to trial. Further, the cost of mediation is generally far lower than the cost of other ADR approaches, such as arbitration. The cost disadvantage of mediation is that it can still be expensive and not result in a resolution. A simple negotiation between the parties can resolve a dispute for free; but, employing counsel to represent the parties at mediation and employing the mediator can cost significant money. Generally, the mediator takes a small percentage of the total settlement amount between the parties.
- *Privacy* - As with other types of ADR, mediation is a private process. The parties do not have to disclose the dispute or any of the facts of the situation to the rest of the world. Litigation, on the other hand, is generally a public affair. Unless the court orders otherwise, anyone can attend a public trial and can access the court records. This includes access to all allegations, testimony, and the evidence presented in the case. The disadvantage to privacy generally concerns the expectations of the aggrieved party. In many cases, the injured party seeks compensation for the harm or loss to make certain that the alleged wrong is not repeated. Negotiating a settlement of the dispute outside of the public's knowledge does less to prevent a party from repeating the allegedly illegal conduct. This is particularly true when that party's conduct is intentional.
- *Relationships* - Disputes between parties can destroy their on-going relationship. Being able to work out a mutually agreeable settlement of the dispute can serve to preserve the relationship. This is important for businesses that depend upon each other as future business partners (such as in supplier-purchaser relationships). Litigation generally destroys the business relationship, as the process is highly competitive and confrontational. The negative aspect of mediation is that relationships can still be strained without any resolution to guide the relationship going forward. A judicial determination that one party's conduct is not legal establishes precedent to guide the future conduct of a business. A negotiated settlement does not always achieve this same effect.

The above-mentioned advantages and disadvantages of mediation are general examples. There may be any number of party or case-specific benefits or detriments to mediation.

- **Discussion:** Can you think of any other benefits to pursuing mediation over litigation? Why do you think mediators are often successful in negotiating a settlement between parties? Do you think businesses generally see litigation as a favorable or unfavorable option? Why?
- **Practice Question:** Mark and Sam are in a business relationship. They are now in a dispute over the quality of the last shipment of goods. While they generally get along well, they are unable to reach a resolution on this dispute. Mark and Sam are considering submitting their dispute to a mediator. What are the advantages of pursuing mediation?
- **Resource Videos:** <http://thebusinessprofessor.com/mediation-pros-cons/>

6. How do the parties initiate mediation?

Mediation can be either mandatory or voluntary. General principles applicable to each are below:

- *Mandatory Mediation* - Mandatory mediation is initiated pursuant to a court order or pursuant to the law (statute or regulation). For example, it is common for jurisdictions or courts to mandate that the parties to a family dispute, such as a divorce, work with a government sanctioned mediator prior to initiating litigation. Remember, mediation does not involve a decision-maker. Mandatory mediation, therefore, simply requires that the parties begin the process. The parties are not forced to negotiate or arrive at a settlement. The hope is that requiring the parties to take part in mediation will help them to voluntarily work out the legal dispute without having to resort to litigation.
- *Voluntary Mediation* - Voluntary mediation is initiated pursuant to agreement among the parties. The parties may establish this agreement before a legal dispute arises or afterward. Pre-dispute mediation agreements are generally part of a separate contract between the parties. That is, the parties enter into any form of contract. A clause in the contract dictates that any legal dispute between the parties must be submitted to mediation before pursuing litigation or another dispute resolution method. A post-dispute mediation agreement generally arises pursuant to a separate agreement between the parties to employ a mediator to resolve the dispute. That is, the parties seeking to resolve a legal dispute recognize the value of pursuing mediation and voluntarily enlist the services of a mediator.

People often confuse mandatory and voluntary mediation by assuming that mediation is mandatory because there is a mediation clause in a contract. Even though a contract contains a mediation clause, it was still a voluntary decision to enter into that contract. As such, this is voluntary mediation. Mandatory mediation only arises pursuant to law or judicial procedure.

- **Discussion:** Why do you think some jurisdictions, either through statute or court procedure, impose mandatory mediation? Do you think mandatory mediation is effective when the parties always retain the ability to refuse a settlement or resolution of the dispute?
- **Practice Question:** Jonathan enters into a service contract with Melinda. Soon after entering into the agreement, the relationship begins to sour. Now Jonathan and Melinda do not want to continue doing business together and they have a dispute over the amount owed under the contract for services. The parties are considering undertaking mediation in an attempt to resolve the dispute. How would Jonathan and Melinda go about submitting their dispute to mediation?
- **Resources Video:** <http://thebusinessprofessor.com/how-do-parties-initiate-mediation/>

7. What are the procedures for carrying out mediation?

The voluntary mediation process is far less rigid than that of mandatory mediation. Involuntary mediation is somewhat of an informal process. The mediator may employ any number of techniques to help the parties arrive at a negotiated settlement. Mandatory mediation procedure may be subject to law or court order. The most common format for carrying out voluntary or mandatory mediation of a legal dispute with or between businesses is as follows:

- *Delivery of Evidence* - Each party provides the mediator with all of the facts and evidence surrounding the

dispute. The mediator will set a date for the mediation.

- *Introductions* - At the mediation, the mediator will introduce everyone, give an overview of the mediation process, and summarize the dispute at hand.
- *Initial Statements* - The mediator will often allow the parties to give an initial statement directed to the mediator and the other party. This serves a couple of purposes. First, it appeases the parties to allow them to voice their opinion on the matter. Second, it allows the parties to state a summary of their belief and facts in a persuasive manner.
- *Private Sessions* - Following the initial statements, the mediator will generally break the parties out into private sessions or caucuses. This means that the parties are placed in separate rooms, while the mediator moves back and forth between the rooms to negotiate the position of each party. These private sessions are optional at the mediator's discretion, though, they prove to be very effective in getting the parties to exchange dialogue or enter into negotiations. They tend to break down the competitive spirit that is present when the parties are together. The mediator is in the position to play devil's advocate and help each party understand the logic and legality of the other party's argument. Importantly, the mediator explains the likely results at trial if the parties proceed to litigation. This can be the strongest tool of the mediator in opening the parties up to negotiation.
- *Formalization of Agreement* - If the mediator is successful, she will assist the parties in negotiating a resolution to the dispute. Once a consensus is reached, counsel for one party is then directed to draft a legal contract memorializing the terms of the settlement. The parties sign the contract to settle the dispute. They are legally obligated act in accordance with the terms of the contract.

Involuntary mediation may follow the same or similar steps, but the process is more closely dictated by court procedure, statute, or regulation.

- **Discussion:** Do you think it is important to give a mediator autonomy in carrying out the mediation process? Why or why not? Can you see any disadvantages to employing the process outlined above? Can you think of any techniques that could help the disputing parties arrive at a negotiated settlement?
- **Practice Question:** How and why do mediators use the isolation of the parties and conducting private sessions to help them reach a resolution of their dispute?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-process-of-carrying-our-mediation/>

8. Challenging the mediation agreement?

A successful mediation results in a negotiated settlement between the parties. This is a formal contract that memorializes the agreed-upon resolution of the legal dispute. Once the parties enter into this agreement, it takes the place of the underlying dispute. The parties can no longer pursue litigation for the underlying dispute without breaching this contract. If, after the settlement agreement is signed, the parties wish to dispute the agreement, they must bring a contract action in court attacking the validity of the agreement. In this situation, however, the suing party is not suing regarding the underlying dispute but is arguing that the settlement agreement is not valid based upon some contract law principle. If the party is successful in rescinding (doing away with) the mediation agreement, the parties would be free to litigate the

underlying dispute or pursue other forms of ADR.

- **Discussion:** Should parties be able to revisit the subject of the mediation even if the mediation resulted in a settlement agreement? What are the arguments for and against disregarding the settlement agreement?
- **Practice Question:** Venus and Maria submit their dispute to mediation. After several hours, they reach a resolution of their dispute and sign a settlement agreement. The next morning, Venus regrets having signed the settlement agreement. She thinks that the hours of mediation unduly pressured her into reaching an agreement. What are Venus's options for pursuing litigation of the original dispute?
- **Resource Video:** <http://thebusinessprofessor.com/how-do-parties-challenge-a-mediation-agreement/>

ARBITRATION

9. What is "Arbitration"?

Arbitration is a form of ADR in which the parties choose to forgo litigation and solve their problems through a third-party decision maker, known as an "arbitrator". The key characteristic of arbitration is that the parties are hiring one or more unrelated and unbiased third parties to decide the legal dispute. Basically, the arbitrator(s) acts as judge and jury in deciding the dispute. Unlike in mediation, the arbitrators are decision makers. Arbitration yields a final resolution of the dispute in the form of an arbitrator's "award". The award generally consists of monetary damages, but may include equitable remedies as necessary. Parties may generally enforce an arbitrator's award similarly to a judgment.

- **Note:** It may surprise you to know that popular reality court television shows are actually arbitrations, as apposed to trials. The proceeding is made to look like a trial proceeding, with the arbitrator acting like (and even taking the title of) a judge.
- **Discussion:** How does the core principle behind arbitration compare to that of mediation? (Hint: Think about the role of a decision maker versus that of a facilitator).
- **Resource Video:** <http://thebusinessprofessor.com/arbitration/>

10. What are the advantages and disadvantages of arbitration?

There are numerous advantages and a few disadvantages of arbitration, as follows:

- **Expertise** - Arbitrators are generally chosen based upon their expertise in the subject matter of the dispute. This is a key advantage over litigation, which generally involves the use of jurors as fact-finders. The jurors will lack the subject-matter knowledge of professional arbitrators chosen by the parties. Some argue that this fact makes it less likely that jurors will arrive at a fair and just result.
- **Resolution** - Similar to litigation, in arbitration the parties lose control of the dispute resolution process. The benefit of this situation is that the arbitrators will decide the dispute and issue an award. This may give the parties

comfort in knowing that the legal dispute will be resolved.

- *Costs* - There may be significant cost savings associated with arbitrating rather than litigating a dispute. While the parties generally share the responsibility of paying the arbitrators, it avoids many of the court fees, legal fees, and other expenses associated with going to trial. The primary point of savings is the lack of formality in the discovery process. Generally, the arbitrators control the proceeding and request from the parties whatever evidence they require in deciding the dispute.
- *Privacy* - As with other types of ADR, arbitration is a private process. The parties do not have to disclose the dispute or any of the facts of the situation to the rest of the world. Privacy in arbitration offers the same advantages and disadvantages as mediation.
- *Relationships* - Arbitration can have the effect of preserving on-going business relationships. The parties may feel comfortable that the dispute is not decided arbitrarily, as experts are reviewing the facts and deciding the case. In this way, the parties are less likely to feel that they were treated unfairly by the system.

The above aspects of arbitration may be seen by a party as an advantage or disadvantage. For example, a party may hope to sway jurors by appealing to their emotions. This is not as easy when dealing with expert arbitrators who are more likely to apply the law without regard to personal emotions. Further, arbitration will lead to a decision on the dispute. One party may see this finality as a benefit, while other parties may want to retain the ability to continue negotiating a settlement.

- **Discussion:** Do you think businesses generally prefer arbitration to litigation? Why or why not? Do you think individuals in a dispute with a business generally prefer litigation or arbitration? Why or why not?
- **Practice Question:** Bernie and Hillary do business together. Unable to reach a compromise in a dispute, they decide to submit their issue to arbitration. What advantages does arbitration offer to Hillary and Bernie?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-the-advantages-of-arbitration/>

11. How do the parties initiate arbitration?

Arbitration can be either voluntary or mandatory.

- *Voluntary Arbitration* - Voluntary arbitration, as the name indicates, means that the parties voluntarily agree to submit a dispute (or any dispute) to arbitration. This is also known as “arbitration at common law”. This is normally done through a formal, written agreement entered into between the parties. Voluntary arbitration generally takes two forms:
 - *Pre-dispute Arbitration* - A contract between parties may contain an arbitration clause. These agreements require that any dispute over the contract will be arbitrated.
 - *Example:* Assume you enter into a contract to purchase a vehicle. The contract contains a clause stating that any legal disputes about the contract will be arbitrated. This is a pre-dispute arbitration clause.

- *Post-dispute Arbitration* - The parties may enter into an agreement after the dispute arises to resolve a dispute through arbitration.
 - *Note:* Even if the contract has an arbitration provision that makes arbitration of any disputes mandatory, it is still voluntary arbitration. The reason is because the parties voluntarily entered into the contract.
 - *Example:* Now, continuing the above example between you and the car salesman, suppose the agreement does not contain an arbitration clause. If a dispute arises, you and the car salesman may enter into an agreement to submit the dispute to arbitration rather than litigate it.
 - *Mandatory Arbitration* - Certain state and federal laws require parties to arbitrate specific types of disputes. When a statute or court requires the parties to arbitrate a matter, this is known as “mandatory arbitration”. This is common in some very technical areas of law, such as alleged violations of rules put forward by the Financial Industry Regulatory Authority (FINRA). The requirement to arbitrate may be tied either to the type of dispute or the amount in controversy in the dispute. When the law requires arbitration, there is also a procedure in place for the identification and hiring of certified arbitrators.
- **Discussion:** How do you feel about laws requiring that individuals arbitrate their dispute? Does this have any constitutional implications (such as the right to Due Process under the law)?
 - **Practice Question:** Carlos has a dispute with his employer. He believes that he has been discriminated against in the promotion selection process. In his employment contract, there is a clause requiring arbitration of any dispute under the agreement. Also, a state employment law requires arbitration of any employee-employer, discrimination disputes. In this situation, is the arbitration between the parties voluntary or mandatory?
 - **Resource Video:** <http://thebusinessprofessor.com/statutorily-mandated-arbitration/>

12. What are the procedures for carrying out an arbitration?

The rules and procedures applicable to an arbitration depend on the jurisdiction. Some jurisdictions rely upon common law to supply the rules applicable to arbitrations. In these jurisdictions, judges often draw heavily upon model laws or other influential sources in the development of the law. Historically, common law arbitration jurisdictions have far less developed procedural rules. Notably, these jurisdictions vary in the degree to which they support the arbitration process. Other jurisdictions pass statutes controlling the arbitration process. In such jurisdictions, the general procedure for carrying out an arbitration proceeding is as follows:

- *Subject Matter of the Arbitration* - The dispute may be a question of fact, law, or a mixed question of fact and law. There is a great deal of controversy surrounding what issues the arbitrator has the ability to decide. The arbitration agreement should be clear about the extent of the arbitrator’s authority.
 - *Note:* The arbitrator exceeding her authority is the most common grounds for challenging arbitration awards.

- *Choosing Arbitrators* - In voluntary arbitrations, the parties choose the arbitrator(s) to decide the dispute. In most cases, arbitration involves three arbitrators, which allows for a majority vote on the matter. There are numerous methods the parties can employ in selecting arbitrators. In some cases, an arbitration agreement will outline the procedure.
 - *Note:* Mandatory arbitration may identify or provide a limited pool of certified arbitrators. Otherwise, the parties have latitude in choose an arbitrator. Most jurisdictions do not require that arbitrators have any special training.
 - *Example:* Each party may select one arbitrator and those arbitrators select the third arbitrator. The parties will seek to select experts with experience in the particular industry and with knowledge of the customs and practices.
- *Submit to Arbitration* - Arbitration begins by the parties “submitting” their dispute to the arbitrators. Submission is simply the act of contacting the arbitrators and providing them with the dispute information and setting up a time to have an arbitration proceeding. Submitting a dispute to arbitration authorizes arbitrators to make a decision that binds the parties and resolves their dispute. In mandatory arbitrations, many jurisdictions require that the parties submit the matter to arbitration within 6 months of the dispute arising.
- *Agreement with Arbitrator(s)* - In voluntary arbitration, the parties must enter into an agreement with the arbitrators to resolve the dispute. The terms of the arbitration agreement and the dispute are passed on to the arbitrator. The parties may propose the rules governing the arbitration. In most cases, however, the arbitrator will agree to arbitrate the matter based upon model arbitration procedural rules. Mandatory arbitration may have formalized documents or procedures for this purpose.
 - *Note:* Many arbitrations employee the rules provided in the Federal Arbitration Act.
- *Arbitration Proceeding* - The arbitration procedure follows a semi-formal format with the arbitrators controlling the process. Often the arbitrators will orchestrate the arbitration similarly to a trial. The judicial rules of evidence and procedure do not apply, so the arbitrators have a great deal of latitude. They look beyond strictly legal criteria to other factors that bear on the proper resolution of a dispute. They can look at such factors as the state of the law, fairness, productivity, consequences on morale, and whether tensions will be heightened or diminished. Of note, they can generally request any evidence from the parties that is necessary to arrive at a decision.
 - *Note:* The arbitrator will often follow a form of model arbitration rules in holding the proceeding. Mandatory arbitrations will always follow the procedure proscribed by the law or court mandating arbitration.
- *Award* - Arbitrators do not issue a judgment, as in civil trials. Rather, they decide the matter and hand down an “award” in favor of one party or the other. The arbitration agreement and the rules employed by the arbitrators may limit the amount or type of award the arbitrators can issue. Generally, the arbitrators do not need to set forth findings of fact, conclusions of law, or reasons for the award. The arbitrators may, however, be required to elaborate on their reasoning if required by statute or arbitration agreement. If so, the arbitrators generally provide the reasoning for their decision in the form of an “opinion letter”. This opinion letter becomes part of the award. Regardless of the reasoning, parties are generally bound by the arbitrator’s decision.

- *Enforcement* - Courts will generally enforce arbitration awards either through contract law or through recordation and recognition as a judgment. Enforcement of arbitration awards is discussed in greater detail in a separate section.

- **Discussion:** What differences do you see between the arbitration and mediation process? What differences do you see between the arbitration and litigation process? Do you think it is wise for businesses to include arbitration clauses in contracts? Is it wise for individuals?
- **Practice Question:** You work for ABC, Inc. ABC is involved in arbitration of a major business dispute. Your boss wants you to attend the arbitration and provide evidence to the arbitrators. Concerned that you perform well, you begin researching the arbitration process. In a short memo, explain the process for carrying out an arbitration.
- **Resource Video:** <http://thebusinessprofessor.com/procedure-for-carrying-out-an-arbitration/>

13. What rules govern the arbitration process?

The rules governing an arbitration vary depending upon whether the arbitration is voluntary or mandatory. In a voluntary arbitration, the parties may agree upon the rules to govern the proceeding. It is rare that the parties will specifically state all of the governing provisions; rather, the agreement to arbitrate will agree that statutory provisions or a set of model rules will govern the arbitration proceeding.

- *Note:* The Revised Uniform Arbitration Act of 2000 is a model law commonly employed in voluntary arbitrations.

In a mandatory arbitration, state law or court order dictates the rules governing the arbitration. Notably, in 1925, Congress passed the Federal Arbitration Act (FAA) to encourage the use of arbitration to resolve conflicts. The FAA provides the process and procedure for carrying out the arbitration. The FAA applies when the dispute is subject to mandatory federal arbitration or when there is an voluntary arbitration agreement and the dispute involves federal law. Of course, the parties to voluntary arbitration may agree to a different set of laws, but applying FAA standards may affect a party's ability to enforce the arbitrator's award through the court system. Importantly, the FAA requires that where the parties have agreed to arbitrate, they must do so in lieu of going to court.

- **Discussion:** Why do you think Congress found it necessary to establish uniform Federal Arbitration Procedures? How do you feel about a federal law attempting to control the state court procedure for recognizing and enforcing arbitration agreements?
- **Practice Question:** Pam and Lisa enter into a contract with an arbitration clause covering any disputes. When a dispute arises, Pam and Lisa decide to submit the matter to arbitration. If the contract does not indicate, what rules apply to the arbitration process?
- **Resource Video:** <http://thebusinessprofessor.com/federal-arbitration-act/>

14. Challenging the “arbitration award”?

An arbitration is a non-judicial process. As such, there is no appeal available. There is, however, a limited ability to challenge an arbitration award in an Art. III court. The standard for challenging an arbitration award differs for voluntary and mandatory arbitrations.

- *Review of Voluntary Arbitration Awards* - Parties may challenge an arbitration award based upon the arbitrator exceeding her authority or based upon a contractual defense to the validity of the arbitration agreement. That is, the court will not disturb an arbitrator's award based upon an error in the application of law or determination of a fact. The challenging party must file a legal action attacking the validity of the arbitration agreement or the authority of the arbitrator. For example, the arbitrator may have issued an award that affected property that was not subject to the original contract.

In general, arbitration clauses are liberally interpreted when a party contests the scope of the clause. If the scope is debatable or reasonably in doubt, the clause is construed in favor of arbitration. In summary, the fact that the arbitrator made an erroneous ruling or reached erroneous findings of fact are not grounds for setting aside the award. Of course, an error of law may render the award void when it requires the parties to commit a crime or otherwise to violate a positive mandate of the law. In any event, judicial review of the arbitration award may correct fraudulent or arbitrary actions by an arbitrator.

- **Discussion:** Why do you think courts, when reviewing a challenge to an arbitration award, refuse to revisit the facts or procedures of the arbitration? Do you believe they should revisit the facts and procedures?
- **Practice Question:** Brad and Angela agree to arbitrate their contract dispute. At the end of the arbitration, Angela is not happy with the award handed down by the arbitrators. What are her options for challenging the arbitration award.
- **Resource Video:** <http://thebusinessprofessor.com/judicial-review-voluntary-arbitration/>
- *Review of Mandatory Arbitration* - Mandatory arbitration effectively cuts off the parties' access to a trial court. Many courts have held that mandatory arbitration statutes that close the courts to litigants are void as against public policy and are unconstitutional. The arguments against enforcing mandatory arbitration statutes include:
 - they deprive one of property and liberty of contract without due process of law;
 - they violate the litigant's 7th Amendment right to a jury trial and or state's constitutional access to courts; and
 - they result in the unconstitutional delegation of legislative or judicial power in violation of state constitutional separation of powers provisions.

Mandatory arbitration is generally deemed constitutional if fair procedures are provided by the legislature and ultimate judicial review is available. As such, statutorily mandated arbitration requires a higher level of access to judicial review of the awards by the court. If a party can reject the arbitrator's award and seek *de novo* judicial review, mandatory arbitration is generally considered constitutional. The right to reject the award and to proceed

to trial is the sole remedy of the parties. If a party rejects an arbitrator's award and challenges the case at trial, the court may impose sanctions on the party who fails to improve its position. Also, failing to attend the arbitration could forfeit the right of a party to reject the award and proceed to trial.

- **Discussion:** What is your opinion with regard to the above-mentioned arguments against mandatory arbitration? Do you think that allowing a party to refuse an arbitrator's award makes mandatory arbitration constitutional? Why or why not?
- **Practice Question:** Brad and Angela have a dispute that is subject to a state law requiring mandatory arbitration. At the end of the arbitration, Angela is not happy with the award handed down by the arbitrators. What are her options for challenging the arbitration?
- **Resource Video:** <http://thebusinessprofessor.com/judicial-review-mandatory-arbitration/>

- **Review Under the Federal Arbitration Act** - In cases involving federal matters, the Federal Arbitration Act controls the procedures. The procedures of the FAA are binding upon both state and federal courts when called upon to review an arbitration. Once an award is entered by an arbitrator or arbitration panel, it must be "confirmed" in a court of law. Per the FAA, awards must be confirmed within one year. A losing party must object and challenge the award within three months.
 - **Note:** As a federal law, the FAA trumps state statutes that conflict with its provisions. For example, the FAA trumps state laws that allow for challenge of arbitration awards in a manner that differs from the provisions of the FAA.

- **Discussion:** Do you think that the provisions of the FAA requiring a court to confirm an arbitration award make the arbitration process more fair? Why or why not? Do these provisions help to ensure the mandatory arbitration statute observes Constitutional rights? Why or why not?
- **Practice Question:** Erica is a party to an arbitration under the Federal Arbitration Act. She receives an award from the arbitrators. What is the process for enforcing the arbitration award?
- **Resource Video:** <http://thebusinessprofessor.com/review-under-the-federal-arbitration-act/>

15. How are arbitration awards enforced?

The method of enforcing an arbitration award will vary depending upon the jurisdiction. In a common-law arbitration jurisdiction, a party must generally initiate a legal action to enforce an arbitration award as a contract. Most statutory-arbitration jurisdictions establish a process for enforcing arbitration awards. This may include seeking court recognition and approval of the award. Many jurisdictions require arbitration awards be registered with the court system to receive judicial assistance in enforcement. Generally, the holder of the award will file the award with the Clerk of Court's office. The clerk will prepare a certification of judgment order for a judge's signature. Once a judge signs and certifies the order, it may be enforced in the same manner as a judgment. Once confirmed, the award is then reduced to an enforceable

judgment, which may be enforced by the winning party in court, like any other judgment.

- *Note:* Under the FAA, state courts are encouraged to enforce arbitration agreements. Arbitration agreements “shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”
- **Discussion:** What do you think about the process for enforcing an arbitration award? Should it be easier or require more effort to enforce? Should the courts get involved at all?
- **Practice Question:** Josh receives an arbitration award in an arbitration governed by the Federal Arbitration Act. What process can Josh follow to enforce his arbitration award?
- **Resource Video:** <http://thebusinessprofessor.com/how-are-arbitration-awards-enforced/>

TOPIC 8: THE PROPERTY SYSTEM

Overview

This chapter explores the legal concept of property, property interests, and ownership. It explains the role of government in the recognition of property rights and the justification for doing so. It introduces several types or classifications of property and rights of possession. It explains the legal system for recording ownership interests in real and personal property. It also explains the relationship between individuals holding or claiming an interest in property. Lastly, it identifies the government's authority to affect an individual's property rights.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• <u>Tangible and Intangible Property</u> • <u>Real and Personal Property</u> • <u>Fixture</u> • <u>Ownership</u> • <u>Government & Property Rights</u> • <u>Property Rights as Incentives</u> • <u>Acquiring Property Rights</u> - <u>Accession</u> - <u>Rule of First Possession</u> - <u>Lost/Mislaid Items</u> - <u>Adverse Possession</u> - <u>Contract</u> - <u>Gift</u> - <u>Confusion</u> • <u>Quitclaim and Warranty Deed</u>	• <u>Fee Simple</u> • <u>Life Estate</u> • <u>Leasehold</u> • <u>Life Estate</u> - Remainder Interest - Reversion Interest • <u>Joint Tenancy & Tenancy in Common</u> • <u>Community & Separate Property</u> • <u>Easement</u> - Express Easement - Appurtenant Easement - Easement In Gross - Negative Easement - Affirmative Easement - Natural Easement - Easement by Prescription	• <u>License</u> • <u>Bailment</u> • <u>Unilateral and Mutual Benefit Bailment</u> • <u>Limitations on Property Rights</u> • <u>Nuisance</u> • <u>Zoning</u> • <u>Taxes</u> • <u>Eminent Domain</u>

TOPIC 8: THE PROPERTY SYSTEM - QUESTIONS & ANSWERS

1. What is “Property”?

Property is any tangible or intangible physical item, design, creative work, or concept that is owned.

- *Tangible and Intangible Property* - Tangible refers to physical property. That is, tangible property is anything that can be physically touched. Intangible property refers to non-physical property. That is, intangible property is any property that cannot be physically touched.
 - *Example:* Intangible property includes patents, trademarks, trade secrets, copyrights, debts, and company good will.

- **Discussion:** Do you think that there should be a distinction between tangible and intangible property? Why or why not? Should they be afforded the exact same protections? For example, is theft of a copyrighted song the same as stealing someone’s wallet? Why or why not?
- **Practice Question:** Austin purchases a book of photography. Has he purchased tangible or intangible property?
- **Resource Video:** <http://thebusinessprofessor.com/tangible-vs-intangible-property/>

- *Real and Personal Property* - Property is further broken down into personal property and real property. Real property is land and anything permanently attached to it. Personal property is anything other than real property.

- **Discussion:** Can you think of any reason why the law would differentiate real from personal property? What characteristics make real property unique from personal property?
- **Resource Video:** <http://thebusinessprofessor.com/real-vs-personal-property/>

- *Fixtures* - A fixture is personal property that is converted into real property by physical annexation to (attachment to or close association with) the land or its buildings.

- *Example:* A piece of equipment that is physically installed into the floor of a factory building would become a fixture and is one with the property. It is no longer personal property and cannot be removed from the real property without the consent of the real property’s owner.

- **Discussion:** Should personal property that is permanently attached to real property become part of the real property? Would this have any effect on businesses that sell or rent personal property?

- **Practice Question:** Megan owns a warehousing business. She purchased a \$1 million storage facility and financed it with a bank mortgage. She purchased heavy steel shelves to stack heavy pallets of goods and installed them in the factory. The shelves cost approximately \$200,000 and are financed by the seller. The steel shelves are anchored to the floor of the building with a heavy steel bolts that are driven into the concrete floor. Has the steel shelving become a fixture of the warehouse building?
- **Resource Video:** <http://thebusinessprofessor.com/fixtures-and-real-property/>

Ownership of property refers to the legal right to exclude others from the specific thing owned. So property is a bundle of rights associated with all physical and non-physical things. Aside from the right to exclude others from using property, ownership rights often include the right to possess, to use, to transfer, and to commercialize the property. Any of these rights, however, are subject to modification by the owner of the property.

- **Discussion:** Do you associate property with physical possession or with the rights in something? Do you think the right to exclude others should be the defining characteristic of property?
- **Practice Question:** Suzie develops a new method for synthesizing radioactive material from common elements. She patents the process and develops a machine to extract the radioactive particles. The Federal Government notifies Suzie that the production of radioactive material is illegal and prohibited. In this situation, what are Suzie's recognizable rights of ownership? Are those rights tangible or intangible? How are those rights limited?
- **Resource Video:** <http://thebusinessprofessor.com/ownership-in-the-context-of-property-rights/>

2. What is the role of government with regard to individual ownership of property?

The government establishes laws concerning property. More specifically, ownership of property depends upon legal recognition of ownership rights. The government establishes and enforces property ownership rights through a formalized system for recording and disclosure that puts others on notice of those rights. Without government recognition and enforcement of property rights, ownership rights would be synonymous with possession or control of the property. Those capable of obtaining and maintaining possession or control through any means (such as force or coercion) would own all available property.

- **Discussion:** Do you agree that an individual only has ownership in something to the extent that the government (the law) recognizes that individual's rights? Are you concerned by any requirements that the government puts in place to establish ownership?
- **Practice Question:** Gordon enters into a verbal agreement to purchase land from Wynona. He pays for the land and takes possession of it. Gordon and Wynona never execute a deed or otherwise title the land with Gordon. When Wynona passes away, her children claim ownership of the land. Who likely has legal ownership of the land and what is the role of government in establishing and recognizing ownership?
- **Resource Video:** <http://thebusinessprofessor.com/role-of-government-in-property/>

3. How are property rights linked to economic activity?

Property as an Incentive

The ability to possess property for one's benefit and to exclude others is understood as a desire or want of many individuals. Research has shown that individuals will expend effort to acquire resources that meet a need or want. Providing a system whereby individuals may acquire property incentivizes those individuals to work toward that end. That is, people will expend effort to acquire property if they have the knowledge that they will be able to retain the property for their personal use and without the threat of forfeiting the property to others. They will undertake work that they were not otherwise willing to undertake in the absence of acquiring new property. Some individuals are willing to work longer and harder incentivized by the amount of property they are able to acquire as a result of their efforts. This tendency often results in greater efficiency in effort and overall economic productivity. Increased productivity of individuals is linked to increases in total economic output in an economy.

- **Discussion:** Do you believe that ownership rights in property have a positive or negative effect on individual productivity? Why or why not? If yes, are there any negative effects of the incentives created by property rights? Are there any disincentives associated with property rights?
- **Practice Question:** Jonathan works in a 9 to 5 job. His performance objectives and career path is very clear. He is promoted based upon meeting minimum performance standards over a specified period of time. If he meets these standards each year, he will gradually receive higher benefits and increasing responsibility. If he fails to meet those standards, he will likely remain in his current position. While superior performance may bring praise from his colleagues and superiors, it will not increase the rate at which he is promoted or bring any additional, tangible reward. In this system, how is property used (or not used) as an incentive to induce greater economic output?

Capital Formation

Property ownership rights allow individuals to possess and demonstrate the results of their own efforts. Individuals are then able to employ that property toward creating additional property. That is, individuals can use their acquired property (or provide it to others) with the intention of generating or acquiring ownership rights in more property. In furtherance of capital formation, the nature of property allows ownership rights in any resource to be divided among individuals. As such, individuals can employ their resources collectively in the creation or acquisition of new property.

- **Example:** Abe's ownership of property allows him employ the services of Bob in exchange for providing Bob with a form of property. Bob's effort generates additional property for Abe, which Abe can use for the creation of additional property.
- **Discussion:** Can you think of any other examples of how ownership rights allow individuals to accumulate or grow economic value or wealth?
- **Practice Question:** Jane is renting an apartment in New York for \$2,000 per month. She decides to purchase a home because it will be financially advantageous. She buys a very small apartment for \$350,000. Her mortgage

each month is \$1,650 and her property taxes are \$600. Of her mortgage payment, \$1000 goes to principal, while \$650 goes to interest. In this scenario, how does owning property allow for capital formation where renting an apartment does not?

- **Resource Video:** <http://thebusinessprofessor.com/property-and-economic-prosperity/>

4. How do individuals acquire an “ownership” interest in property?

Accession - Accession refers to additions to existing property to modify it in a way that results in new property. Accession is very similar to creation of something new. That is, if you add something to raw materials, you own the product that you make from the raw material.

- *Example:* I build a tree house with lumber that is not mine. I used property that was not mine, so I am liable for the value of the lumber. But, I own the product of my labor (the tree house). Of course, in my situation, the person may be able to file a legal claim against you if you do not pay for the lumber.

- **Discussion:** Do you believe that something created from raw materials should be considered new property? In the business context, should ownership rights in newly created property vest in the owner of the raw materials?
- **Practice Question:** Tom needs a place to live. He owns land, but he does not have the money to build a house. One day, he is riding by a construction site. Out front is a large stack of lumber that belongs to Angie, the general contractor. Tom comes back that evening and steals all of the lumber to build himself a house. Tom is a skilled carpenter and using the lumber it only takes him a week to frame in his house. If Angie learns that Tom stole his lumber, does she effectively own Tom’s house? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/acquiring-property-through-accession/>

Acquiring Resources Through Possession

- *Rule of First Possession* - The first person to reduce previously un-owned things to her possession becomes its owner. In reality, there are few things that have never been previously possessed or owned.
 - *Example:* An individual may obtain ownership of real property through “original entry” or “title by occupancy”. This is where the government grants ownership rights in land to individuals willing to settle or claim a stake in the land. This rule was important during the founding and colonizing of the United States.
- **Discussion:** How do you feel about the principle that the first possessor of property owns it? What are the benefits of this principle? What are the negative aspects of the principle?
- **Practice Question:** Ernest is walking down the street when he sees a flash of light and a large object fall from the sky. Ernest immediately recognizes that a meteor has hit the earth. He runs over to where the

meteor landed and finds that the meteor contains a large chunk of precious metal. He picks up the precious metal and takes it home. Does Ernest own the metal?

- **Resource Video:** <http://thebusinessprofessor.com/acquiring-property-the-rule-of-first-possession/>

- *Lost, Mislaid & Abandoned Items* - These include situations in which an individual loses ownership rights to another person.

- *Lost Items* - Things that are lost may also acquire a new owner through possession. Most states have a statutory procedure in place for establishing ownership rights in lost property. These statutes generally require that the lost property be advertised for a period of time in an effort to notify the original owner. If, however, the original owner fails to claim the lost item, ownership rights vest in the individual who found the item. The purpose of such statutes is to avoid the situation where no one owns or makes beneficial use of lost items. Without following this procedure, the finder of the lost property obtains limited ownership rights through possession, which may always be subject to challenge by the original owner.
- *Mislaid Items* - These are items that are lost or left behind by an individual. It commonly arises when someone leaves clothing or accessories behind in a store or restaurant. The owner of the location where the item was left becomes the guardian of the property until retrieved. After a reasonable amount of time without the owner coming to claim the item, the guardian of the property may follow the statutory procedure to establish ownership rights. In the absence of following a procedure to establish ownership, the holder has limited ownership rights simply by possession.
- *Abandonment* - Mislaid or lost property may be deemed “abandoned”. If a mislaid or lost item is abandoned, the finder may retain the item and claim ownership. The key attribute is that the original owner must demonstrate “an unequivocal intent to abandon the property”. Intent can be inferred from conduct, such as stopping looking for it, permanently leaving the geographic area, etc.

- **Discussion:** Do you agree with this treatment of lost or mislaid items? Why or why not? What would be an alternative approach to dealing with ownership rights in lost or mislaid property?
- **Practice Question:** Tamara finds a valuable diamond ring laying on the sidewalk. She takes it home and puts it in her jewelry box. Years later, she gives it to her daughter as a present. One day, her daughter is approached by a stranger who claims that she was the original owner of the ring when it was lost. If the stranger’s claims are true, who has ownership of the ring?
- **Resource Video:** <http://thebusinessprofessor.com/laws-for-lost-mislaid-and-abandoned-items/>

- *Adverse Possession* - This is a situation where someone legally gains ownership or title to someone else’s property by wrongfully claiming rights of use or possession of that person’s land. There are several elements that must be present to claim an ownership interest in property through adverse possession:

- *Open* - The individual(s) claiming possession must be open about their claim of ownership. Openness is

generally characterized as living upon or using the land as an owner would.

- *Example*: Hiding or squatting on land intentionally out of site of others will not qualify as an open claim of ownership.
- *Notorious* - The individual's presence on the land must be known by others. This is closely related to openness. If others are aware that a person is claiming ownership of the land, it serves to substantiate all other elements of adverse possession statutes or common laws.
 - *Example*: Setting up a mailbox to receive mail would demonstrate that the claim of ownership is known or notorious.
- *Actual* - The claim of ownership of the land must be actual, rather than nominal. Simply claiming or voicing an ownership interest without physical possession or control of the land is not sufficient. It requires the person to assert her ownership rights through actual possession or control.
- *Exclusive* - The claim of ownership must be to the exclusion of others. As previously defined, property is something held or possessed to the exclusion of others. The individuals claiming ownership must seek to exclude others from claiming those same ownership rights. This can thwart a claim of adverse possession through group squatting (vagrant community) efforts if not done or undertaken by all squatters as an exercise of group ownership.
- *Continuous* - The claim of ownership must be continuous throughout the entire period of adverse possession. Breaks in periods of claimed ownership stop the statutory period from running and starts it over when ownership rights are claimed again.
- *Wrongful* - The individual claiming ownership cannot have the permission or legal right to use the land. If an individual has the legal right (such as through a rental contract) to be on the land, it is not wrongful.
- *Statutory Period* - Each jurisdiction with an adverse possession statute requires that the possession take place for a prescribed period. The statutory period typically ranges from 7 - 20 years depending upon the jurisdiction and the nature of the property interest. The time period may also vary depending upon the nature of the ownership interest claimed in the land. For example, claiming an easement interest in land may require use for a shorter or longer period than claiming fee simple ownership of the property.

The recognition of ownership through adverse possession seeks to promote beneficial use and ownership of property. If property lays dormant for a period that is sufficient to allow for adverse possession, it is not being beneficially used. This harms economic productivity and is contrary to the public good.

- **Discussion**: What do you think about this law? Is it fair? Should someone be able to acquire legal ownership of someone else's property without her consent? Are you convinced by the government's justification for this law? Is there any way you would alter the law to make it more fair?
- **Practice Question**: Trina has owned a small parcel of land in town for about 15 years. When she decides to sell the house, she pays a surveyor to draw up a plat of the land. To her surprise, her plot is slightly

bigger than she originally suspected. Further, it appears that the neighbors built part of their garage on her land about 12 years ago. What are Trina's rights with regard to the land encroached upon by her neighbor's garage?

- **Resource Videos:** <http://thebusinessprofessor.com/adverse-possession-explained/>

5. How is an ownership interest transferred between individuals?

- *Contracts* - Contract law provides rules under which people agree to exchange value. Contracts, express and implied, are the dominant manner by which individuals exchange real and personal property. Contract law is a staple of a developed rule of law system. Enforceable contract rights provide confidence in undertaking economic activity with others. Increased confidence drives economic productivity.

- **Discussion:** Do you believe that contract law has an effect on economic activity? Why or why not? If so, what is the effect and why?
- **Practice Question:** Abby and Frank are sitting in the cafeteria eating their lunch. Abby notices that Frank has a delicious chocolate bar. Frank notices that Abby has a bag of his favorite potato chips. Abby agrees to trade her potato chips for Frank's chocolate bar. Who owned the chocolate bar and potato chips before and after the trade?
- **Resource Video:** <http://thebusinessprofessor.com/acquiring-property-through-contract/>

- *Acquiring Resources through Gift* - A gift is a transfer of ownership from one party to another without the consideration (mutual exchange of value) necessary to establish an enforceable contract. A gift may, however, transfer ownership of property. A gift normally transfers ownership at the time that the owner expresses intent to transfer the property and physically surrenders the property to someone else who accepts it. The individual receiving the gift must act to accept the gift to make the transfer final.

- **Note:** The gift made during a person's life is known as an "*inter vivos*" gift. A "testamentary gift" is one that is made through a will or other testamentary document.
- **Example:** The last will and testament expresses the donative intent necessary for a transfer of property. An executor or personal representative may be charged with delivering the property in accordance with the deceased's intent. Lastly, the recipient of the inheritance must accept the inheritance. If the intended recipient rejects the inheritance, there is no enforceable transfer of property.

- **Discussion:** What is your opinion regarding the transfer for property by gift? Should a gift be enforceable under the law? If so, at what point should the gift or intended gift be enforceable?
- **Practice Question:** Elsa has a beautiful dress made of satin that she rarely wears. She decides to give the dress to Ingrid. Ingrid is extremely excited to receive such a lavish gift. Before Elsa surrenders the dress,

however, she changes her mind. She informs Ingrid of her change of heart without any ounce of remorse. Who is the owner of the dress before and after Elsa reneges on the promise?

- **Resource Video:** <http://thebusinessprofessor.com/acquiring-ownership-rights-through-gift/>

- **Confusion** – In some cases, individuals will combine their property in ways that makes it indistinguishable. In this situation, there is an amalgam of property to which the contributors have a claim. If a contributor seeks to withdraw her property, she will not receive the exact same property contributed.

- **Example:** Think of farmers placing their grain collectively in storage silos. In such a case, the individuals contributing property retain ownership of an amount of property equal to their original contribution. In a way, this is a transfer of property between individuals.

- **Discussion:** Can you think of other situations where combined property of multiple individuals can become indistinguishable? Are there any situations in which confusion of combined property could detriment one or more of the property owners?

- **Practice Question:** Bert is a cattle rancher in Texas. Every year, he drives his cattle from his West Texas ranch to a more northern location where there is more water and better grazing. At the end of the year, he drives the cattle back down to his southern ranch. Bert has never felt the need to brand or tag his cattle until time to send them to the market. Unfortunately, during one of his annual cattle drives, many of his cows become mixed in with a neighbor rancher's cattle. Neither Bert nor his neighbor can identify their actual cows, so they agree to divide the cows based upon size and total number. In this scenario, has any change of ownership taken place?

- **Resource Video:** <http://thebusinessprofessor.com/acquiring-property-rights-through-confusion/>

OWNERSHIP INTERESTS IN REAL PROPERTY

6. How do individuals establish and document an ownership interest in real property?

Interests in real property are subject to an instrument of title. A deed is the primary manner of establishing ownership and transferring an interest in land. The deed contains a precise legal description of the land and specifies the exact location and boundaries according to a mapping or surveying system. Some types of property interest, such as an easement, can be created through a legal document other than a deed; however, a deed is still required to subsequently transfer an established ownership interest in the property. There are several types of property deeds:

- **Warranty Deed** - This is a deed that purports to transfer any ownership that an individual has in the real property. The seller warrants that she holds title to the property free and clear of any liens or encumbrances and that she is legally entitled to transfer the property. A warranty deed may be divided into “general warranty” and “special warranty” deeds.
 - **Note:** Individuals providing warranty deeds often purchase title insurance to protect themselves

against warranty liability in the event of a defect in title.

- *General Warranty* - The general warranty deed warrants the title against any defects that have ever existed in the title.
- *Special Warranty* - A special warranty deed warrants the title against any defects caused by or relating to actions or omissions of the seller.
- *Grant Deed* - A grant deed is a deed in which the seller guarantees to the purchaser that the property has not be previously sold and that there are no liens, encumbrances, or restrictions that are not disclosed. She also guarantees that there are no current ownership claims by third parties. Unlike the warranty deed, the grant deed does not warrant title against all claims by third parties. That is, the seller will not defend the title if anyone else claims an interest in the property. The recipient is left to rely upon her own search of title to the property to identify potential claims.
- *Quitclaim Deed* - A deed that purports to transfer the ownership that an individual has in the real property without warranty. That is, the seller or transferor does not warrant that she has any particular ownership interest in the subject property. These types of deeds are commonly used in disputes over real property and in situations where title history is very uncertain.
 - *Note:* This type of deed is commonly used in complicated divorce or inheritance situations.

- **Discussion:** Why do you think that the law requires a special legal document to transfer an ownership interest in land? Why do you think a simple contract to transfer land insufficient to transfer ownership?
- **Practice Question:** Hannah, along with her five sisters, inherits land from her grandfather. There is a bit of uncertainty as to each daughter's inheritance rights, so Hannah is not certain of her ownership percentage in the land. Ted is a developer who wants to build condos on the land. He works out a deal with Hannah and her five sisters to purchase all of their interests in the land. As part of this transaction, what type of deed would you recommend that Hannah use in transferring her interest to Ted? Why?
- **Resource Video:** <http://thebusinessprofessor.com/deeds-and-transfer-of-interest-in-real-property/>

7. What is a “fee simple” interest in real property?

Fee simple is the term used to represent the maximum ownership interest in real property that is allowed under law. It can be referred to as complete ownership. A fee simple owner has full legal rights and powers to possess, use, and transfer the land. There are, however, certain limitations that can be placed on fee simple ownership, including:

- *Fee Simple Absolute* – Fee simple absolute ownership means that all interests in the property are transferred. There is no limitation or conditions attached to the transfer.
- *Fee Simple Defeasible* – Fee simple defeasible ownership means that a condition (or multiple conditions) are attached to a transfer of the property. This means that if a certain event occurs, the transfer is undone and the

property either reverts back to the original owner or to a third party.

- *Example:* Tom transfers property to Ann under the condition that it always be used for residential purposes. If the land is ever used for anything other than residential purposes, it reverts back to Tom (or his heirs).
- *Note:* The rights retained by the transferor of a fee simple defeasible or a designated third party is discussed below in the context of a life estate.

These characteristics of a fee simple interest are important tools for individuals when determining the extent of property interest to transfer.

- **Discussion:** How do you feel about the ability of an owner of land to transfer and interest in that land subject to conditions? Can you see any advantages or disadvantages to limiting the owner of land's use of her property? Does this ability in any way run afoul of the goals or objectives of government in recognizing ownership interest in land?
- **Practice Question:** Veronica wishes to transfer land she inherited from her grandfather to her alma mater, Great College. She drafts a deed that states that all interest in the property is transferred to Great College, so long as it is used for academic purposes. If it is ever not used for academic purposes, it reverts back to her estate. Years later, Great College decides to rent the land to a group of fast-food restaurants seeking to serve the student body. If Veronica has passed away, what are the rights of Veronica's estate to demand return of the property?
- **Resource Video:** <http://thebusinessprofessor.com/fee-simple-defined/>

8. What is a "life estate" interest in real property?

A life estate is a temporary transfer of an ownership interest in real property. The transfer is good for the life of the transferee or some other third-party identified in the deed of transfer.

- *Reversion* – At the end of the life estate, the land reverts back to the original owner who has a reversion interest.
- *Remainder* – At the end of the life estate, the person to whom the property returns has a remainder interest.

The holder of a life estate has the ability to fully use and enjoy the property. The holder cannot, however, cause extraordinary changes to the property or knowingly deplete the property of non-renewable resources (such as digging up minerals). The holder may, however, build new structures or cut timber from the land. Any improvements to the land revert or transfer along with the property at the end of the life estate.

- *Example:* Beth transfers property to Carl for the rest of his life. At the end of his life, the property reverts back to Beth or her heirs. If Beth has no heirs, it goes to Fran or her heirs. Beth has a reversion interest and Fran has a remainder interest.

- **Discussion:** How do you feel about the ability to transfer a temporary ownership in land for an individual's life? Should that right be limited by requiring that the life estate be measured by the life of the holder of the interest? Are there any economic utility arguments for or against the government recognizing life estates?
- **Practice Question:** Linda works as a tenant on the farm of Eric, a local aristocrat. Upon Eric's death, he grants Linda the right to live and farm the land for the rest of her life. At the end of her life, however, the land will transfer back to Eric or his children. If Eric is not alive and he does not have any children, the land will transfer to Gladys, Eric's cousin. What interests do Linda, Eric, and Gladys have in the land?
- **Resource Video:** <http://thebusinessprofessor.com/life-estate-defined/>

9. What is a "leasehold estate" in real property?

A leasehold estate, commonly called a lease, is the property right granted to a tenant by a landlord. The lessor has limited rights similar to that of an owner, but for a limited term. The renter cannot materially change the property without the landlord's consent. Any material changes to the property (such as installation of fixtures) become the property of the landlord upon termination of the lease.

- **Note:** The provisions of the Uniform Commercial Code, Article 2A govern leases of personal property.

- **Discussion:** Should a lease be considered a form of ownership interest in property? At what point do you think the right of use turns into rights of ownership?
- **Practice Question:** Gayle has a house that she generally rents to tenants. Juliet comes into town and asks Gayle if she can stay with her for a few days. Gayle agrees to allow Juliet to stay in her rental house. After a couple of days, Juliet offers to clean up the house as a thank you for letting her stay in the house. Gayle agrees without any talk of compensation or rent. Juliet proceeds to paint the walls, install curtains, and replace some of the faucets. What is the relationship between Gayle and Juliet? Did Juliet have the right to undertake the aforementioned changes to Gayle's house?
- **Resource Video:** <http://thebusinessprofessor.com/leasehold-interest-in-real-property/>

10. What types of co-ownership interests exist in property?

It is very common for individuals (particularly family members) and businesses to own property collectively. The most common forms of co-ownership of property are as follows:

- **Joint Tenancy** – All owners of the real property are indicated on the title and each owns an equal undivided interest in the property. There is a "right of survivorship" among owners. The interests of all owners are unified, so that when one owner passes away the other owners acquire the deceased owner's interest. If any owner seeks to sell or transfer her interest in the property, the joint tenancy is broken and the ownership becomes a tenancy in common.
- **Tenancy in Common** – Each owner owns a specific percentage of the property. This percentage of ownership is

separate from other owners' interest. The ownership interest is not unified; rather, it is "divisible". Any owner can sell her ownership interest and there is no right of survivorship. If the owner passes away, her ownership interest passes to her heirs and assigns. The remaining owners do not acquire the deceased owner's interest.

- *Tenants by the Entirety* - This is a method of joint ownership in property by married spouses. Each spouse owns and equal and undivided interest in the real property. There is a right of survivorship, so either spouse will inherit complete ownership of the property when the other spouse passes. The land passes automatically without having to go through probate. Neither spouse may transfer the property without the other spouse's consent. There is a presumption of tenancy by the entirety in most states, unless the deed or title indicates that only one spouse is the owner of the property.

- **Practice Question:** Elaine and Jerry are co-owners of property that they use in their business venture. They own the property as joint tenants. What happens to the property if either Jerry or Elaine pass away?
- **Resource Video:** <http://thebusinessprofessor.com/joint-tenancy-tenancy-in-common-explained/>

- *Community Property vs. Separate Property* – This property designation further concerns the ownership of real property by legally married couples. It applies to real and personal property. As explained above, ownership of property as tenants by the entirety would control with regard to real property. Generally, property held by a married couple is either classified as "marital property" or "separate property".
 - *Marital Property* - Is owned equally by both spouses and each spouse's consent must be present to legally sell the property.
 - *Separate Property* - Belongs to one spouse or the other. It does not require the consent of both spouses to sell or transfer.

There are two systems in the United States for determining whether property is marital or separate. One system follows the "common law" rule and the other follows the "community property" rule.

- *Common Law Rules* - Common law states that marital or separate property is determined by whose name is on the title, who purchases the property, or who receives it as a gift.
- *Community Property Rules* - In states observing community property rules, all property acquired during the marriage is considered marital property, with the exception of property acquired before marriage, property inherited, or received as a gift. This rule is analogous to the concept of property owned as tenants by the entirety. This rule becomes important in the event of divorce between the parties. The court will be forced to determine who owns property.
- *Example:* Tom and Jane are married. Their primary possessions are a home and a car. Determining who owns the property will depend on whether it is marital property or separate property. If the state is a common law state, whoever's name is on the title to the home and car own it. If it is a community property state, ownership depends on whether the home or vehicle was acquired by an individual prior to marriage or pursuant to a gift or inheritance. If it was purchased during the marriage, it will be considered

community property.

- **Discussion:** Which do you believe is most fair to spouses, community property laws or equitable distribution laws? Why? What is an argument for or against following equitable distribution principles? Community property principles?
- **Practice Question:** Ervin and Betty are husband and wife. Over the years they have acquired several parcels of real estate. The real estate is always registered in Betty's name. Terry, a general contractor, approaches Betty about purchasing one of the properties. Who has the right to sell the property? What do we need to know about the law of the jurisdiction to answer this question? Why?
- **Resource Video:** <http://thebusinessprofessor.com/community-property-vs-separate-property/>

11. What is an “easement interest” in real property?

An easement is a limited interest in real property. It involves a particular right to use the subject property in a particular manner, but does not necessarily create a right to possess the property. Generally, the easement rights exist at the same time as the rights of other property interest holders.

- *Example:* An easement commonly grants the right to cross or use someone else's land for ingress and egress. This is known as a “right of way”.

An easement may arise by a number of methods, as follows:

- *Express Easement* - An express easement is an easement intentionally granted to another person in writing. It generally arises pursuant to a deed, contract, or testamentary document.
 - *Example:* Emma sells property to Dianne. Emma reserves an easement across Dianne's property. As part of the transaction, Dianne signs a deed granting an easement to Emma.
- *Affirmative & Negative easements* – An affirmative easement grants an individual the right to do something on the subject property. A negative easement, on the other hand, restricts an individual from using her land in a certain way. Generally, it arises pursuant to a transfer of land whereby the original owner does not want the land used in a specific manner.
 - *Example:* Brad owns two pieces of land that are side by side. He sells one of the pieces of land to Teri. He establishes a negative easement in the land at the time of transfer that states that the land cannot be used in a certain manner.
- *Appurtenant & In-Gross Easement* - The easement may attach to the land or it may belong specifically to the person. An “easement in gross” is an easement that allows an individual to use the subject land. The easement does not attach to the land, rather it is a right held by the individual. In this way the easement in gross is similar to a license. An “easement appurtenant” is an easement that attaches to or is a part of the land, rather than owned by an individual. The easement will remain with the property, no matter who owns the property.

- *Example:* Sally may grant an easement to Victor that allows him to cross her land at a specific location. The easement states the right belongs to Victor and does not attach to the property. Sally can determine whether Victor can transfer the easement to another person, but it is personally owned. This is an easement in gross.
- *Natural Easement* (Easement by Necessity) – A natural easement arises when it is necessary for an individual or the public to make use of land located near the property subject to the easement.
 - *Example:* Will owns land located behind Gloria's land. The only way that Will can access his land from the public highway is to cross Gloria's land. Will may be able to bring a court action establishing a natural easement allowing him to cross Gloria's land at a specific point. The justification for the grant of easement is that without it, Will cannot use or enjoy his property.
- *Easement by Prescription (Adverse possession)* – An easement by prescription is obtained by adverse possession (see the discussion of adverse possession). An individual who wrongfully uses someone else's land under the conditions required for adverse possession may pursue a court action to establish ownership rights in the property.
 - *Example:* Winston drives cattle across Mary's property every year for 20 years (the applicable state's statutory period). He did so openly; claiming the right to do so; it was known to others; it was done every year; and it was done without the permission and against the Mary's wishes. When Mary finally tries to put up a fence to stop Winston from driving cattle, he brings a court action to establish an easement by prescription.

- **Discussion:** How do you feel about an individual acquiring easement rights that are not express? Why should an easement ever belong to an individual rather than attaching to the land or burdened property? How strong should the need be for an individual to acquire an easement by necessity? How frequent must the use of someone else's property be to give rise to an easement by prescription?
- **Practice Question:** Steven owns a tract of land that adjoins the river. He decides to divide his land into two parcels. He maintains ownership of the parcel that adjoins the river. The other piece of property sits directly in front of his property and borders the road. Steven agrees to sell the property adjoining the road to Amy, but he puts in the deed a specific limitation stating that Amy cannot build a building on the far right side of the property. Steven and Amy later get into an argument and Amy seeks to stop Steven from crossing her land to access his property. What legal issues are at play in this situation?
- **Resource Videos:** <http://thebusinessprofessor.com/easement-or-right-of-way-in-real-property/>

PERSONAL PROPERTY

12. What is a “license” of real or personal property?

A license is a grant of the right to use real or personal property. It is not a true property interest. A license of real property will be limited to a particular holder and it will have a definite (limited) term. Because it allows for use (without

possession) of the real property, it is similar to an easement in gross. An easement, however, must be in writing. An oral grant of permission to use real or personal property would be considered a license.

- **Discussion:** Do you think a license to use property should be considered a property interest? Why or why not? If so, what type of uses should be considered a property interest?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-license-of-real-property/>

13. What is a “bailment”?

A bailment is a situation where the owner of personal property gives the property to another person to hold or to use in a specific manner. The owner of the property is called the “bailor” and the person receiving the property is called the “bailee”. A bailment can be express (pursuant to agreement by the bailor and bailee) or implied (simply a result of the parties’ conduct).

- **Example:** To illustrate an express bailment, Alex gives his car to Brandi to sell. Brandi will receive a commission for selling the car. Until the car is sold, the situation is a bailment. Brandi is the bailee holding the property with the specific purpose of selling it for Alex. Another common form of express bailment is shipping a package through the public or private delivery service. The package is held by the common carrier is a bailment.
- **Example:** To illustrate an implied bailment, Gary accidentally leaves his computer at Dina’s house. Dina leaves Gary a message to let him know he left it and that she will hold on to it until he can pick it up. In this situation, an implied bailment is created. Dina is holding the computer for Gary with the expectation that she return it whenever he comes to get it.

- **Discussion:** What do you think about the prospect of creating a bailment by accident? Does it matter whether the parties realize that they are part of a legal relationship? Should the bailor and bailee know that the other exists?
- **Practice Question:** Rhonda is leaving a restaurant and picks up her coat from the rack at the door. When she reaches her home, she realizes that she has picked up someone else’s coat. Rhonda decides to return the coat to the restaurant, but she cannot do so until the following day. What is Rhonda’s legal status while in possession of someone else’s coat?
- **Resource Video:** <http://thebusinessprofessor.com/bailment-defined/>

14. What is a “unilateral benefit bailment” and “mutual benefit bailment”?

A bailment can be made to benefit either party or both parties.

- **Unilateral Benefit Bailment** - A unilateral benefit bailment is a situation where either the bailor or the bailee receives a benefit from the bailment, while the other party does not. This situation may arise as a gift or favor by one party to the other.

- *Example:* Sam agrees to look after Judy's car while she is on vacation. This is a unilateral benefit bailment in favor of Judy (the bailor). If Judy later loans her car to Sam for him to drive while his car is being repaired, this is a unilateral benefit bailment in favor of Sam (the bailee).
- *Mutual Benefit Bailment* - A mutual-benefit bailment provides a benefit to the bailor and bailee. Generally, a mutual benefit bailment is pursuant to an enforceable contract, as there is an exchange of value that is the impetus of the relationship.
 - *Example:* Ralph agrees to fix Laura's chainsaw if he can use it to cut up some trees that fell on his property. This is an enforceable contract. Since the contract involves Ralph holding Sandra's property and returning it at some point in the future, the relationship constitutes a mutual-benefit bailment. Any situation where the bailee is paid to hold or dispose of the property is a mutual-benefit bailment. In business, most bailments are mutual benefit.

Rights - The bailor and bailee have specific rights in the bailment relationship.

- *Bailor Rights* - The bailor generally has the right to receive return of the property (or any proceeds derived from disposing of the property).
- *Bailee Rights* - The bailee generally has the right to possess the bailed item, the right to use it (unless otherwise limited in the bailment agreement), the right of compensation (if provided for in the bailment agreement), and may have the right to limited personal liability or indemnification by the bailor for potential liability arising from the bailee carrying out her duties.

Duties - The bailor and bailee owe specific duties to each other in the bailment relationship.

- *Bailor Duties* - In a unilateral-benefit bailment, the bailor must reveal any defects in the bailed item. She warrants that there are no defects in the bailed object that could have been discovered through reasonable inspection.
- *Bailee Duties* - Bailee has an absolute duty to return the object to the bailor or to dispose of it as the bailor directs. The bailee is potentially liable to the bailor for failing to do so.

Standard of Care in Duties - The bailor and bailee owe duties of care to each other in the bailment relationship.

- *Bailor* - The bailor must take reasonable care to protect the bailee from known risks in the bailment relationship.
- *Bailee* - The bailee's duty of care in the bailment relationship depends upon the nature of the bailment. In a mutual benefit bailment, the bailee generally must exercise reasonable care in taking care of the bailed property. If the bailment is a unilateral benefit for the bailee, the bailee owes a higher standard of care in carrying out her bailment duties. The standard of care is lower if the bailment relationship is a unilateral benefit for the bailor. This could mean that the bailee avoid recklessness in carrying out her duties.

Numerous special bailment relationships exist that may entail higher levels of care for the bailee. For example, some jurisdiction make common carriers strictly liable for any damages to the bailed property (such as a package shipped with a common carrier). The bailee may have limited rights to disclaim some level of liability. Further, some jurisdictions make hotels and motels strictly liable for losses to property held as part of the business-client relationship (such as goods stolen

from the hotel room).

- **Discussion:** Do you believe that there should be a difference in duties between unilateral and mutual benefit bailments? Should the duties be stronger for the bailor or bailee in either situation? Why or why not?
- **Practice Question:** Ralph asks Arnold to watch his car while he is on vacation. Arnold agrees under the condition that he get to drive it whenever he wants. Ralph agrees and hands over the keys before heading on vacation. Arnold drives Ralph's car to a bar. He drinks too much and has to take a taxi home. The next day he returns and someone has vandalized Ralph's car. Is Arnold potentially liable in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/unilateral-and-mutual-benefit-bailments/>

LIMITATIONS ON PROPERTY RIGHTS

15. How are property ownership rights limited?

The US Constitution protects individual ownership rights in property. The concept of property allows the owner to exclude others from possessing or using that property. Nonetheless, laws may limit property by regulating when and how a person can use her property. In general, owners are prohibited from using their resources in ways that harm or injure others. The Federal Government limits the use of property through its power to regulate interstate commerce. State and local governments regulate the use of property pursuant to their police power to protect the health, safety, morals, and general welfare of its citizens.

- **Discussion:** How do you feel about the ability of the federal, state, and local governments to infringe upon a property owner's rights? Does it matter to you that the ability to infringe upon property rights is derivative power, where the constitutional protections of property rights are express? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/how-are-property-and-ownership-rights-limited/>

16. What is "Nuisance"?

Nuisance is the use of one's property in a manner that creates a substantial, unreasonable interference with the use or enjoyment of another person's property.

- **Public Nuisance** - Public nuisance arises from use of land that causes a substantial interference with the use and enjoyment of the property by the public at large.
 - **Example:** Pollution from a factory that affects an entire neighborhood or town may constitute a public nuisance.
- **Private Nuisance** - Private nuisance arises when a person uses her property to substantially interfere with the use and enjoyment of another person's property.

- *Example:* Allowing your dog to bark and disturb your neighbor could constitute a private nuisance.

- **Discussion:** How do you feel about a nuisance action as a method of enforcing one's property rights? How should the court balance the rights of one landowner versus those of another? Should there be public laws broadly targeting nuisance, such as criminal actions for general nuisance? Why or why not?
- **Practice Question:** Evelyn buys a home in a small neighborhood. Since moving in, her neighbor Derek has been extremely rude to her. Specifically, Derek sent her an email asking that she avoid allowing her home to become a gaudy, eye sore in the neighborhood. Evelyn, ever the feisty one, is very angry about the email. She decides to paint a largely smiley face sticking out its tongue on the side of her house facing Derek's house. Derek is outraged by Evelyn's actions. What are Derek's options in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/nuisance-explained/>

17. What is "Zoning"?

Zoning refers to local (city or county) ordinances controlling how property within specific areas can be used. Zoning ordinances generally divide areas of counties or municipalities into districts designated for residential, commercial, or industrial use. The local government will charge anyone using her property in violation of the ordinance with an infraction.

- *Note:* If the land is being used in a certain manner prior to the passage of an ordinance, the user may receive a "non-conforming use" exemption from the ordinance. Landowners who desire to use their land in a manner disallowed by the ordinance may seek an exemption or "variance". This generally requires petitioning the local zoning board or council and submitting the proposal for public comment.

- **Discussion:** How do you feel about allowing local governments to choose the manner in which land can be used? How should this power be weighed against the rights of the landowner?
- **Practice Question:** Beth owns a home in a small neighborhood. She has the idea to begin printing t-shirts and selling them over the Internet. She researches all of the applicable requirements for starting a business. One of the requirements is to register for a business license. What will she have to know about zoning in order to apply for a license?
- **Resource Video:** <http://thebusinessprofessor.com/zoning-ordinances-explained/>

18. What is "Eminent Domain"?

Eminent domain is the power granted local, state, and federal governments under the Takings Clause of the 5th Amendment. This clause allows the various levels of government to take away property from private owners under certain conditions. Generally, the taking must be for a "public purpose" and the government must provide "just compensation" to

the landowner for the taking. A taking refers to a physical seizure of the land as well as unduly burdening an individual's use and enjoyment of her property.

- *Note:* An owner whose land is being taken may challenge the action in civil court. Generally, the landowner must show that the taking is not for a public purpose or that she was not given just compensation.
- *Example:* If the state builds a highway that brings traffic into someone's front yard, this would likely be a taking. The individual's ability to use and enjoy her property is diminished by proximity of the traffic.
- **Discussion:** How do you feel about the ability of the government to take a person's land? Does it affect your opinion that this right is expressly included in the Constitution? Why or why not? Does your opinion about this authority vary depending on whether the governmental authority is the federal, state, or local government? What standard should apply when determining what constitutes a public purpose?
- **Practice Question:** Melinda owns a small farm on the edge of town. The local township is in negotiations with Save-Mart, Inc., to build a new store in the town. Save-Mart has identified Melinda's farm as the perfect location. Melinda is unwilling to sell the land. What are the options for the township with regard to Melinda's property?
- **Resource Video:** <http://thebusinessprofessor.com/eminent-domain-explained/>

19. What is "taxation" of personal and real property?

Property taxes are a form of direct tax on the real and personal property owned by individuals or businesses. Property taxes (primarily on real estate) often fund local schools, police, and county administration. A common tax on personal property is a tax on the value of one's personal vehicle, commonly known as "ad valorem" taxes or business equipment and inventory.

- **Discussion:** The US Constitution includes the ability of the government to tax individuals. Do you feel that this power is overly broad? Why or why not? Should this power extend equally to the state and local governments? Why or why not? Should there be any specific limits on this power? Local property taxes are often linked to funding for schools, police, and fire departments. How does income level and property values relate to quality of public services? How do you feel about this method of funding for these public services?
- **Practice Question:** The town of Pleasantville is considering building a new high school building. To raise funds for the project, what are some of the town's options?
- **Resource Video:** <http://thebusinessprofessor.com/taxation-of-real-and-personal-property/>

TOPIC 9: TORT LAW

Overview

Tort law generally encompasses situations where an individual's conduct causes harm to another. Torts are specific causes of action against individuals when a recognized statutory or common law right is violated. It is distinct from civil actions involving contract or family law. This chapter explores tort law and specific causes of action in tort. Specifically, it explains the three categories of tort — intentional torts, negligence, and strict liability torts — and the elements necessary for establishing liability under each. Lastly, it explains the types of damages available to plaintiff's injured by a defendant's tortious conduct and the defenses available to a defendant.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• <u>Tort</u> • Types of Tort - <u>Intentional Tort</u> - <u>Negligence</u> - <u>Strict Liability</u> • <u>Assault and Battery</u> • <u>Intentional Infliction of Mental Distress</u> • <u>Invasion of Privacy</u> • <u>False Imprisonment</u>	• <u>Malicious Prosecution</u> • <u>Trespass</u> • <u>Conversion</u> • <u>Defamation</u> • <u>Defenses to Defamation</u> • <u>Defamation and 1st Amendment</u> • <u>Fraud</u> • <u>Interference with Contractual Relations</u> • <u>Legal Duty</u>	• <u>Unreasonably Behavior</u> • <u>Cause in Fact</u> • <u>Proximate Cause</u> • <u>Compensatory Damages</u> • <u>Punitive Damages</u> • <u>Common Defenses to Negligence</u> • <u>Strict Product Liability</u> • <u>Common Strict Liability Actions</u> • <u>Defenses to Strict Product Liability</u>

TOPIC 9: TORT LAW - QUESTIONS & ANSWERS

1. What is a “Tort”?

A tort, in the legal context, means a “wrong”. More specifically, it is a civil wrong, as apposed to a breach of contract or other civil action.

- *Note:* Individuals may be liable in tort for their own conduct and for the conduct of others.

- **Resource Video:** <http://thebusinessprofessor.com/torts-defined/>

2. What types of torts exist?

There are three broad categories of tort, as follows:

- *Intentional Torts* - Intentional torts, as the name implies, are characterized by the mental intent of the tortfeasor. The tortfeasor undertakes an activity with either the desire to bring about an intended result or with the knowledge that the result is “substantially certain”. When the action results in an identifiable harm or loss to a third party, it constitutes an intentional tort.
 - *Example:* If one person physically batters another person by punching him in the face. This is an intentional tort because the individual intended her actions and the probable result.
- *Negligence* - Negligence is conduct by an individual that drops below a reasonable standard of care and causes harm to another person. Succinctly, an individual has a duty to act reasonably when interacting with others. When that individual fails to act reasonably and thereby causes harm to others, that individual is negligent.
 - *Example:* A person who is driving too quickly, following too closely, or not paying close attention may be negligent if her careless behavior results in an automobile accident.
- *Strict Liability* - Strict liability subjects an individual to liability for activity that causes harm to another without regard for her intent or the standard of care she shows in carrying out that activity. That is, simply undertaking the activity that results in harm is sufficient to make the actor liable. The injured party is not required to demonstrate the actor’s intent or the level of care they exercised in undertaking the activity.
 - *Example:* A person who deals in very hazardous material, has a vicious or wild animal, or takes part in the production or sale of an unreasonably dangerous product may be liable if her activity causes injury to someone. It does not matter that the person did not intend to harm anyone or that the person took extra precautions to not harm anyone. These activities alone are enough to subject the person to liability.
- **Discussion:** Why do you think that torts are generally categorized based upon the mental state of the tortfeasor? Should the mental state of the tortfeasor affect the severity of the potential liability for the tort? Why or why not?

How should the intent of the tortfeasor be compared against the result of the tort when determining the liability of the tortfeasor?

- **Practice Question:** Doug is speaking with his friend Annie about an unfortunate accident involving her pet dog. Her pit bull bit the mailman, apparently mistaking him for an intruder. The mailman is now suing Annie. Annie says that she is going to trial to contest her liability because her dog broke out of its cage and it wasn't her fault. Animal bites are strict liability torts in Annie's state. What does Annie need to know before going to trial?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-the-types-of-torts/>

INTENTIONAL TORTS

There are many intentional statutory and common law torts. Some of the more common intentional torts are discussed below.

- **Resource Video:** <http://thebusinessprofessor.com/intentional-torts/>

3. What is “assault and battery”?

Two commonly recognized intentional torts are “assault” and “battery”.

- **Assault** - Acting to place another person in immediate apprehension of a harmful or offensive physical contact. There are several elements to this tort. First, the individual must intentionally act and the action cannot be unconscious or inadvertent. Second, the individual witnessing the act must sense or apprehend immediate contact. Apprehension is more than fear. While the individual may also be scared, fear or intimidation is not required; rather, she only need be aware that a touching is likely to ensue. The apprehension of the touching is judged by a reasonable person standard. That is, would a reasonable person believe that physical contact is imminent. Lastly, the contact must be harmful or offensive. Offensiveness is judged based upon a reasonable person in the individual's situation.
 - **Example:** A person picks up a baseball bat and begins walking toward another person in a menacing manner. If the second individual reasonably believes that the first individual is going to hit him with the baseball bat, this is an assault. The second individual is in immediate apprehension of a harmful touching. The same situation could apply if the second individual believed that she would be touched inappropriately (such as groping or fondling), which would be considered offensive touching.
- **Battery** - A battery is an illegal touching of another. The touching is harmful or offensive and done without justification and without the consent of the person touched. A battery often accompanies an assault.
 - **Example:** In the above example, actually hitting the individual with the bat or touching the individual in an unwanted sexual manner would be a battery.
- **Note:** An individual can be assaulted but not battered (and vice versa). A battery without an assault occurs when

the individual was not aware in advance or did not see the battery coming.

- **Discussion:** Why do you think assault and battery are separated into different causes of action? Should one cause of action be more severe in liability than the other?
- **Practice Question:** Erin is very angry at Marshall. She walks up behind him and acts as if she is going to hit him with a baseball bat. Fortunately for Marshall, she decides against her plan before Marshall becomes aware. Still annoyed, however, she walks up to Marshall and slaps him in the face. Marshall did not expect to be slapped and was taken totally by surprise. If Marshall sues Erin, what causes of action will likely prevail?
- **Resource Video:** <http://thebusinessprofessor.com/assault-and-battery/>

4. What is the “intentional infliction of mental distress”?

The intentional infliction of mental distress upon another is a form of battery to the emotions. Like a battery, it is caused by intentional conduct that carries a strong probability of causing mental distress to the person at whom it is directed. Generally, the conduct must be very extreme or outrageous in nature to result in emotional distress. To recover for this tort, the plaintiff must demonstrate that the intentional conduct actually caused her mental distress that manifests itself physically.

- **Example:** Intentionally exposing a person to extreme ridicule in front of a large crowd may constitute such a tort.
- **Discussion:** What type of conduct would you consider sufficiently extreme or outrageous to qualify as a battery on the emotions? Do you agree with the requirement that mental distress must also manifest itself through physical symptoms?
- **Practice Question:** Helen is shopping in the mall with her daughter, Penny. They are on the second floor of the mall looking over the railing at the large, central fountain when a stranger approaches Penny. The stranger picks up Penny and begins screaming at her. He then holds her over the railing and threatens to drop her into the fountain a floor below. Helen screams hysterically for help and begs the stranger to put her down safely on the ground. Some bystanders grab Penny and tackle the stranger to the ground. Helen is so emotionally distraught by the incident that she develops nightmares, insomnia, and begins seeing a therapist. Can Helen sue the stranger and, if so, for what? Explain.
- **Resource Video:** <http://thebusinessprofessor.com/intentional-infliction-of-emotional-distress/>

5. What is the tort - “invasion of privacy”?

Invasion of privacy is comprised of three principle types of invasion of personal interest:

- **Use of Name or Likeness** - Individuals have a property interest in their name and physical image. As such, appropriating an individual’s name or likeness for business use without her consent violates her property rights.

- *Note:* Before using anyone's picture or name, a business must obtain a proper release from that person to avoid possible liability.
- *Example:* Using a candid picture of Ann smiling in an advertisement for a local business without her consent violates her personal rights.

- ***Discussion:*** Do you agree with the idea that an individual has an ownership interest in her name or physical likeness? Does it matter to you the nature of the likeness? Should a drawing or painting of an individual receive the same protections as a photograph or video? Why or why not?
- ***Practice Question:*** Judy owns a supermarket. She is advertising the sale of basketballs. She puts a small caption in her weekly newspaper flyer that uses an image of Steve Curry, a professional basketball player. Is there a legal issue?

- *Invasion of Physical Solitude* - Individuals have an expectation of privacy in their home and within other personal spaces. Viewing or monitoring such places is an invasion on the individual's physical solitude.
 - *Example:* Entering a person's home, spying through windows, illegal wiretapping, and persistent unwanted telephoning all may constitute an invasion of privacy.

- ***Discussion:*** Do you think that an individual should have a right to prevent individuals from spying or eaves dropping on them in private places? What amount of effort should be required to constitute an invasion and how would you measure it? Should an individual have to show damages to bring an action for invasion of physical solitude?
- ***Practice Question:*** Scott is walking by Karla's house and sees her through the window. She forgot to close the blinds and is walking around her bedroom in a state of undress. Scott is very curious and makes an effort to get a better view. He even climbs the tree growing beside the street on public property to get a better view. Has Scott committed a tort against Karla?

- *Disclosure of Private Information* - Disclosure of highly-objectionable, private information about someone may be an invasion of that person's privacy. Generally, the information must be obtained by an individual who owes a duty of confidentiality to the individual whose rights are violated. In some cases, the information must be obtained without the person's consent.
 - *Note:* A personal or professional relationship could give rise to a confidential relationship.
 - *Example:* A nurse disclosing someone's private medical information could constitute an invasion of privacy. The tort generally requires that the private information result in disclosure to the public at large.

- ***Discussion:*** What type of information should be considered private for purposes of an invasion of

privacy? Why? Should it matter whether there is a relationship between the individual whose information is disclosed and the discloser?

- **Practice Question:** Deshaun works in a pharmacy as a technician. One day, Dolly comes to the window and requests to fill a prescription. The prescription is for a medicine commonly used to treat a common venereal disease. Deshaun does not like Dolly, so he immediately gossips to friends about Dolly's medication. The friends post the information on a popular social media site and the news quickly travels back to Dolly. Has Deshaun committed a tort?

- **Resource Video:** <http://thebusinessprofessor.com/invasion-of-privacy/>

6. What is "false imprisonment"?

False imprisonment is the wrongful detention of a person without that person's consent. The detention does not have to involve physical force. It can involve a threat of physical force or the apprehension of harm for failure to remain in a specific location. The key aspect is that the detained individual must reasonably believe that she cannot leave the detention without unjust repercussions.

- **Note:** The detention area must be relatively defined.
- **Example:** This situation often arises when an agent of a retail establishment detains a suspected shoplifter. If the individual is not actually a shoplifter, the detention is wrongful and can constitute false imprisonment.

- **Discussion:** What type of action do you believe would reasonably make a person believe that she is detained without the ability to leave? Why?
- **Practice Question:** Everett is a security guard at a local clothing store. He believes that a customer is shoplifting. He asks the customer to step into the back room of the store to interrogate her. Upon arriving in the back room, the customer says that she feels uncomfortable and wishes to leave the store. Everett tells her that the police are coming and that she cannot leave until they arrive. Under what conditions has Everett committed a tort?
- **Resource Video:** <http://thebusinessprofessor.com/false-imprisonment/>

7. What is "malicious prosecution"?

Malicious prosecution is wrongfully subjecting someone to the prosecutorial process. This tort often arises from causing someone to be arrested or formally charged through intentional false swearing or malevolent pretenses.

- **Example:** I cause the police to arrest Tom simply to harass him. I do so by stating to the police that he stole my computer, when this is not true.

- **Discussion:** How would you propose balancing the objective of protecting the wrongfully accused against dissuading someone from pressing charges against someone who committed a crime against them?
- **Practice Question:** Autumn cheats on her boyfriend with Isaac. She is very embarrassed when everyone, including her boyfriend, learns of her actions. To cover up her infidelity, she accuses Isaac of improperly taking advantage of her while she was intoxicated. She informs the police who proceed with pressing charges against Isaac. When pressed to take a lie detector test, Autumn comes clean and admits her false accusation. What are Isaac's options for suing Autumn?
- **Resource Video:** <http://thebusinessprofessor.com/malicious-prosecution/>

8. What is “trespass”?

The tort of trespass is similar to the crime of trespass. It involves physically entering onto someone else's land without consent or remaining there after being asked to leave (consent is revoked). The difference between the civil action and the criminal charge is that a tort requires the existence of damages to be actionable.

- **Note:** In addition to personally entering someone's land, trespass can occur by projecting something (such as pollution or garbage) onto another's land without consent.
- **Discussion:** How does the civil tort of trespass relate to constitutional protections? How do you feel about trespass and the requirement for damages to bring a civil action? Can you think of scenarios where trespass could take place with no damages, but a civil action is preferable to pursuing criminal charges?
- **Practice Question:** Jason is in a local bar and music venue listening to a popular musical group. He drinks too much and becomes intoxicated. The bar bouncers kindly asks Jason to leave, but he refuses on the grounds that he rightfully paid the cost of entrance. If Jason refuses to leave, has he committed a tort?
- **Resource Video:** <http://thebusinessprofessor.com/trespass/>

9. What is “conversion”?

Conversion is a civil cause of action for taking another person's property without her consent. It entails the wrongful exercise of dominion (power) and control over the personal (non-land) resources of someone else. In doing so, a person violates the owner's lawful right to exclude others from her resources. The deprivation may be temporary or permanent, but it must constitute a serious invasion of the owner's legal rights.

- **Example:** Stealing something from an employer is conversion – as is purchasing something that has been stolen. Failing to return something at a designated time, delivering something to the wrong party, and destruction or alteration of someone else's property also constitutes conversion.
- **Discussion:** What level of interference with another person's use and enjoyment should be considered

conversion? How does the nature of the deprivation affect your opinion? Does the length of deprivation affect your opinion? Should the interference be intention? How would you balance the rights of an innocent transferee of the property against the rights of the original owner?

- **Practice Question:** Ervin purchases a luxury watch from Carl. Carl claims to have received the watch as a gift. In reality, Carl stole the watch from Todd. Todd learns that Ervin has possession of his watch, what are his options for securing its return?
- **Resource Video:** <http://thebusinessprofessor.com/conversion/>

10. What is “defamation”?

Defamation is the publication of an untrue statement about another that subjects that individual’s character or reputation to contempt or ridicule. “Publication” simply means that the untruthful statement was told or made known to at least one other person.

- **Note:** Individuals and businesses can sue for defamation. In business, false accusations of dishonesty or inability to pay one’s debts frequently lead to defamation suits. Approximately one-third (1/3) of all defamation claims are brought by employees against present and former employers.

Types of Defamation

There are three general types of defamation:

- **Slander** - Slander is spoken or oral defamation.
- **Libel** - Libel is recorded defamation (i.e., written) or defamation over the television or radio.
- **Disparagement** - Disparagement is defamation of another person’s trade or business prowess, product, or service.

- **Discussion:** Why do you think the government recognizes a legal cause of action for defamation? Should a business’s reputation be treated differently than an individual’s reputation? Why or why not? Should verbal defamation be treated differently than recorded defamation? Why or why not? Should defamatory statements be treated differently depending upon how they are communicated (written, spoken, text, song, video, etc.)? Why or why not? Why do you think actions for defamation are common in the employment context? Should employment related defamation be afforded greater or lesser protection than personal character defamation? Why or why not?
- **Practice Question:** Marvin gets into an argument with his supervisor and quits his job. He lists his employer on his résumé. When a potential employer calls his former employer to verify his employment, his former supervisor says all sorts of harsh and arguably untrue things about Marvin. Marvin does not get the job. Does Marvin have a legal action against his former employer?

- **Resource Video:** <http://thebusinessprofessor.com/defamation/>

Defenses to Defamation

There are several recognized defenses to a defamation claim. First, if the allegedly defamatory statement is true, it is an absolute defense. Second, a communication may be privileged under the law and specifically exempted from defamation actions.

- *Example:* In most circumstances, statements made by legislators, judges, attorneys, and those involved in lawsuits (in court or in session) are privileged.
- **Discussion:** Do you think defamation should extend to truthful statements in some situations? Should truthful communications that are presented in a way to create a false impression about someone be defamatory? Why or why not? How do you feel about certain forums being privileged or exempt from defamation actions? What are the arguments for and against such privilege?
- **Practice Question:** Dora learns from Elvis that Sandra has a venereal disease. While this is true, Dora and Elvis are incorrect about the specific disease. When Dora incorrectly tells another person that Dora has a specific venereal disease, has she committed a tort?
- **Resource Video:** <http://thebusinessprofessor.com/defenses-to-defamation-actions/>

1st Amendment Considerations

Special rules apply to defamation of celebrities and public figures and defamation by the news media. The media is not liable for the defamatory untruths they print unless the plaintiff can prove the untruths were published with “malice” (evil intent that is the deliberate intent to injure) or with “reckless disregard for the truth.” Likewise, for a celebrity or public figure to recover for defamation, she must demonstrate that the defendant defamed her with malice or with reckless disregard for the truth.

- **Discussion:** Do you believe that defamation laws violate the 1st Amendment? Why or why not? How should the rights of individuals against defamation be balanced against individual freedom of speech? Do the higher standards for defamation against celebrities, public figures, and the media effectively balance those rights? Why or why not?
- **Practice Question:** Donald is running for political office. He routinely says things about his opponents that are not true. Many of the statements are very offensive and attack the opponent’s personal character. Under what conditions could Donald be liable for his statements?
- **Resource Video:** <http://thebusinessprofessor.com/defamation-and-1st-amendment-considerations/>

11. What is “fraud”?

Fraud is the intentional misrepresentation of a material fact that is justifiably relied upon by someone to his or her injury. The false statement inducing the other party's misunderstanding must regard a material fact about the prospective transaction. Fraud often involves intentional misrepresentations regarding ownership of property or one's financial status.

- *Note:* Fraud may be an intentional failure to disclose a material fact that induces another into action which results in her harm. This may be the case when a legal duty to disclose the material fact exists.
- *Example:* Lying about assets or liabilities in order to get credit or a loan is a common form of fraud.
- **Discussion:** How do you feel about the requirement that fraud be intentional? Should a misrepresentation that is reckless and unverified be considered fraudulent, even if it is not intentional? Why or why not?
- **Practice Question:** Daryl is selling a poster bearing the signature of a known celebrity athlete. Daryl advertises that the poster is 15-years old and was signed when the athlete was a rookie. In reality, the poster was signed recently, following the athlete's retirement. If someone buys the poster based upon Daryl's representations, is there a tortious act? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/fraud/>

12. What is the "intentional interference with economic relations"?

This is a tort based in common law rather than statute. There are several categories of conduct that may violate common law rights of individuals:

- *Disparagement* - This is an untrue statement about someone's business acumen, product, or service. This tort may be addressed as defamation; however, some states lack a statute or common law protecting commercial rights against defamatory statements.
- *Interference with Contractual Relations* - This tort occurs when a non-party to a contract knowingly induces a party to the contract to fail to honor or breach the agreement.
 - *Example:* This situation often arises when one company raids another for employees. The raiding company knowingly induces employees to breach their employment contracts with their current employer.
- *Interference with Perspective Advantage* - This cause of action entails a situation in which there is a business relationship between the plaintiff and a third party. The defendant then acts in a way intended to disrupt the relationship. This conduct is done not for personal advantage but with the purpose of harming the plaintiff. The plaintiff may bring an action to recover the losses or damages sustained.
 - *Example:* A third party intentionally creating distrust between a supplier and vendor to harm the vendor may constitute an illegal interference.
- *Wrongful Appropriation of Business Interests* - This tort arises when a fiduciary breaches the duty of loyalty and appropriates someone else's intellectual property rights, such as patent, trademark, copyright, trade secret, or good will.
 - *Note:* This type of conduct is often addressed in non-compete and non-disclosure agreements. These

agreements establish a contractual right. This is in addition to any common law rights to seek redress in tort for such conduct.

- *Example:* An employee downloading an employer's client list (that is a trade secret) with the purpose of opening her own business would constitute wrongful appropriation.

- **Discussion:** How do you feel about the tort of intentional interference with contractual relations? Does the tort conflict with valid business practice? Why or why not? Who do you think this cause of action is meant to protect?
- **Practice Question:** ABC, Inc., is a competitor of 123, Inc.? ABC knows that 123's contract with Supplier Corp is instrumental to its business operations. ABC offers Supplier Corp a substantial sum of money to breach its contract with 123, Inc. ABC does not plan on doing business with Supplier Corp. What are 123's legal options and why?
- **Resource Video:** <http://thebusinessprofessor.com/intentional-interference-with-economic-relations/>

NEGLIGENCE TORTS

13. What is "negligence"?

Negligence is unreasonable behavior that causes injury to another person or business.

Elements of Negligence

Five elements make up a claim for negligence:

- existence of a duty of care owed by the defendant to the plaintiff;
 - unreasonable behavior by the defendant that breaches the duty of care;
 - causation in fact;
 - proximate causation; and
 - an actual injury.
-
- **Discussion:** What are the core differences between intentional torts to negligence actions? How does the existence of a duty to act reasonably compare to intentional activity with a specific *mens rea* attributable to the activity?
 - **Practice Question:** Luther is driving through a parking lot and listening to music through his headphones. He inadvertently runs into Sandra, who is walking through the parking lot. What type of legal action potentially exists in this scenario?
 - **Resource Video:** <http://thebusinessprofessor.com/negligence-actions/>

14. What is a “legal duty”?

The first element of a negligence tort is establishing the nature and extent of the defendant’s duty to the plaintiff. A duty generally arises pursuant one’s conduct or activity, such as assuming a position of authority, control, or other special relationship with someone. Any form of activity in the presence of or otherwise affecting a third party gives rise to a duty of care. A special relationship between individuals may include: parent-child, doctor-patient, attorney-client, etc. The extent of a person’s duty to others is based upon the nature (or genesis) of that duty. Once the nature of the duty is determined, the individual owing the duty must use reasonable care and skill in her actions. That is, an individual must act reasonably in a given situation (based upon the nature of the duty owed) to avoid causing harm to those to whom she owes a duty. The greater the risk or potential harm to others, the greater the level of care required to meet the duty owed.

- *Example:* An individual who decides to drive an automobile owes a duty of care to other motorists and pedestrians. An individual walking on the sidewalk with others owes a duty not to walk carelessly and bump into others.
- **Discussion:** How do you feel about the duty to act reasonably? What level of interaction between individuals gives rise to a duty? What types of factors should contribute to the establishment and strength of the duty between individuals?
- **Practice Question:** Eric is a lifeguard by profession. He is taking a leisurely stroll along the lake when he notices a person in distress. Does Eric have a duty to attempt to rescue the individual drowning individual?
- **Resource Video:** <http://thebusinessprofessor.com/duty-of-care-negligence/>

15. What is “unreasonable behavior” that constitutes a breach of duty?

Negligence entails unreasonable behavior that breaches the duty of care that the defendant owes to the Plaintiff. This standard is known as the “reasonable person” standard. Whether conduct is unreasonable is a mixed question of law and fact. The duty of care exists under the law, but the determination of what is reasonable may be unreasonable in another situation. In determining whether conduct is unreasonable, a court will consider “the likelihood that the defendant’s conduct will injure others, taken with the seriousness of the injury if it happens, and balanced against the interest which he must sacrifice to avoid the risk.” Notably, the reasonable person standard of care is an objective standard based upon the nature of the relationship and the subjective characteristics of the plaintiff.

- *Note:* A professional, such as a doctor, will be held to the standard of a reasonable professional in a given situation. A failure of a professional to act reasonably within the scope of her duties is known as “malpractice”. Further, a large person interacting with a small child may owe a higher standard of care to avoid harmful physical contact than a small person interacting with a large person.

Inaction as Unreasonable Behavior

In some situations, inaction may constitute unreasonable behavior. This is true when a special relationship exists or one individual causes the risk of harm to the other person. In such a situation, an individual incurs an affirmative duty to act.

Failing to act drops below a reasonable standard of care.

- *Example:* A mother fails to help her child cross the street. If the child strays into traffic and is injured, the mother's inaction is negligent in causing harm to the child. A mother is assumed to act in the best interest of her child, such that others will not act assuming the mother will act. I push a non-swimmer into deep water, I now have a duty to act reasonably in preventing that person from drowning. My inaction to rescue her will result in liability.

Gross Negligence, Reckless & Wanton Behavior

Negligence generally entails a simple failure to meet the standard of care owed to others. "Gross negligence", in contrast, is a severe departure from the standard owed.

- *Example:* I am rock climbing with a friend. I do not hook our climbing rope in carabiners every 5 feet, as recommended. I think we will make better time if I hook the rope every 15 feet. When my friend slips, he falls 15 feet, rather than 5 feet, before the rope catches him. This causes him to slam very hard into the rock face. This may be an example of gross negligence. I may not have intended the result or appreciated the risk, by my actions fall way below an acceptable standard of care.

"Reckless" behavior demonstrates a complete disregard for the potentially harmful consequences of one's conduct. It generally requires a defendant to appreciate the nature and severity of the potential harm that may arise from the conduct. Though it does not entail intent to cause the harm, it shows an extreme lack of due care. Such conduct falls below the standard of care owed to other individuals and constitutes negligence. In some jurisdictions reckless conduct is known as "aggravated negligence". The law frequently allows a plaintiff to recover punitive damages as well as actual damages in such situations.

- *Example:* Shooting an arrow up into the air without knowing whether anyone will be harmed by the arrow could be reckless conduct.

Res Ipsa Loquitur & Negligence Per Se

Two situations exist where a defendant may either be held liable without a showing of unreasonable conduct or the unreasonableness of conduct is inferred from the facts of the situation.

- "*Res Ipsa Loquitur*" posits that in some situations the very nature of the accident or situation indicates that conduct of the defendant was negligent. That is, this type of harm would not have occurred in the absence of negligence by someone in the defendant's position. As such, it is not necessary to demonstrate how a reasonable person would or should have acted in the situation.
 - *Example:* Tom is walking by a building when a potted plant falls on his head. It is apparent that the potted plant fell from the room of the building where there is a community garden. Ginny keeps a garden and is present in the garden when the plant falls. There is no evidence that Ginny intentionally dropped the plant or that she was negligent in allowing the plant to fall, but this could result in her liability for negligence pursuant to *res ipsa loquitur*. It is abnormal that a plant would fall from the top of the building unless someone was negligent in her actions causing the resultant harm.
- Negligence *per se* posits that a failure to meet a standard or guideline, often established by a statute or regulation,

means an individual is negligent without examining whether the individual's conduct in the situation was reasonable.

- *Example:* A professional practice group may establish standards of conduct for its employees. If an employee does not comply with that standard, it could be negligence *per se*. Violating the standards is assumed negligent without a demonstration of how a reasonable person would act. Further, if an individual is involved in a car crash while speeding, the violation of the speed limit may demonstrate negligence *per se* without a need to show that a reasonable person would not have been driving at that rate of speed.

- **Discussion:** How do you feel about using the fictional, reasonable person standard to determine whether an individual has acted reasonably? Do you think that the reasonable person standard varies depending upon the fact-finder? Why or why not? Does it surprise you that inaction can constitute unreasonable behavior in some circumstances and not in others? Why or why not? Should reckless and wanton behavior be considered an intentional tort or unreasonable behavior for purposes of liability? Why?
- **Practice Question:** Eric is a lifeguard by profession. He is taking a leisurely stroll along the lake when he notices a person in distress. He begins to swim after the drowning individual. A few feet into the water, he realizes the water is cold. He does not want to get sick, so he quickly gets out of the water and goes on his way. Has Eric committed a tort?
- **Resource Video:** <http://thebusinessprofessor.com/breach-of-duty-of-care/>

16. What is “Causation in Fact”?

In a negligence action, the defendant's conduct must have caused the injury to the plaintiff. Causation in fact presents the question, “but for” the act of the defendant, would the injury have occurred? This is the broadest aspect of causation, as any number of causes together could have contributed to the injury. The jury must determine whether the defendant's conduct is a “substantial, material factor in bringing about the injury”. If there are multiple defendants, each individual defendant can be held jointly and severally liable for the collective actions of the group.

- **Discussion:** Can you think of a situation where an individual is a contributor to an outcome, but the outcome would have occurred regardless of the individual's involvement? Should a person be held liable if a particular damage would have occurred regardless of her involvement in a tortious activity? Why or why not?
- **Practice Question:** Jessica and 5 friends are jumping up and down on a trampoline. Terry falls while bouncing, but the other friends continue to bounce. Terry is thrown from the trampoline by the force generated by the other bouncers. Is Jessica's conduct the cause in fact of Terry's injury?
- **Resource Video:** <http://thebusinessprofessor.com/cause-in-fact-element-of-tort-liability/>

17. What is “Proximate Causation”?

Proximate causation means that the harm suffered by the defendant was reasonably foreseeable as a result of the plaintiff's conduct. More specifically, for the type of injury to be foreseeable, the plaintiff must be one whom the defendant could reasonably expect to be injured by a negligence act. Further, the injury must be caused directly by the defendant's negligence. The relationship between the defendant's actions and the harm caused cannot be too far removed or tenuous. This may be the case when an unexpected intervening actor or occurrence is involved in bringing about the harm. It would breach the "chain of causation" necessary for finding a defendant negligent. This determination is left for the jury to decide.

- **Discussion:** How do you feel about the "reasonably foreseeable" standard? What factors should influence what one determines to be reasonably foreseeable? Can you think of scenarios where the outcome would not occur without a person's involvement, but the outcome is not reasonably foreseeable from her conduct? Should conduct that is reasonably foreseeable to result in a particular outcome give rise to liability, even if the outcome would have occurred without the individual's involvement? Why or why not?
- **Practice Question:** Jessica brings a box of fireworks on a train. While she is boarding, she trips and the box of fireworks explodes. The explosion shakes the loading platform violently. At the opposite end of the loading platform, a large vending machine falls over and injures a passenger. Is Jessica the proximate of the passenger's injury? That is, does bringing fireworks on a train lead to a foreseeable risk that a distant, heavy object will fall over and hurt someone? Or, is the tall, heavy, inherently unstable design of the vending machine an intervening cause that negates proximate causation?
- **Resource Video:** <http://thebusinessprofessor.com/causation/>

18. What are the common defenses to negligence actions?

Jurisdictions commonly recognize three principle defenses to negligence actions.

- *Contributory Negligence* - This doctrine bars a plaintiff's recover in a negligence action if her own fault contributed to the injury "in any degree, however slight."
 - *Note:* Contributory negligence is only applied in a few jurisdictions and in limited circumstances.
- *Comparative Negligence* - Comparative negligence compares the degree of fault assessable against the defendant with that assessable against the plaintiff. The jury is left to access the percentage of negligence between the parties.
 - *Pure Comparative Negligence* - In a pure comparative negligence jurisdiction, the plaintiff can only recover the percentage of damages not attributable to her own fault.
 - *Example:* If the plaintiff is 90% negligent for her loss of \$100k, she can only recover \$10K from the defendant.
 - *Modified Comparative Negligence* - In a modified comparative negligence state, the plaintiff cannot

recover if her negligence is greater than (or “as great as” in some jurisdictions) the negligence of the defendant.

- *Example:* If the plaintiff’s negligence is less than 50% compared with that of the defendant(s), she can recover damages. Her recover is reduced, however, by her percentage of negligence.
- *Assumption of the Risk* - Assumption of the risk arises when the plaintiff knowingly and willfully undertakes an activity made dangerous by the negligence of another. That is, the plaintiff identifies a potentially harmful situation brought about by the defendant’s conduct, understands the risk associated with the situation, and proceeds to voluntarily expose herself to this risk of harm. This is a defense against any harm suffered by the plaintiff as a result of this exposure. In some situations, the parties can contractually acknowledge certain risks in a given activity. This may have the effect of assuming the risk of any harm suffered as a result of those risks.
 - *Example:* Skydiving is an inherently risky activity. Bob hires Plane Jumpers, LLC to instruct him in this activity. Before his first solo jump, Bob signs an acknowledgement of the potential dangers inherent in this activity. Bob is injured when heavy winds cause him to crash while landing. His acknowledgement is likely an assumption of this risk — which may bar his recover from PlaneJumpers for allegedly negligent instruction for not preparing him for landing in heavy wind.

- **Discussion:** Which, if any, of the defenses to negligence do you find most compelling? Why?
- **Practice Question:** Beverly owns a small store. She recently mopped the floor and placed “wet floor” signs all around the area. William is wearing sneakers with small wheels on the sole. These wheels allow him to skate around on smooth surfaces. He approaches the wet floor area and takes notice of the sign. He proceeds to skate across the wet floor, but falls and breaks his ankle. If William sues Beverly, what defenses might she put forward?
- **Resource Video:** <http://thebusinessprofessor.com/defenses-to-negligence/>

STRICT LIABILITY TORTS

19. What is “strict liability”?

Strict liability concerns an individual’s legal liability for injury-causing behavior that is neither intentional nor negligent. Basically, an individual will be liable for any harm resulting to a third party from a course of conduct to which strict liability applies. Injuries caused while working with explosives, dangerous animals, product design or manufacturing, and serving alcohol to the public are strict liability torts in most states.

- *Example:* Beth has a business conducting fireworks shows. She is hired to conduct the fireworks display during a 4th of July celebration. During the event, a large firecracker veers into the crowd and explodes. Two people are injured by the explosion and sue Beth. She will be held strictly liable regardless of the amount of care she exerted in orchestrating the show.

- **Resource Video:** <http://thebusinessprofessor.com/strict-liability/>

20. What is “strict products liability”?

Strict products liability involves the commercial sale of defective products. In most states, any retail, wholesale, or manufacturer who sells an unreasonably dangerous, defective product that causes injury to a user of the product is strictly liable. This applies to commercial sellers who normally sell products like the one causing injury or who place them in the stream of commerce, such as suppliers of defective parts and companies that assemble a defective product.

There are two kinds of defects for purposes of strict product liability:

- *Production Defects* - A production defect occurs when products are not manufactured to a manufacturer’s own standards. Consumers of the defective product are later injured as a result of this variation from the manufacturer’s standards.
- *Design Defects* - A design defect occurs when a product is manufactured according to the manufacturer’s standards but is an unsafe design. The product injures a user due to its unsafe design.

If either of these defects makes the product unreasonably dangerous if used as intended, any seller of the product (from manufacturer to retailer) may be liable for an injury caused by the defective product. Strict products liability is useful in protecting individual consumers who suffer personal injury or property damage.

- **Discussion:** How do you feel about the fact that anyone in the chain of distribution can be liable for design or manufacture defects? Why do you think the law allows for such wide liability?
- **Practice Question:** Fancy Motors is a car manufacturing company. They develop a new, compact car for the US market. The car has troubles from the minute it comes off of the assembly line. The gas tank is located behind the fender-well of the vehicle. This leads to an increased risk of fire in the event of a rear-end collision. Also, Fancy Motors installed a seatbelt system that is designed to have three points of contact with the car frame. Due to space concerns and a lack of understanding of the seatbelt system, Fancy only attached the seatbelt to the frame in two locations. Can you identify any points of potential liability for Fancy Motors in this scenario?
- **Resource Video:** <http://thebusinessprofessor.com/strict-product-liability/>

21. What other common strict liability causes of action exist?

Most states recognize similar types of conduct as subject to strict liability:

- *Ultrahazardous Activity* - Courts may impose strict liability in tort for types of activities they call ultrahazardous. This may include activities such as working with explosives, wild animals, or extreme sports.
- *Dram Shop Acts* - These laws make sellers of alcoholic beverages directly to customers on the seller’s premises liable for harm caused as a result of the consumer becoming intoxicated.
- *Common Carriers* - Carriers of cargo on behalf of others may be strictly liable to the owner for any harm suffered

by the cargo. Risk of loss, however, may be shifted back on the owner *via* contract.

- **Discussion:** How do you feel about the idea that an individual can be held liable for actions without having any intent to achieve a result or knowledge that the action is wrong? What if an individual is intentionally deceived into undertaking activity that entails strict liability?
- **Practice Question:** Garth has a Rottweiler named Alf. Alf is generally very amiable. She has an buried electric fence that keeps Alf in her yard. One day, Alf sees a bicyclist riding by her house. She runs through the electric fence and bites the bicyclist. What is the likelihood that Garth will be held liable in this situation?
- **Resources Video:** <http://thebusinessprofessor.com/examples-of-strict-liability-actions/>

22. What defenses exist to strict product liability actions?

The following defenses affect liability in a strict product liability case.

- *Contributory and Comparative Negligence* - These are generally not defenses to strict products liability actions; though, the negligence of the plaintiff may be used to reduce damage awards.
- *Assumption of the Risk* - If a plaintiff knowingly undertakes a dangerous activity to which strict liability applies, she may be barred from recovering from the defendant for harms suffered. Individuals may contractually acknowledge their assumption of any risks in a given activity. In most jurisdictions, however, assumption of the risk may constitute a defense.
- *Misuse of a Product* - Strict product liability depends upon an individual use the product as intended by the manufacturer or in an otherwise reasonable manner. This means that the defendant may avoid liability if the injury to the plaintiff was the result of using the product in a manner that is not intended or is cautioned against.
 - *Note:* Compliance with federal or state standards regarding the manufacture and design of a product is evidence that the product is not defective, but it is not a complete defense. Many states are beginning to adopt a reasonableness standard for design defects, failure to warn, and testing inadequacies. These standards replace the traditional strict liability standard.
 - *Examples:* Handling fireworks while smoking could be an assumption of the risk if the explosive nature of the product is known or expressed to the user. Removing safety guards from equipment is a common misuse that could constitute a defense to strict product liability.

- **Discussion:** How do you feel about the available defenses to strict product liability actions? Should comparative negligence apply to such actions? Why or why not? Why do you think assumption of the risk is a commonly accepted defense? Should any defense apply differently depending upon who is being sued (manufacturer, distributor, retailer, etc.)? Why or why not?
- **Practice Question:** Mycroft purchases a new Sherlock model of riding lawnmower from Watson's hardware. After

using the mower once, he decides to remove the cover guard from the top of the mower deck. This makes it easier for him to clean excess trimming from the deck after use. One day, he accidentally sticks his foot in the pulleys and severely injures his foot. If he sues Watson's and Sherlock, Inc., under strict product liability, what potential defenses apply?

- **Resource Video:** <http://thebusinessprofessor.com/defenses-in-a-strict-liability-action/>

TORT DAMAGES

23. What are “compensatory damages”?

Tort plaintiffs may generally recover compensatory damages for injuries or losses suffered as a result of the tortious conduct. As the name implies, these damages are used to compensate the plaintiff for an injury suffered and to make the plaintiff whole again. Compensatory damages may include financial loss, pain and suffering, decreased life expectancy, loss of enjoyment, and loss of life or limb. Calculation of damage awards are made by the jury.

- **Note:** Juries may employ life expectancy tables and present value discounts in arriving at a damages award.
- **Discussion:** Do you have any opinions on how compensatory damages should be calculated? Should any factors other than the harm suffered by the plaintiff be considered? Do you think the award of compensatory damages is always fair? Why or why not? Should there be cap on damages? Why or why not?
- **Practice Question:** Arthur gets into an automobile accident. He suffers some bruising and a broken ankle. He also has to take leave from work for several months until his ankle fully heals. The doctors are concerned that Arthur could suffer long-term pain and arthritis in the ankle. He sues the other driver for negligence and wins. What do you think the jury will consider in awarding compensatory damages to Arthur?
- **Resources Video:** <http://thebusinessprofessor.com/compensatory-damages/>

24. What are “punitive damages”?

Punitive damages are used to punish defendants for committing intentional torts and for negligent behavior considered “gross” or “willful and wanton.” The key consideration in the award of punitive damages is the defendant’s motive. Usually, a defendant’s motive must be malicious, fraudulent, or evil. Punitive damages are also awarded for dangerously negligent or reckless conduct that shows a conscious disregard for the interests of others.

- **Discussion:** How do you feel about the award of punitive damages? If punitive damages are awarded by the jury, is it fair that they go to the defendant? Why or why not?
- **Practice Question:** Happy Motor Co. manufactures cars. The company learns that the braking system in the vehicle is subject to fail in certain weather and road conditions. The company calculates the likelihood of losses from lawsuits from the failed braking system and realizes that it would be far cheaper to pay out awards in those lawsuits than to recall all of the vehicles and replace the braking system. When a plaintiff is severely injured

because of the malfunction and sues Happy Motor Co., what type of damages do you think the jury will award and why?

- **Resources Video:** <http://thebusinessprofessor.com/tort-damages/>

TOPIC 10: CONTRACT LAW

Overview

Contract law concerns the legal principles governing the exchange of goods or services between individuals or businesses. This chapter will explore the sources of contract law applicable to the sale or exchange of goods or services. It will lay out the elements necessary to form a contract and each party's duty of performance under the contract. It will examine key contract principles, such as performance, breach, enforceability, voidability, etc. It will lay out the generally applicable rules that courts employ when interpreting contracts. This includes rules about what terms or communications are considered to be part of the contract. Lastly, it explores the remedies available to parties who suffer harm as a result of another party's breach.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• Contract • Restatement of Contracts & Uniform Commercial Code • Unilateral & Bilateral Contract • Types of Contract - Express - Implied-in-Fact Contract - Implied-in-Law Contract • Elements of a Contract • Offer • Terminate an Offer • Acceptance of Offer - Mirror-Image Rule - UCC Rule - Silence as Acceptance - Mailbox Rule • Consideration • Promissory Estoppel • Valid & Enforceable Contract • Void & Voidable Contract - Mental Capacity - Lawful Purpose - Voidable Contracts	• Statute of Frauds - Exceptions • Contract Beneficiaries - Third-party Donee - Third-party Creditor • Assignment & Delegation of a Contract • Contract Duty of Performance • Executed and Executory Contract • Contract Performance - Divisible Contract • Discharge Duty to Perform • Conditions Precedent & Subsequent • Conditions on Performance • Impossibility of Performance • Commercial Impracticability • Frustration of Purpose • Waiver & Release • Breach • Resolving a Breach	• Remedies for Breach - Compensatory (Actual) Damages - Consequential Damages - Liquidated Damages - Nominal Damages - Specific Performance - Rescission • Efficient Breach • Interpreting a Contract (Rules) • Parol Evidence Rule • Contract Integration - Complete - Partial • Extrinsic Evidence - Exceptions • Patent & Latent Ambiguity

TOPIC 10: CONTRACT LAW - QUESTIONS & ANSWERS

1. What is a “contract”?

A contract is a legally enforceable promise or an exchange of promises. To be enforceable, the contract must meet certain elements. There must be an offer, acceptance of that offer, and then an intended exchange of value between the parties. These elements demonstrate a “meeting of the minds” between the parties. That is, the parties have a common understanding of the material terms of the agreement. A contract does not have to be a formal, written document. It can be a verbal agreement or it can arise through the conduct of the parties. Those who make a contract do not have to use the word contract or even recognize that they have made a legally enforceable promise. Each state develops its own contract law. Contract law provides confidence and promotes productivity by making private agreements between individuals legally enforceable. Plainly stated, it helps make buyer and seller willing to do business together.

- *Example:* One individual offers to purchase a widget from another person for \$1. The other person agrees. This is an contract, as there is an offer and acceptance of that offer, a planned exchange of value, and a meeting of the minds as to these primary terms of the agreement.
 - *Note:* As you can see, a contract does not necessarily have to be formal or in writing. A simple conversation or even actions of two or more individuals can be a contract.
- **Discussion:** Does it surprise you how easy it is to form a contact? Why or why not? Why do you think it is so easy to form an enforceable contract? Are there any negatives to this? How do you judge whether there is a meeting of the minds between the parties? How do you account for the subjective nature of one person’s understanding?
 - **Practice Question:** Mark goes to an antiques auction. A nice painting comes up for auction and Mark love it. The auction provides extensive background on all of the items being offered. The auctioneer begins taking bids and Mark the winning bidder. Has a contract been formed in this situation?
 - **Resource Video:** <http://thebusinessprofessor.com/what-is-a-contract/>

2. What are the sources of contract law?

States create their own contract law. They pass statutes and allow courts to develop common law. In doing so, state legislators and judges rely upon model laws in developing the statutory and common law. These model laws are known as the Restatement of Contracts and the Uniform Commercial Code. These model laws influence judges who interpret contract law and legislators who draft statutes that resemble (or copy exactly) these model laws. As such, you can study model laws to acquire a broad understanding of how contract law works. You can then look to the specific laws of your state to determine the exact law that applies to a given situation.

- *Restatement of Contract* - The Restatement of Contracts (Restatement) is a model law that deals primarily with contracts that do not involve the sale of goods or when goods are not the primary subject of the contract. Most state common law generally tracks closely the provisions of the Restatement.

- *Article 2 of the Uniform Commercial Code* - Article 2 of the Uniform Commercial Code (UCC) governs contracts for the sale of goods. It has been uniformly accepted by nearly every state in the United States. A sale of goods includes any manufactured product, crops, timber, livestock, attachments to land, exchanged currencies, mined minerals, etc. It does not include intellectual property, securities, non-commodity currencies, and un-mined minerals.

To be subject to the provision of the UCC, goods must be the primary purpose of the contract. If services are the primary purpose of the agreement, the incidental inclusion of goods is not covered by the UCC or corresponding state statutes.

- **Discussion:** What are some of the advantages and disadvantages of model codes of laws? Why do you think states more readily adopt a uniform code of contracts covering the sale of goods, but are less apt to adopt a uniform code covering services?
- **Practice Question:** Jill approaches an interior designer about designing and purchasing furniture for her home. Jill owns a large mansion. The designer quotes Jill a price of \$10,000 for her services and \$1 million for all of the furniture. If Jill's state adopts the Restatement of Contracts and UCC, which model law will primarily govern the contract?
- **Resource Video:** <http://thebusinessprofessor.com/influential-sources-contract-law/>

3. What are “unilateral contracts” and “bilateral contracts”?

Contracts are divided into unilateral and bilateral agreements based upon the duty of performance and how an offer to contract is accepted.

- *Bilateral Contract* - A bilateral contract consists of two promises between individuals that form a contract. Specifically, one party makes a promise to another party that she will do something (or forgo doing something) in exchange for the other party's promise to do something (or promise to forgo doing something).
 - *Example:* Eric promises to wash Julia's car if she promises to pay him \$20. The both activities will occur at some point in the future, so you have two promises of future performance.
- *Unilateral Contract* - A Unilateral contract is an agreement with only one promise. That is, one party promises a future action if the other party performs whatever is requested of her. The promising party does not want a return promise. As such, a contract is formed or comes into exists once the other party begins to perform the requested services.
 - *Example:* Suppose Eric tells Julia that he will pay her \$20 if she washes his car. Eric does not want a promise to wash the car. Julia can accept Eric's offer by beginning to wash his car. Julia is not obligated to wash the car unless or until she begins doing so. Further Eric is not obligated to pay Julia until she begins washing the car.
- *Note:* The common characteristic between unilateral and bilateral contracts is that it entails a promise of

performance and a demand from the offeree. This is critical to the requirement that a contract contain an offer, acceptance, and exchange of value.

- **Discussion:** Why do you think it is important to distinguish and recognize these two types of contracts? Do you think each type of contract is more applicable in either sales of goods or services? Why or why not?
- **Practice Question:** Jennifer is looking for someone to paint her house. She sends out an email to several painters in the neighborhood that she has purchased the paint and will pay \$3,000 to anyone who paints her house. She also includes some detailed requirements for the painting process and states that project must be completed by the coming weekend. Rob shows up the next morning with all of his equipment and ready to paint. Is there a contract in this situation? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/unilateral-and-bilateral-contracts/>

4. What are “express contracts”, “implied-in-fact contracts”, and “implied-in-law contracts”?

- **Express Contract** - An express contract arises from interactions in which parties actually discuss the agreement and the promised terms. The contract does not have to be formal or in writing, but it requires that the parties express their intentions in an agreement.
 - **Example:** One person expressly offers to sell a widget to another person. The other person accepts the offer by saying she will buy it. The parties have an expressed contract because they have stated an offer, stated an acceptance, and identified consideration. These expressions can be verbal, as in this situation, or written.
- **Implied-in-Fact Contract** - An implied-in-fact contract arises from the conduct of the parties, rather than from words. That is, the parties interact in a manner that constitutes a legally enforceable contract. This means that all of the elements of an enforceable contract can be inferred from the actions of the parties.
 - **Example:** Ellen asks Albert, an attorney, for professional advice. Ellen knows that Albert is an attorney and charges for his advice. Asking Albert for his professional advice implies a promise from Ellen to pay the going rate for that advice. This is true even though Ellen and Albert did not make an express promise to pay for it.
- **Implied-in-Law or Quasi-Contracts** - An implied-in-law contract is a contractual relationship ordered by the court. It lacks the mutual assent element of a contract, but the court deems the interactions between parties to be a contract under the law. This court action is generally taken to avoid an unjust result, such as when one party is unjustly enriched at the expense of another. The court will hold that the law implies a duty on the first party to pay the second, even though the elements to find a legally enforceable contract between the two parties are absent.
 - **Example:** Bell routinely rakes leaves in the neighborhood for extra money. She rakes leaves for lots of houses and sometimes forgets which houses have requested her services. She begins raking James's yard, having forgotten that she never worked out an agreement to do so. James often pays individuals to rake his yard and has plenty of money to do so. At the end of the job, Bell asks James for \$20 for her effort. If

James refuses to pay the court may hold that it would be unfair for James to receive this value and not pay something for it. As such, the court could hold that an implied-in-law contract to pay for Bell's services.

- **Discussion:** How do you feel about implied contracts? Should all contracts be required to be expressed? What are some arguments for and against this approach? What do you think is the justification for recognizing implied contracts?
- **Practice Question:** Kyle agrees to purchase building material from Anna, a new employee of a construction materials company. Anna executes a contract but makes an error when pricing the material. Per the terms of the agreement, Kyle will pay far less than the cost of the material. Kyle realizes this, but he stays quiet. Kyle uses the material before Anna catches the error. She sends Kyle an additional bill to cover the cost of the material, but not profit. Kyle refuses to pay the additional amount. What might a court do in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/express-vs-implied-contracts/>

5. What are “valid contracts”, “enforceable contracts”, “void contracts”, and “voidable contracts”?

There are several common characteristics of contracts that dictate whether a contract actually exists and whether it is enforceable in a court of law. The following vocabulary is important for characterizing these aspects of a contract.

- **Valid and Invalid** - A contract is valid when all of the elements essential to forming a legal contract are present. Conversely, a contract is invalid (or rather, there is no contract) if any of the essential elements of a contract are missing. The elements to forming a valid contract (offer, acceptance, consideration, and a meeting of the minds) are discussed further below.
 - **Example:** One person announces that she will sell her cell phone for a reasonable price. Another person quickly says, “I will buy it”. In this case there is not a valid contract because there is not enough specificity in the consideration. As such, a critical piece of the contract is missing. While the parties might think they have a contract, if a challenge to the contract arises, a court is likely to hold it to be invalid.
- **Enforceable and Unenforceable Contract** - An enforceable contract is one that can be enforced in court of law. That is, the law allows for enforcement of the contract. An enforceable contract must always be valid. A valid contract may, however, be unenforceable. That is, even though all of the essential elements of a contract are present, a court will not enforce the contract.
 - **Example:** An oral contract may be valid, but the court will not enforce it because that specific type of contract is required to be in writing under the state's law. Contracts that are required to be in writing are discussed further below.
- **Discussion:** Why do you think there is a distinction between a invalid contract and contract that is unenforceable against a party? Are there any reasons or justifications for treating them as one in the same?

- **Practice Question:** Gayle arrives at work one morning and says to all of her colleague, “I am tire of my piece of junk car. I would sell it right now for \$500.” Bert thinks about Gayle’s statement and determines that it would be a good buy. After lunch, Bert approaches Gayle and says, “I will buy your car” and extends \$500 in cash. Gayle, surprised by Bert’s actions, replies that she is not willing to sell her car. If Bert sues Gayle for breach of contract, what will be the likely result?

- **Resource Video:** <http://thebusinessprofessor.com/enforceable-vs-valid-contracts/>

- **Void and Voidable Contracts** - An otherwise valid contract may be void pursuant to the law. That is, state law identifies certain types of contracts that are deemed void from the outset. These include contracts that violate public policy or have an illegal purpose. A voidable contract is an agreement where either one or both parties has the right to make the contract void. That is, the contract is valid and enforceable until one party elects to void it.

- **Example:** A contract to purchase illegal drugs is void. A party to a contract who is below the legal age of mental capacity may void the contract at any point before she reaches the age of mental capacity. Various situations where contracts are deemed valid, enforceable, void, or voidable are discussed further below.

- **Discussion:** What do you think are the justifications for deeming a contract voidable? Can you think of scenarios where you think one party should be allowed to get out of the contract, but not the other party? Can you think of scenarios where both parties should be allowed out of the contract?

- **Practice Question:** Amy is extremely angry at David. She hires Laura to pour sugar into the gas tank of David’s car. Laura loses her nerve and backs out of their agreement? Can Amy enforce her agreement with Laura?

- **Resource Video:** <http://thebusinessprofessor.com/voidability-of-a-contract/>

CONTRACT FORMATION

6. What elements are required to form a valid contract?

As previously discussed, a contract is a specific promise to another and also a specific demand of that person. The demand could be a promise of future action (bilateral contract) or immediate performance of an act (unilateral contract). The promise and demand is an “**offer**”. Meeting with the offeror’s demand is known as “**acceptance**”. Both parties must give or exchange something of value with the other. The thing of value is known as “**consideration**”. Consideration is the promise to give, or actual giving, of a requested benefit or the incurring of a legal detriment (i.e., doing something one does not have to do.). Both parties must be of a legal age and sound mind, and the purpose of the agreement cannot be illegal or against public policy.

- **Example:** One person offers to sell a product, service, or offers something of value (money, goods, etc.) in exchange for someone else’s product, service, or other thing of value. This constitutes a valid offer. The things of value constitute consideration. A second person accepts the offer by either agreeing to the offeror’s request to trade things or actually trading those valuables.

- *Note:* An important thing to remember is that each party must provide something of value to the other. It does not matter how much value or even whether anyone else in the world would consider it valuable.
- **Discussion:** Why do you think that the law requires an agreement to have all of the elements to be enforceable? Can you think of situations where any of these elements are not present, but you believe the agreement should be enforceable anyway?
- **Resource Video:** <http://thebusinessprofessor.com/requirements-to-form-a-contract/>

7. What constitutes an “offer” to contract?

The following elements must be present to establish a valid offer to contract.

- *Offeror and Offeree* - An offer to contract must contain a specific promise from the person making the promise (offeror) and a specific demand of the individual receiving the offer (offeree).
 - *Example:* I tell you that I will sell you a product for \$5. I am the offeror and you are the offeree. My offer is to transfer ownership of a product and my demand is that you transfer ownership \$5.
- *Intent to Make an Offer* - The offeror must intend to make the offer. Whether there is intent to make an offer is judged from the position of the offeree. If a reasonable person in the position of the offeree would believe the offeror's words or actions constitute an offer, it is an offer. This is an objective, rather than subjective, standard for determining whether the intent to make an offer exists.
 - *Example:* I shout out loud in frustration that I would sell my piece-of-junk car for a \$100. The words look like an offer to sell my car. In reality, I am simply espousing my frustration. I do not have the intent necessary for my statement to constitute an offer and no reasonable person would interpret my statement as truly demonstrating that intent.
- *Definite Terms* - An offer to contract must be sufficiently definite. That is, the terms of the offer must be sufficiently specific to allow the offeree to understand and accept the offer. The offeree must understand that she is the intended recipient of the offer and may accept it. Also, the terms of consideration must be stated.
 - *Example:* Simply stating that I will sell you an item “for a reasonable price” is not sufficient to constitute a definite offer. Most advertisements, catalogs, and web page price quotes are considered too indefinite to form the basis for a contract. To be sufficiently definite, the advertisement must be specific about the quantity of goods being offered and who is the intended offeree.
 - *Note:* There is an exception to this rule for the sale of goods pursuant to the terms of the UCC. Some contracts for the sale of goods can leave open non-quantity terms to be decided at a future time.

Remember, the above elements do not have to be in writing or formal. Further, the parties do not have to realize that their words or actions constitute a valid contract; rather, each element is judged by an objective standard. That is, how would a

reasonable person perceive the actions potentially constituting an offer?

- **Discussion:** How do you feel about the requirement that a contract meet this level of formality? Should it be more or less formal, and why? How do you feel about the fact that individuals can form a contract without fully realizing that their agreement is legally enforceable?
- **Practice Question:** Ashton is reading looking at the merchandise for sale on Smart Clothes Corp's website. He places an order for a new shirt and goes through the process of setting up an account and attempting to pay. At the end of the process, he gets notification that his purchase is discontinued and cannot be purchased. Ashton is furious and wants to sue Smart Clothes for breach of contract. If he does, what is the likely legal result in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-valid-offer/>

8. When does an offer to contract terminate?

An offer to contract terminates at the following times or under the following conditions:

- *Specific Provision* - An offer may include a specific provision detailing how long an offer will stay open and the conditions under which it terminates.
- *Lapse of Time* - Unless the offer states otherwise, an offer terminates after a reasonable period of time. A reasonable period of time will vary depending upon the type of contract.
 - *Example:* An offer to sell bananas will terminate more quickly than an offer to sell cement.
- *Offeree's Rejection* - An offer terminates if the offeree receives the offer and rejects it. Once the offeree rejects the offer, she cannot come back later and accept the offer. Any attempt to do so may constitute a new offer to the original offeror.
- *Counter Offer* - If an offeree makes a counter offer or counter proposal in response to an offer, the original offer terminates. This is the case with negotiations. If a party attempts to negotiate new or additional material terms to the offer, the original offer terminates. Attempting to offer ancillary or non-material terms may not terminate the offer.
- *Revocation by Offeror* - Generally, the offeror may revoke an offer at any time before the offeree accepts it. If the offeree has already accepted the offer, a valid contract exists and an attempt to revoke the offer may constitute breach of the contract.
 - *Note:* There are certain offers, known as "firm offers", that state that the offer cannot be revoked for a certain period. This type of offer is a form of contract in itself.
- *Destroy Subject Matter of Contract* - An offer terminates if, before the offer is accepted, the property that is the subject of the offer is destroyed. If the offer has already been accepted, this could serve to void the contract.

- *Death or Mental Incapacity* - If the offeror dies or loses mental capacity at any time before an offer is accepted, the offer is revoked.
 - *Note*: The offer does not become effective again if the offeror regains mental capacity.
- *Illegality* - An offer terminates if the subject of the offer (the activity or product) becomes illegal. If the offer has been accepted, the subject matter becoming illegal will void the contract.

Some of the methods of contract termination are voluntary, while others are a result of circumstances beyond the control of the parties.

- **Discussion**: Do any of the common methods by which an offer terminates surprise you? What factors should a court consider when determining whether a “reasonable time” has passed? What factors should the court consider in determining whether an offeree has been rejected? Does the rule regarding counter-offers discourage negotiation? Why or why not?
- **Practice Question**: Dudley is interested in purchasing an ownership interest in Sarah’s business. Sarah sends over a term sheet that places a specific value on her business and offers a specific number of shares. Dudley reviews the sheet and sends back a sign subscription agreement that lists a lower valuation, but agrees to buy a larger number of shares. The total purchase price for all shares would equal the amount indicated in Sarah’s term sheet. Sarah writes back and says that she will work with other investors. Dudley is angry and wants to sue for a breach of contract? What is the likely outcome?
- **Resource Video**: <http://thebusinessprofessor.com/terminating-an-offer/>

9. What is “acceptance” of an offer?

Acceptance of a contract is the assent of the offeree to the demands contained in the offeror’s offer. Acceptance of the contract varies depending upon whether the contract is unilateral or bilateral. An offeree accepts a bilateral contract by making the return promise demanded by the offeror. An offeree accepts a unilateral contract by undertaking the performance demanded by the offeror. The acceptance of an offer must meet a specific standard based upon the type of contract and the governing law. The standards that a specific type of contract must meet are as follows:

- *Mirror-Image Rule (Restatement)* - Contracts that are not primarily for the sale of goods may be governed by rules derived from the Restatement of Contracts. The Restatement proposes the “mirror-image rule” for acceptance of an offer. This rule states that the acceptance of an offer must be exactly as demanded by the offeror. That is, the acceptance must “mirror” the offer. If the offeree adds new terms to the acceptance, it is not really an acceptance. Acceptance with different or additional terms constitutes a counteroffer.
 - *Example*: I offer to perform a service for you at a given fee. You reply that my prices are too high and that you want a 15% discount. You changed the terms of the consideration (the price), which is a material aspect of the offer. As such, you have effectively rejected my offer, as your attempted acceptance was not the mirror image of my offer.

- **Discussion:** Why do you think about the mirror-image rule? Does it concern you that a minor deviation in an acceptance can effectively reject a contract? Why or why not? What if this was not the intent of the parties at the time of entering into the agreement?
- **Practice Question:** Kate offers to paint Roger's house for \$2,500. Roger attempts to accept the offer by saying, "Great. But, you have to paint the storage shed in the backyard as well." Kate does not respond and decides to take a different painting job. Roger is angry, particularly when he learns that the next closest offer is twice as expensive. He wants to sue Kate for her failure to perform. What is the likely result?
- **Resource Video:** <http://thebusinessprofessor.com/mirror-image-rule/>

- **Rule for Sale of Goods (UCC)** - The mirror-image rule does not apply to sales of goods under the UCC. The UCC recognizes that a contract is formed if the acceptance of the offer is unequivocal. That is, if it is obvious the parties agree on the primary or material terms of the agreement, an acceptance that changes or adds additional terms is a valid acceptance. The effect of different or additional terms depends on whether the parties are merchants. If either party is not a merchant, any additional or different terms are deemed suggestions for addition and do not become part of the contract. If both parties are merchants, the additional terms become a part of the contract, unless:
 - they materially alter the contract,
 - acceptance is conditioned on the specific terms of the offer, or
 - the offeror specifically rejects the additional or different terms.
 - *Example:* I am a merchant and I offer to sell you goods. You respond that you are willing to purchase the goods, but I must provide you with a warranty. I send the goods and you accept them. If you are not a merchant, there is no warranty. That was simply a recommendation to be part of the contract. If you are a merchant, the warranty is a part of the contract.
 - *Note:* In the above example, if we are both merchants, I could have excluded the warranty from the contract by expressly rejecting the warranty. If I sent the goods and you accepted them, you have agreed to the terms of my original offer.

- **Discussion:** Why do you think the sale of goods employs a different rule than contracts to provide services? Can you think of any reasons for differentiating between the rules that apply to merchants of goods and non-merchants?
- **Practice Question:** Darla is purchasing consumer goods from Isaac's business. Darla sends in a purchase order and the payment for the goods. Isaac sends the goods and a receipt that includes a clause stating that any disputes about the goods must be submitted to arbitration. Darla is not happy with the quality of the

goods and she asks Isaac to return her money. When Isaac refuses she seeks to sue Isaac. What is the result in this situation?

- **Resource Video:** <http://thebusinessprofessor.com/battle-of-forms-ucc-acceptance-of-contract/>

- *Silence with Regard to Offer* - Failing to reply to an offer is not acceptance in most cases. This is true even if the offer says silence will be considered acceptance. There are, however, exceptions to this rule. If the relationship between the parties is such that it is not expected that the offeree reply, silence by the offeree may constitute acceptance. Another exception would be where the offeree readily understands that silence or a failure to respond means acceptance of the offer. This generally only arises in situations where the offeror and offeree have a history of prior dealings. Lastly, in the case of contracts between merchants under the UCC, silence may constitute acceptance of an offer. In some instances, a merchant is required to expressly reject goods that are delivered; otherwise, her silence constitutes acceptance of the contract.

- *Example:* I offer to paint your house for \$100. If you do not respond to my offer, there is no acceptance. If, however, I specifically state that, "If I do not hear anything from you by Friday, I will assume you agree to my offer." You reply, "That sounds good." You now realize that silence become acceptance on Friday. Changing the scenario a bit, you are a contractor and I routinely provide you quotes on houses. You expect me to paint all of your houses. If our routine practice is that I provide a quote and am expected to paint the house if you do not object, silence may be acceptance.
- *Example:* If we are both merchants dealing in expensive bicycles. You make a monthly order with me for the same inventory. One month, I send a shipment of inventory without receiving an order from you. If the goods arrive and you do not reject them for two weeks, your silence constitutes acceptance.

- **Discussion:** How do you feel about the idea that, in some instances, an individual can accept and offer simply by failing to respond? Are you convinced that the applicable exceptions are justified? Why or why not?

- **Practice Question:** Eric enters his email address to receive offers from a CD of the month club. The next week, Eric receives a CD in the mail with instructions state that he must return them within 10 days or he incurs an obligation to purchase the CD. What is the likely result?

- **Resource Video:** <http://thebusinessprofessor.com/silence-is-not-acceptance-of-an-offer/>

- *Mailbox Rule* - The mailbox rule is a default rule that applies when the offeror does not place specific requirements on the manner of acceptance. Under this rule, the offeree accepts the offer when it is sent to the offeror. This could include dropping it in the mail or sending it with a courier. This may also include providing notice of acceptance *via* email or other electronic communication (regardless of whether the offeror actually checks or reads the email). As such, if an offer is made to multiple offerees, the first offeree to accept in any manner (including by dropping the acceptance in the mail) has a binding contract.

- *Example:* You offer to sell me your car for \$500. I immediately send you a letter accepting your offer and

a \$500 check. We have a contract as soon as I drop the letter in the mail.

- **Discussion:** What do you think about the mailbox rule? Should it be the default rule in contracts? Why or why not?
- **Practice Question:** Pamela is a musician and writer. She offers to sell her copyright to a popular song to Devon and Mark. Devon drops his acceptance of the offer in the mail on Friday evening. On Saturday morning, Pamela meets with Mark and signs an agreement transferring the copyright to him. What is the likely result in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/mailbox-rule-for-contracts/>

10. What is “consideration” in the context of contract formation?

Consideration is anything of value. Recall that a valid contract must include an exchange of value between the offeror and offeree. The value should be the inducement or incentive for the other party entering into the agreement. That is, it must be the subject of the bargain between the parties. A promise to make a gift is not binding because the party receiving the gift gives no value in return for the promise. When the existence of consideration is not clear, the court will examine the transaction as a whole to determine if consideration exists and the contract is enforceable.

- *Types of Consideration* - The amount or value of the consideration present does not matter. It need not be money or goods. Acceptable types of consideration include:
 - *Agreement to Refrain:* An agreement to refrain from doing something that you have the right and ability to do may constitute consideration.
 - *Example:* I really want to stand up and sing in the middle of a crowded restaurant. You would be very embarrassed if I do so. You offer me \$5 to not stand up and start singing. My refraining from doing this may constitute consideration.
 - *Agreement not to Sue:* An agreement not to sue the other party may be sufficient consideration when reasonable grounds exist to make a lawsuit possible.
 - *Example:* You claim that I owe you additional funds under a contract. I disagree and argue that all accounts are settled. You threaten to sue me. I offer to pay you a small sum of money in exchange for your agreement not to bring a legal action against me. Forgoing your right to sue me in exchange for money is a valid exchange of consideration.
- *Prior Consideration* - Generally, consideration in a prior agreement is not valid consideration in a new agreement, except in very limited circumstances. The reason is because the individual is already obligated under the old agreement. Trying to promise to do the same thing does not provide a new form of value. Under the UCC, however, a preexisting obligation can constitute valid consideration if the offeror is a purchaser of \$500 or more in goods, and she offers to pay more than an additional \$500 for the same goods. This exception exists to protect certain business arrangements from failing.

- *Example:* We are both merchants. You enter into a contract to purchase goods from me for \$5,000. In the pendency of the contract, you realize that I am likely breach the contract. You really do not want to find another seller, so you offer to pay an additional \$1,000 for me to perform the contract. May agreement to perform my existing contractual obligation (sell you the goods) is valid consideration - even though it is the consideration for a prior agreement.

- **Discussion:** How do you feel about the requirement for consideration? Should there be a value requirement for the consideration? Why or why not? What do you think is the purpose or objective behind requiring any form of consideration, regardless of the nature or value?
- **Practice Question:** Donna is merchant and enters into a contract with Ashley to purchase bricks from me for \$10,000. In the pendency of the contract, the cost of bricks rises dramatically. Ashley will lose money by selling the bricks to Donna for \$10,000. Donna realizes that Ashley is going to lose money and will likely breach the contract. Donna really needs the bricks and it is most convenient to purchase from Ashley. She offers to pay an additional \$1,000 for the bricks. If, after Ashley ships the bricks, Donna decides not to pay the additional \$1,000, what is the probable result?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-consideration/>

- *Promissory Estoppel Exception to Consideration Requirement* - A doctrine known as “promissory estoppel” may serve as a substitute for consideration to make an agreement into a valid contract. Promissory estoppel is an equitable doctrine. If the offeree reasonably relies on the offeror’s promise to her detriment, the doctrine of promissory estoppel may make the contract valid despite the absence of consideration. The two key elements are:
 - that the reliance must be reasonable in light of the situation, and
 - the relying party must suffer a tangible detriment.
- *Note:* The court may also consider whether performance causes a hardship on the promising party.
- *Example:* You are having erosion problems in your yard. You cannot afford to pay to have it fixed, so I offer to give you the materials necessary to build a retaining wall. You spend your available money grading out the ground and digging the dirt where the wall will go. After all of this, I back out of my promise. You have now spent your available money and, without installing the wall, made the situation far worse than it was before. A court may deem my promise to be an enforceable contract because you relied to your detriment on my promise.

- **Discussion:** How do you feel about the idea that a person’s reliance on another person’s promise can substitute for consideration? How much of a detriment must the relying party suffer before you think a court should enforce the agreement? Should the promise be enforced if it would result in a significant hardship for the promising party?

- **Practice Question:** Tina says that she will give Sam her car to drive across the country from Georgia to California. Sam relies on Tina's promise by not purchasing a plane ticket. Tina fails to follow through with her promised gift. Sam has to purchase a plane ticket that is dramatically more expensive than it would have been if he had purchased the ticket at the time that Tina made her promise. If Sam wants to sue Tina for breach of contract, what is the likely result?

- **Resource Video:** <http://thebusinessprofessor.com/promissory-estoppel/>

- *Other Exceptions to Consideration Requirement* - There are two very broad, common exceptions to the requirement that a contract be supported by consideration.
 - *Option Contracts* - An option contract is an agreement between parties that allows one party a specific period of time to purchase a particular asset at a given price.
 - *Example:* Mark believes that the price of Apple, Inc., stock is going to rise. He purchases an option contract from Tom that allows him to purchase the Apple stock at the current price at any time within the next 30 days. Tom believes that the price is going to go down, so he is happy to sell the option to Mark.
 - *Firm Offers* - The UCC recognizes the enforceability of a promise to keep open (not retract or cancel) the offer to purchase or sell a good for a specific period of time.
 - *Example:* Agnes offers to sell a piece of equipment to Maria. She states that the offer is good for 30 days. Agnes and Maria now have an enforceable agreement for the next 30 days, despite the absence of consideration in the agreement to keep the offer open.

- **Resource Video:** <http://thebusinessprofessor.com/options-contract-and-firm-offers-exception-to-consideration-requirement/>

ENFORCEABLE, VOID, & VOIDABLE AGREEMENTS

11. What is “mental capacity” to contract?

To enter into a contract, a person must have mental capacity sufficient to understand the nature and consequences of her actions. If mental capacity is absent, the contract is voidable by the person lacking capacity. There are three classes of persons commonly understood to lack capacity to be bound by contractual promises:

- *Minors* - A minor is someone below the statutory age of mental capacity within a jurisdiction. Generally, a person must be 18 years old or older to have the requisite mental capacity to contract. As such, a minor who enters into a contract can void the contract at any time prior to reaching the age of majority. The exception to this rule is when the contract involves goods or services necessary for the child's survival. This could include food, water, shelter, etc. In the case of necessities, the child will be obligated to pay the reasonable value of the goods or services received. If the child fails to disaffirm the contract by this time, she thereby ratifies the contract and is bound

going forward.

- *Example:* Jane is 17 years old. She goes to a local gym and signs up for a year-long membership. This is not a contract for a necessity. Jane will be able to void the contract at any time before she turns 18 years old. She will, however, have to pay the reasonable cost of any value she receives from the gym.
- *Intoxicated Person* - An intoxicated person may lack the mental capacity necessary to contract. Generally, this will require extreme intoxication. If the intoxicated person enters into a contract, she must disaffirm the contract within a reasonable time of regaining capacity and learning of the contract. If she fails to do so within a reasonable time, she has ratified the contract and will be bound.
 - *Example:* Don gets incredibly drunk in a bar. He does not know where he is and asks a stranger for a ride home. He offers to give the stranger, Gary, his Rolex watch in exchange for a ride home. Gary takes him home and takes the Rolex. When Don sobers up, he can immediately demand return of the Rolex. He was too intoxicated to appreciate the nature of his actions. As such, he can void the contract. He must act within a reasonable period to void the contract upon becoming sober.
- *Mentally Incompetent Person* - A mentally incompetent person generally lacks the ability to enter into a contract. If the mental incompetency is temporary, the individual must disaffirm any contract entered into during incapacity within a reasonable time of regaining capacity. If the person is permanently incapacitated, the contract is either void or voidable at the insistence of a legally appointed guardian.
 - *Example:* Ernie is having psychotic delusions. He goes to a security firm and hires a private security guard. Ernie's legally appointed caretaker will be able to void the contract based upon Ernie's lack of mental competence to enter into the agreement.

Each state may pass additional situations in which it deems an individual mentally incompetent to enter into contractual relations.

- **Discussion:** How do you feel about the requirement for mental capacity to contract? Do you agree with arbitrarily setting an age at which a person is deemed to have mental capacity? Why or why not? How should a person's level of intoxication be measured to determine whether she has mental capacity to contract?
- **Practice Question:** Phyllis is in a bar and drinking heavily. She realizes that she cannot drive in her state, so she solicits a ride from Harriet. She does not have any money, so she offers Harriet her new Rolex watch in exchange for a ride. Harriet accepts and drives Phyllis 3 miles to her home. The next morning Phyllis realizes that she traded a very expensive watch for a 3-mile ride. What are Phyllis' options?
- **Resource Video:** <http://thebusinessprofessor.com/mental-capacity-to-contract/>

12. What is the requirement that a contract have a "lawful purpose"?

A contract must have a lawful purpose to be enforceable. That is, the contract cannot violate or cause others to violate the law or public policy.

- *Crimes and Torts* - Contracts that require commission of a crime or tort or violate accepted standards are void. If a contract has both legal and illegal provisions, a court will often enforce the legal provisions and refuse to enforce the illegal ones.
- *Unconscionable Contracts* - An unconscionable contract is one that is so unfair that it is said to “shock the conscience”. Unconscionability is broken down into “substantive unconscionability” and “procedural unconscionability”.
 - *Substantive Unconscionability* - This means that the terms of the agreement are so extremely unfair or one-sided in favor of a party that it is unlikely that the other party to the agreement understood its terms.
 - *Procedural Unconscionability* - This refers to the conditions under which the contract was formed. The terms of the contract may indicate that one party was taken advantage of by another party with greater bargaining power. Such a contract may be void as against public policy if the circumstances indicate that a reasonable person would not have entered into the agreement without the existence of an undue hardship. In some situations, the undue hardship must have been brought on by the party unduly benefited by the contract.
- *Contracts that Restrain Trade* - Contracts that restrain trade may be illegal and thus void. This is true for contracts that create a monopoly, fix prices, and divide up markets. This is generally the area of antitrust law. A court may also find a contract void if it serves to frustrate economic activity in a manner not covered by antitrust law or it intentionally interferes with contractual relations or unfairly competes.
 - *Example:* An example of a contract that directly prohibits competitive business activity is a “covenants not to compete”. This type of contract restricts an individual from carrying on a trade or practice. These contracts are held to be void when they are unduly burdensome in their restrictions regarding the time and geographic locations for doing business. A covenant not to compete that has a limited time frame (3-6 months) and a limited jurisdiction (up to 50 miles) is generally enforceable if there is good reason for the restriction.

States are free to pass statutes or develop common law that protects the public interest. A contract that runs afoul of what is deemed necessary for the public good may also be void.

- **Discussion:** How do you feel about the requirement that a contract have a lawful purpose? Can you think of any situations where this requirement may cause an unfair result for parties? Should there be a sliding scale for determining enforceability of contracts that violate public policy or are illegal? Why or why not?
- **Practice Question:** Carter lives in New Orleans, Louisiana. The state is in a state of emergency based upon an approaching hurricane. Carter, along with thousands of other people, attempts to flee the city. The traffic is horrible and folks are running out of gas on the roadway. Carter is low on gas and pulls into a gas station. The gas station is charging \$250 per gallon of gas. Carter is outraged, but purchases the gas and continues to flee the city. What are his legal options?
- **Resource Video:** <http://thebusinessprofessor.com/lawful-purpose-for-contracts/>

13. What common situations give rise to a voidable contract?

- *Fraud* - Fraud involves an intentional misstatement of the material (important) fact that induces one to rely justifiably to his or her injury. If a person is defrauded into entering a contract, the defrauded party may void the contract upon learning of the fraud. Voiding the contract is at the option of the defrauded party, as she may wish to remain in the contract. The party committing fraud may not void the contract. If the defrauded party fails to void the contract upon learning of the fraud, she is deemed to have ratified it and is bound.
- *Misrepresentation* - Misrepresentation is a material misstatement of fact that induces one to rely on the statement. The difference with misrepresentation and fraud is that misrepresentation does not involve the intent to mislead. As in the case of a fraud, a party who enters a contract as a result of a material misrepresentation may void the contract upon learning of the false representation. The misrepresenting party may not void the contract. If a party fails to void the contract upon learning of the misrepresentation, she is deemed to ratify the agreement.
- *Duress* - Duress means the use or threat of force to convince a person to act according to one's wishes. If a party enters into a contract due to the physical or economic duress imposed by the other party, the contract is voidable at any time by the party subject to duress.
- *Undue Influence* - Undue influence arises when one party unfairly takes advantage of another party by using a position of trust, influence, or confidence.
 - *Example:* A psychiatrist who enters into a contract with her patient that is not related to medical services may be deemed to have exercised undue influence. The influenced party may have been pressured to enter into the agreement or felt unduly obligated to enter into the agreement for fear of destroying the doctor-client relationship.
- *Mutual Mistake* - A mistake by both parties regarding "material" facts or circumstances relevant to the contract may make a contract voidable. In such a situation, either party may void the contract upon learning of the mutual mistake. The standard for whether the mistake of fact is material is whether a reasonable person would have entered into the agreement if the true facts were known. A mutual mistake of law may make a contract voidable if it caused the parties to not have a "meeting of the minds" with regard to the core aspects of the contract. If no meeting of the minds exists, there is never a valid agreement between the parties.
- *Unilateral Mistake* - Generally, unilateral mistake by one party to the contract does not make the contract voidable. A unilateral mistake about the basic assumptions of the contract will only make the contract voidable when the non-mistaken party knew or had reason to know of the other party's mistake. In such a case, the effect of enforcing the contract against the mistaken party must be unconscionable and the non-mistaken party would not suffer a substantial hardship by voiding the contract. If the non-mistaken party did not know about the other party's mistake, the standard for voiding the contract is even higher. In such a case, the contract must not yet have been performed or the parties must be easily restored to their pre-performance positions. The mistake must be substantial, and the mistake must directly relate to some computational or clerical error in the construction of the terms of the agreement.
 - *Note:* No defense exists if the mistaken party knowingly assumed the risk of the mistake; is grossly

negligent in making the mistake; violates a legal duty; fails to act within her duty of good faith and fair dealing; or intentionally fails to read the contract.

- **Discussion:** How do you feel about the idea that both parties may hold the right to void a contract? Is there any justification for holding that the contract is void rather than voidable? Do you agree with the scenario under which a unilateral mistake is voidable? Why or why not?
- **Practice Question:** Constance enters into an agreement to purchase Gerald's business. The contract contains a calculation for the business's cash on hand at the time of sale to be added to the purchase price. Constance and Gerald did not pick up on the calculation error at the time of signing the agreement. The week prior to closing, Constance's attorney caught the error, which causes a huge increase in the calculated value of the business. Gerald wants to hold Constance to the dramatically increased price, as she signed the contract containing the calculation error. What are Constance's options?
- **Resource Video:** <http://thebusinessprofessor.com/voidable-contract-scenarios/>

14. When is a contract required to be in writing?

Some valid contracts are required to be in writing to be enforceable by a court of law. The requirement that a contract be in writing is generally dependent upon the subject matter of the agreement. A statute requiring that a contract be in writing is known as a "statute of frauds". These statutes are designed to prevent fraud in the formation of contracts. Most statutes do not require that the entire contract be in a formal writing; rather, there must be sufficient writing (in any form) to demonstrate the core aspects of the agreement.

The following types of contract are generally required to be in writing in all jurisdictions:

- *Sale of an Interest in Land* - Contracts concerning the transfer of an interest in land must be in writing to be enforceable. An "interest in land" includes contracts for mortgages, mining rights, easements, etc.
 - *Example:* I agree to sell you an easement to cross my land. Our contract must be in writing to be enforceable.
 - *Note:* A construction agreement is not a transfer of an interest in land.
- *Collateral Promise to Pay Another's Debt* - Debt surety or guarantee agreements are required to be in writing to be enforceable. These instruments document when one person promises to repay the debt of another. This includes situations where business owners guarantee the debts of their business.
 - *Example:* You approach your rich uncle and ask that he loan you money to buy a car. I am your friend and I promise to repay the loan if you are unable to do so. If you default, your uncle may not be able to recover against me because our agreement is not in writing. That is, your uncle and I do not have an enforceable contract.
- *Cannot Be Performed within One Year* - A contract must be in writing to be enforceable if the duties under the

contract cannot possibly be performed within one year after its making. The ability to carry out the contract must be impossible to a certainty.

- *Example:* You and I enter into an oral contract for services that lasts for twenty months. This is not enforceable, as any service contract or a lease of longer than one year are generally not enforceable.
- *Sale of Goods of \$500 or More* - Sales of goods fall under the provisions of the UCC. The UCC requires that any contract for the sale of goods for \$500 or more must be in writing to be enforceable. Modifications to any such agreement must also be in writing.
 - *Example:* I verbally agree to sell you a piece of equipment for \$750. If I back out of our agreement, you may not be able to enforce our agreement through the courts because the agreement is not in writing.

States may establish other contracts that are required to be in writing to be enforced in that jurisdiction. For example, most states require insurance policies to be written.

- **Discussion:** Why do you think that certain contracts are required to be in writing to be enforceable while others are not? Can you think of any other types of contract that you believe should be in writing to be enforceable? What is your reasoning?
- **Practice Question:** Todd enters into a verbal agreement with Ashley to provide lawn services at her rental property for the next two years. After performing his obligations for one month, he realizes that it is a very difficult property to service and he drastically underbid the job. What are his options?
- **Resource Videos:** <http://thebusinessprofessor.com/statute-of-frauds-explained/>

15. What type of writing is required to satisfy the “statute of frauds”?

To meet the requirements of the statute of frauds, there must be a sufficient writing to demonstrate that a contract exists. The writing can be typed, handwritten, or electronic. The agreement must generally be signed by the party against whom it is being enforced. A signature may be a mark, seal, stamp, electronic signature, or a handwritten agreement. Between merchants, a confirmation regarding the contract by one merchant that is not objected to by the other merchant will be sufficient, even though it is not signed by the other merchant.

- **Discussion:** Why do you think that the definition of a writing is construed so broadly? Is this broad interpretation justified or does it unduly detriment a party? Why?
- **Practice Question:** Frank agrees to sell Amy his collector-edition, signed baseball card. Frank writes on the back of the a napkin, “I agree to sell Amy my Mickey Mantle rookie card for \$2000.” Will this be a sufficient writing to satisfy the statute of frauds?
- **Resource Videos:** <http://thebusinessprofessor.com/types-of-writing-to-satisfy-statute-of-frauds/>

16. What exceptions exist to the requirement that a contract be in writing to be enforceable?

Jurisdictions recognize a number of exceptions to the requirement that certain contracts be in writing to be enforceable. Common exceptions to the writing requirement are as follows:

- *Admission Under Oath* - If a party admits under oath (such as in a deposition or in a court proceeding), the contract may then be deemed enforceable.
- *Part Performance* - A court may deem an oral contract enforceable if the parties (or one party) has partly performed the contract. This principle generally applies to oral agreements to sell or transfer real property (land).
 - *Example:* If the buyer has paid part of the purchase price and taken possession of the land, the court may hold the oral agreement enforceable. This would generally entail a court order to complete the contract performance by signing a deed legally transferring the property.
- *Promissory Estoppel* - The equitable doctrine of promissory estoppel applies in situations where one party relies to her detriment on another party's promise. It arises in a situation where a party believes that her exchange of promises with the other party is a legally enforceable contract. That party puts herself in a position where she would suffer a loss if the other party does not perform.
 - *Example:* Tom promises Jane that he will sell her land to build a house. Jane, relying on the promise, hires individuals to begin grading the land and laying a foundation for the house. Later, Tom refuses to transfer a deed to Jane and claims that the contract is not enforceable because it was not in writing. Jane has spent significant money and time under the belief that the contract was enforceable. As such, a court will probably hold the contract to be enforceable under the doctrine of promissory estoppel.
- *Rules Involving Goods* - The UCC provides several exceptions to the rule that contracts for the sale of goods for \$500 or more be in writing. For example:
 - *Specialty Goods* - If a manufacturer agrees to manufacture specialty goods for a client, once the manufacturer begins production of the goods, the contract may be enforceable without a written agreement.
 - *Partial or Complete Performance* - If goods have been accepted and payment for the goods has been made, the parties cannot later claim that the contract was unenforceable and demand return of the money or property. This may also be true for partial payment or delivery of a portion or installment of the goods.
 - *Contract Between Merchants* - An oral contract between merchants is enforceable when one party delivers goods and the other party either delivers goods or sends written notice confirming the terms of the agreement and the other party does not object to that notice within 10 days.

The justification for the above exceptions to the statute of frauds is that each situation provides an additional level of proof regarding the existence of a contract. It reduces the need for a writing to prove that the contract exists and its terms.

- **Discussion:** Why do you think each of these exemptions from the statute of frauds exists? What standard do you think should apply to determining what is “part performance”? How far should an individual go in relying on a promisor before it exempts the agreement from the statute of frauds? Why do you think these special provisions exist for sales of goods between merchants?
- **Practice Question:** Chris is a professional musician and celebrity. He walks into Grey’s jewelry store and request that Grey make him a custom necklace. Grey agrees, but they do not execute a contract. The necklace is very ornate and will cost about \$150,000. It will contain the musician’s initials and symbol. When Grey finishes the necklace, Chris decides that he does not want it. What are Grey’s options?
- **Resource Video:** <http://thebusinessprofessor.com/exceptions-to-statute-of-frauds/>

INDIVIDUALS WITH RIGHTS UNDER THE CONTRACT

17. Who are the beneficiaries of the contract?

The parties to the contract are the primary beneficiaries. In general, individuals who are not parties to a contract have no rights to sue to enforce the contract or to get damages for a breach of contract. There are, however, exceptions to this rule. It is possible for third parties to have rights in a contract. A third-party beneficiary may have rights under a contract if the original parties to the contract intend for the agreement to benefit the third party and that intent is demonstrated in the agreement. This may happen at the time of the contract, or a third party may also acquire rights in an already executed contract if one party to the contract validly transfers those rights to the third party.

- *Example:* I enter into a contract with ABC Corp to provide them consulting services. As part of the agreement, ABC Corp is to make payments for those services directly to XYZ Corp. Because XYZ Corp is a named (intended) beneficiary, it has rights under the contract that are enforceable against ABC Corp.

The extent of the third party’s rights is determined by her status as either a donee beneficiary or creditor beneficiary.

- *Donee Beneficiary* - A donee beneficiary is a third party who receives contractual rights as a gift from the promisee. If a promisee makes a contract for the benefit of a donee beneficiary and the promisor fails to perform, the third-party may not bring an action against the promisee (individual transferring the contract), but may bring an action against the promisor (individual obligated under the contract). Since the transfer to the beneficiary is a gift, there are no grounds for recourse against the promisee.
 - *Example:* ABC Corp has an obligation to pay me. I instruct ABC Corp to make the payments directly to you. The payments to you are a gift to help your business get started. If ABC Corp refuses to pay you, you may enforce your right to payment against ABC Corp. You cannot, however, sue me if ABC fails to pay.
- *Creditor Beneficiary* - A creditor beneficiary is a third party who receives contractual rights from the promisee as satisfaction of a debt. When a promisor fails to perform under the subject contract, the creditor beneficiary can bring an action against the promisee, as the value of the consideration transferred is gone. The promisee may also bring an action against the promisor, as her rights have been harmed by the promisor’s failure to perform.
 - *Example:* ABC Corp has an obligation to pay me. I instruct ABC Corp to make the payments directly to

you. The payments to you are in satisfaction of a debt I owe to you for services you have already performed. If ABC Corp refuses to pay you, you may enforce your right to payment against ABC Corp. You can also sue me if ABC fails to pay.

- **Discussion:** Why do you think that the rules change depending on whether the beneficiary is intended vs unintended? Donee vs creditor beneficiary?
- **Practice Question:** Big Corp does business with Town Corp. Town Corp is the lifeblood of many smaller businesses in its town. These businesses exist to provide goods and services to Town Corp. Big Corp has a dispute with Town Corp which results in Big Corp breaking off relations with Town Corp and, in turn, breaching a major purchasing contract. The loss of Big Corp as a purchaser is detrimental to Town Corp and they are forced to reduce their output. This affects all of the businesses in Town Corp's town. What legal options exist for the small businesses in Town Corp's town?
- **Resource Video:** <http://thebusinessprofessor.com/third-party-beneficiaries/>

18. What is “assignment” and “delegation” of contracts?

Assignment is the transfer by one party of her right to receive performance from the other party to the contract. Delegation is the transfer by one party of her duties to perform under a contract.

- *Methods of Assignment or Delegation* - The rights under a contract can be assigned or the duties delegated through agreement between the assignor and assignee. Assignments/delegations can be a gift or an exchange for other value. In general, unless the contract deems otherwise, obligees may assign their rights or delegate their duties under the contract to third parties.
 - *Note:* The assignor/delegator must give notice to the other party immediately upon assignment/delegation.
- *Writing Requirement* - Assignments and delegations of common law contracts do not have to be in writing. Assignments of contracts for the sale of goods, however, must be in writing if the original contract was subject to the statute of frauds.
- *Non-Assignable/Delegable Contracts:* Unless the agreement limits assignment of rights, most contracts are assignable. Delegation of duties pursuant to contract is more limited. The following contracts are not capable of delegation:
 - *Material Changes of Responsibility* - A contract that materially alters the obligor's duties under the agreement is not transferable. Particularly, an assignment that greatly increases a party's delivery requirements cannot be assigned. Doing so may detriment the obligor who has to meet a new (and possibly more taxing) delivery schedule.
 - *Example:* I sign a contract to supply all of the cement that your company needs. You are a small construction business with about \$1 million per year in revenue. You attempt to assign the contract to ABC Corp, which is a large company with \$10 million per year in revenue. If this will

dramatically increase my supply requirements, it cannot be assigned without my consent.

- *Increases Burden or Risk* - Generally, any contract that materially increases the other party's burden, risk, or ability to receive return performance is not delegable. As such, requirement contracts generally cannot be delegated because the producer's duty depends on the individual output requirements of the purchaser.
 - *Example:* I sign a contract to supply all of the cement that your company needs. You signed the contract with my company because of my reputation and ability to perform. I cannot then delegate the duties under the contract to another company without your consent. This could increase your risk of not receiving performance.
- *Special Skills* - A party to a contract cannot delegate performance of duties under a contract when performance depends on the character, skill, or training of that party.
 - *Example:* One singer cannot transfer her obligations under a contract to another singer if the other party depended upon the skill of that particular vocalist.
- *Multiple Assignments* - A party can partially assign a contract or assign the same contract to multiple parties. Different jurisdictions follow different rules regarding the priority of the assignees. Some jurisdictions allow that the first assignee of a contract who gives notice to the obligor has priority over other assignees. Other jurisdictions follow the rule that the first assignee to receive assignment of a contract has priority to performance by the obligor. Still other jurisdictions follow the rule that the first assignee has priority, unless:
 - *Purchaser in Good Faith for Value* - If an assignee pays value for the assignment in good faith without notice of a prior assignment (and the prior assignee did not receive the assignment in good faith and for value), she has priority over prior assignments.
 - *Example:* ABC Corp has a duty to deliver goods to me. I assign the right to receive the goods to 123 Corp as a gift. I later decide to assign the right to receive goods to XYZ Corp in exchange for \$1,000. XYZ Corp has no knowledge of my prior assignment to 123 Corp. ABC Corp will have priority over 123 Corp, as 123 Corp did not pay anything for receiving the assignment.
 - *Court Action* - If an assignee receives a judgment against the obligor. If a court adjudicates the matter, the assignee winning at court may be vested with the authority to establish priority in performance of assigned rights.
 - *Example:* I am a party to a contract with ABC Corp. I assign my rights under a contract to Tammy and later to June. Tammy sues me and ABC Corp to establish her priority regarding performance of the contract. The court may award priority to Tammy or June.
- *Novations* - If the assignee executes a novation, the novation establishes priority. A novation is a new contract between individuals that replaces a party to the contract or obligations or rights under the agreement.
 - *Example:* I am a party to a contract with ABC Corp. I assign my rights under a contract to Tammy and later to June. June enters into a novation agreement with ABC Corp that replaces me under

the contract and establishes her as the obligee. June will have priority of performance above Tammy.

- *Written Assignment* - If a later assignee receives a written assignment capable of transfer that is not in writing, she will have rights superior to those of an earlier assignee. Some agreements, such as assignments that are subject to the statute of frauds, are only capable of being assigned *via* a valid writing. If a prior assignment does not satisfy the statute of frauds, a subsequent transfer could take precedent. It is important to review the specific rules applicable to the specific jurisdiction when determining one's rights under an assigned contract.
 - *Example*: I am party to a written contract to sell goods to ABC Corp. I verbally transfer my right to receive payment to Amy. I later transfer the right to receive payment to Zora in a written agreement. Zora may have priority over Amy.
- *Revoking an Assignment* - A gratuitous (gift) assignment cannot be revoked if the assignment is made pursuant to a written document signed by the assignor. If no writing exists, revoking a gratuitous assignment that has not been performed is extremely easy (because no physical transfer has taken place). It can be revoked by an assignor later assigning the same right (the last assignment controls), the death or incapacity of the assignor, or by the delivery of notification of revocation to the assignee or obligor.
 - *Example*: I verbally assign to you my rights to receive payment under a contract. I later tell you that I am revoking the assignment. This is effect to revoke the assignment because the original assignment was a gift and I did not make the assignment in writing.
- *Modification after Assignment* - Generally, a contract cannot be modified after assignment. As previously discussed, once a contract has vested, the parties generally cannot modify the contract in a way that impairs the assignee's rights. If, however, a modification does not affect the assignee's rights, it may be modified.
 - *Example*: I have the right under a contract with ABC Corp to receive payment. I transfer the right to receive payment to you. I later approach ABC Corp and alter my obligation to deliver goods on a specific date. If the alteration of my duties does not affect your rights as assignee, the alteration is not prohibited.
 - *Note*: There is an exception in commercial contracts under the UCC that allows for modifications or substitutions in accordance with commercially acceptable standards. This allows for slight modifications that are within the expectations of the parties.
- *Continued Delegator Responsibilities* - The party delegating the contract is still potentially liable under the contract if the delegatee fails to perform. If, however, the delegatee and the obligee under the contract enter into a novation, the delegator is relieved of responsibility.
 - *Example*: I am obligated to perform services to ABC Corp. I delegate my responsibilities to you. If you fail to perform the consulting duties, ABC Corp can still sue me. If, however, you enter into a novation with ABC Corp that substitutes you for me in the original contract, your failure to perform does not affect me.
 - *Note*: If the delegator expresses her intent to repudiate the contract upon assignment to the delegatee,

there is an implied novation if the obligee does not object. Also, the delegatee will be liable under the contract if she expressly or impliedly accepts responsibility for performance.

Most of the above rules regarding assignment and delegation are capable of modification in a contract between the parties.

- **Discussion:** How do you feel about treating assignments of rights and delegation of duties under contracts differently? Which of the assignment priority rules do you believe is most fair to the parties? Why? Should a party be able to modify a contract after assigning her benefits?
- **Practice Question:** Cleo is a party to a contract with ABC Corp to provide consulting services. Cleo verbally assigns her rights to receive payment to Austin. Cleo later verbally assigns her rights to receive payment to Steve. Austin complains to Cleo about her subsequent assignment. What can Austin do to establish his priority to receive payment from ABC Corp?
- **Resource Video:** <http://thebusinessprofessor.com/assignment-of-a-contract/>

CONTRACT PERFORMANCE

19. When is a party relieved from her obligations under a contract?

Parties to a contract have duties or obligations thereunder. There are generally three options to relieve these obligations:

- **Perform** - An individual is relieved from her duties under a contract once she has fully or substantially performed those duties. The individual is “discharged” from the contract.
- **Release from Contract** - Either party may be released from a contract by the other party. Alternatively, the person may be released if the contract becomes void.
- **Breach** - Once a party to a contract breaches that contract, she and the other party no longer have duties to perform. If the contract is enforceable, the other party then has the ability to enforce the contract against the other party by seeking damages.

Performance of the contract and release eliminate a person’s liability under the contract. Breach exposes the breaching party to damages or losses suffered for the breach. None of these options relieve a party from tort liability if her actions with regard to the contract constitute a tort.

- **Discussion:** Should a party pursue the method to relieve her obligation under a contract that is of greatest advantage to her? Why or why not?
- **Practice Question:** Katie and Smith enter into a contract. Each has a duty to perform services for the other. Neither party ever takes action to act on the contract. What is the result?
- **Resource Video:** <http://thebusinessprofessor.com/duty-of-performance/>

20. What are “executed contracts” and “executory contracts”?

An executed contract is one in which the parties have performed their duties under the contract. An executory contract is one in which the parties have not yet performed their obligations under the agreement.

- *Example:* I enter into a contract with you. Before I have fully performed the contract, it is executory. Once performed, the contract is executed.

- **Discussion:** Why do you think it is necessary in business to characterize contracts as executory versus executed?

- **Resource Document:** <http://thebusinessprofessor.com/executory-vs-executed-contracts/>

21. What is performance of a contract?

Performance of a contract relieves a person from further duties under the contract. There are three levels of performance:

- **Complete Performance** - Complete performance by a party means that the contracting party has fulfilled every duty required by the contract. A completely performing party is entitled to a complete performance by the other party.
 - *Example:* I enter into a contract to build a house for Ellen. I build the house and complete all of the material and non-material requirements of the contract.
- **Substantial Performance** - Substantial performance of a contract means less than complete performance; but, the level of performance is sufficient to avoid a claim of breach of contract. More specifically, it means that a party has performed all material elements of the contract, but there are non-material aspects left uncompleted.
 - *Note:* The other party may be entitled to seek offset or recovery from the substantially performing the party for the aspects of the contract not completed.
 - *Example:* I enter into a contract to build a house for Ellen. I build the house, but fail to paint the interior the color described in the contract. This contract is substantially performed and does not give rise to an action for breach. Ellen may, however, recover or offset the cost of painting the walls when paying me.
- **Breach of Contract** - Any performance that is not complete or substantial performance is a material breach. This entails performance at a level below what is reasonably acceptable. The materially breaching party cannot sue the other party for performance and is liable for damages to the other party for the breach.
 - *Example:* I enter into a contract to build a house for Ellen. I distracted by another contract and make material errors in laying the foundation. It causes the house not to meet standards and pass inspection by the building inspector. In this case, I have breached the contract by failing to perform a material duty under the agreement.

- **Discussion:** How do you feel about the concept of substantial performance? Do you believe that failure to perform certain duties under a contract should not constitute a breach? Why or why not?
- **Practice Question:** Missy enters into a contract to perform auditing functions for ABC Corp. She does reconciliation of many of the accounts, which takes substantial time. She is satisfied that the books are accurate, so she skips performing many of the key tasks required of external auditors. What is the status of Missy's duties under the contract?
- **Resource Video:** <http://thebusinessprofessor.com/performance-substantial-performance-breach/>

22. What is performance of a “divisible contract”?

A divisible contract is one that has multiple parts or is divided up into segments. Each segment exists and can be completed independently. That is, each segment has duties that require completion. An installment contract is an example of a divisible contract. Each installment has duties or obligations that must be completed. Performance of one segment does not relieve a party from the obligation to perform the other segments. Further, breach of one segment does not excuse performance of the other segments by the parties.

- **Example:** I enter into a road construction contract that has three separate and distinct duties of completion. I complete the first phase by constructing a specific stretch of road that entitles me to compensation. I have significant delays in constructing the second stretch of road. I have materially breached this divisible portion of the contract. I still have the duty to complete and be compensated for the third divisible contract.

- **Discussion:** Do you agree that the breach of any phase of a divisible contract should not constitute breach of the entire contract? Why or why not?
- **Practice Question:** Clark's construction company wins the bid to build a large commercial building for the city. The contract is broken into multiple, divisible pieces. Clark completes the first phase consisting of laying the building foundation, which simultaneously working on the second phase. This second phase regards constructing a parking garage beside the building. Clark has some serious difficulties and is unable to complete this phase on schedule. What is Clark's legal status with regard to the third phase of the contract?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-divisible-contract/>

RELIEF FROM DUTIES UNDER THE CONTRACT

23. What situations relieve individuals from performing her duties under a contract?

An individual is relieved from her duty to perform a contract in the following scenarios:

- **Void Contract** - If a contract becomes void, both parties are relieved from their duty of performance.
- **Breach by Other Party** - If the other party materially breaches the contract, the non-breaching party is relieved

from the obligation to further perform the agreement.

- *Failure of a Condition* - A contract may contain any number of conditions that may materialize (or fail to materialize), which relieve the parties' obligation to perform under the contract.
- *Impossibility, Impracticability, of Frustration of Purpose* - Parties to a contract may be relieved from their obligation to perform if performance becomes impossible, commercially impracticable, or the underlying purpose of the contract is frustrated.
- *Waiver or Release* - A party may, per her own volition, sign a waiver or release relieving the other party's obligation to perform.

Any of the above situations may release one or both parties from their duties of performance.

- **Discussion:** Do you agree that the above situations should relieve an individual from her obligations under a contract? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/discharge-from-contract/>

24. What are “conditions” upon the duty to perform a contract?

Conditions are facts or situations that must materialize (or fail to materialize) for either or both parties to have the duty to perform a contract. Conditions are generally divided as follows:

- *Condition Precedent* - A condition precedent is where something must take place or a situation must arise prior to or before a party has a duty to perform.
 - *Example:* Eric agrees to sell Fran one of his playoff seat tickets if the Atlanta Braves make it to the playoffs. The obligation to sell Fran a ticket only arises upon the occurrence of a specific event.
- *Condition Subsequent* - A condition subsequent excuses contractual performance if some future event takes place or situation arises.
 - *Example:* Frank agrees to cut Gina's grass today if it does not rain. If it rains, Frank is relieved from the obligation to cut the grass. Likewise, Gina is relieved from her duty to pay Frank.

A condition may be expressed between the parties or implied from the nature of the agreement. That is, the parties affirmatively discuss or include the conditions in the agreement or the language or nature of the contract may imply certain conditions on performance. The contract may also contain conditions that must take place concurrently before either party has a duty to perform. This is often the case when the contract requires simultaneous performance. Most point-of-sale purchases involve an implied concurrent condition of performance.

- *Example:* I give the cashier money and she sells me the groceries. My giving her money is a condition necessary for her to sell me the groceries.

- **Discussion:** Should conditions precedent and conditions subsequent be treated the same? What is the justification for categorizing each type of condition?
- **Practice Question:** Harold enters into an agreement to sell his house to Emily. The contract states that Emily is relieved from her obligation to purchase Harold's house if the home does not receive approval from a licensed home inspector. What type of condition is present in this agreement?
- **Resource Video:** <http://thebusinessprofessor.com/conditions-under-contract-precedent-and-subsequent/>

25. What are the conditions regarding payment, delivery, and tender of performance?

Tendering performance means to offer or attempt to perform the agreement. Often a party's offer or attempt to perform is sufficient to satisfy the condition of performance and obligate the other party's performance. That is, a party cannot avoid her obligation under the contract by failing to accept the other party's tender of performance. One party offering or attempting to perform is a condition to the other party's obligation to perform. Unless a contract states otherwise, the default rules under the UCC and Restatement place conditions on the delivery of services and the delivery of a product by a party to a contract.

- **UCC Condition of Performance** - The UCC states the buyer tendering payment to the seller of a good is a condition that must be satisfied before the seller has the duty to deliver the good.
 - *Example:* I offer to purchase an expensive jacket from you. You accept. I must offer to give you the money before you are obligated under the contract to give me the jacket.
- **Restatement Condition of Performance** - The Restatement, in contrast to the UCC, requires that a service provider must tender performance before the other party has a duty to pay for those services.
 - *Example:* I offer to paint your house for \$500. You accept. I must complete my obligation to paint your house before you are obligated to pay me \$500. In this case, tendering performance is completing my duty to paint.

In either case, rejecting a party's tender of performance can constitute a breach of contract if the tender of performance conforms to the requirements of the contract.

- **Discussion:** Why do you think tendering performance as a condition is treated differently under the UCC versus the Restatement?
- **Practice Question:** Herman offers to purchase machinery for his business from Jamie. The party is silent on who must perform first. Herman asks that Jamie ship the goods to his business location so that he can inspect it. If it meets inspection, he will pay for the machinery. Jamie refuses and asks Herman to pay first. If both parties refuse to perform first, who is likely legally liable for breach of contract?

- **Resource Video:** <http://thebusinessprofessor.com/tendering-performance-of-contract/>

26. What are “impossibility”, “impracticability”, and a “supervening frustration of purpose” of a contract?

Impossibility of performance, commercial impracticability, and a supervening frustration may excuse a party’s duty to perform a contract. Further, it will relieve the party from liability for the non-performance.

- *Impossibility of Performance* - A party may be excused from her duty to perform under a contract if performance becomes impossible. Events that make a contract impossible include:
 - Illegality of the subject matter;
 - *Example:* I enter into a contract with you to sell you cleaning chemicals. The sale of such chemicals becomes illegal. My duty to perform is excused.
 - The subject of the contract (property) is destroyed;
 - *Example:* I enter into a contract to sell you a car. Before I can sell it to you, a branch falls from a large tree and destroys the car. I am excused from my duty to sell an undamaged car.
 - One of the parties to the contract dies or becomes physically or mentally disabled;
 - Natural forces interrupt the contract;
 - *Example:* A tornado, earthquake, severe storms, flooding, etc., permanently interrupts a party’s ability to perform her contractual obligations.
 - Performance would cause substantial risk of physical harm to one party.
 - *Example:* I enter into an agreement to replace the shingles on our house. Upon inspection, the roof of the house appears to be structurally unsound. Replacing the shingles would put me in an unreasonably dangerous situation. I did not anticipate this danger when entering the contract. As such, my duty to perform is relieved.

Impossibility of performance will only excuse a party’s performance if the impossibility is not the fault of the non-performing party. Further, impossibility will not excuse liability for non-performance if the contract expressly contemplated the risk of conditions making performance impossible and specifically placed those risks upon the non-performing party.

- *Example:* I enter into a contract to sell you a piece of machinery. In the contract, we expressly state that I must repair any malfunction of the machine that occurs prior to sale. The machinery breaks before the sale date. In this situation, the contract anticipates a risk and places it on me. I must repair the machine prior to sale.

- **Discussion:** What do you think is the justification for allowing the above situations to excuse a person's duty under a contract? Can you think of any other situations that you believe should excuse a person's duty?
- **Practice Question:** Derek agrees to sell Artem sheet rock for a construction job. Derek leaves the sheet rock outside and it rains. The sheet rock is ruined. Artem has to purchase sheet rock from another source at a much higher price. If Artem decides to sue Derek, what will be the likely outcome?

- **Commercial Impracticability** - Commercial impracticability arises when performance of a contract by a party has become unfeasibly difficult or costly to perform. The difference between impracticability and impossibility is that impracticability is still physically possible; however, performance will result in a substantial hardship to the performing party. Impracticability will excuse performance where the excused party did not have control over (or was not at fault for) the condition that made performance impracticable. Further, the excused party must not have expressly or impliedly assumed the risk of the duties becoming impracticable. Generally, impracticability is only found in extreme circumstances.

- **Example:** I enter into an agreement with you to sell goods or perform services. The cost of performing the contract spikes because of a government tax, regulatory hurdles, raw material rates, etc. When entering the contract, we did not contemplate the price of goods or the cost of performing services to go up. If performing the contract would result in a serious financial burden to me, I may be able to get out of the contract by claiming that commercial impracticability excuses my performance.

- **Discussion:** How do you feel about the doctrine of commercial impracticability? How unforeseeable must the intervening event be to make the contract impracticable? How severe must the damage suffered by the performing party be?
- **Practice Question:** Tom agrees to sell lobsters to Suzie for resale in her restaurant. Tom sets the price at a specific dollar value per pound. Later, the government imposes a large tax on sales of lobsters. If Tom continues to sell at the contract price, he will go out of business. What are Tom's options?

- **Resource Video:** <http://thebusinessprofessor.com/impossibility-and-impracticability/>

- **Supervening Frustration of Purpose** - This is when circumstances arise that fundamentally frustrate a party's reason or purpose for entering a contract. The doctrine is similar to impracticability, but it does not relate to a party's hardship; rather it focuses on her expectation and purpose in entering the agreement. For a frustrating circumstance to relieve or excuse an obligation under a contract, the party cannot have assumed the risk of the circumstance (in the contract) or be at fault for the occurrence or the non-occurrence of the event or circumstance. Further, the occurrence or non-occurrence must have been a basic assumption on which the contract was made.

- **Example:** John signs up for piano playing lessons from Tara. John suffers a horrible accident that causes him to lose dexterity in his hands. This is a frustration of purpose that was unforeseeable and substantially

frustrates the purpose of learning to play the piano. As such, John will be excused from performance of the contract. Suffering an economic loss is not a frustration of purpose.

- **Discussion:** How do you feel about allowing an unforeseen event relieving a person's duty for performing a contract? How fundamental must the assumption be to the purpose of the contract? To what extent must each party understand this to be the fundamental purpose of the agreement?
- **Practice Question:** Donald bids for and wins a government contract to construct a dam. The contract is subject to legislative approval. He begins preparing by entering into contracts with Lizzie for the purchase of cement. The cement supplier knows that the cement purchase is in preparation for the dam-building project. The legislator ultimately disapproves the dam project, which causes Donald to lose the contract. What is the possible result?
- **Resource Video:** <http://thebusinessprofessor.com/frustrating-purpose-in-a-contract/>

27. What is “waiver” or “release” from a contract?

A waiver and a release serve to excuse one or both parties' duty of performance.

- **Waiver** - When a party intentionally relinquishes a right to enforce the contract. A waiver is generally employed after a party fails to perform.
 - **Example:** Per our contract, I am supposed to paint your house, but I fail to do so in the allotted time. You grant a waiver excusing my liability for failure to perform.
- **Release** - When one party is relieved from her promise of performance. A release generally occurs before a contracting party has to perform.
 - **Example:** We sign a contract where you agree to pay me to paint your house by the end of the month. Before my performance is due, I explain that I do not have time to paint your house. You sign a release that frees me of my duty to paint your house.

Waiver and release are often used synonymously to refer to a single document that simultaneously relieves a party from her duty to perform and excuses a non-performance or breach.

- **Discussion:** What do you think is the justification for categorizing a release and waiver differently? Should the content of a release agreement be treated differently than the content of a waiver?
- **Practice Question:** Pam enters into a contract with Lia to perform consulting services for her business. Pam has a great deal of work and is too busy to perform the contract. She asks Lia to let her out of the contract. What is Pam asking of Lia?
- **Resource Video:** <http://thebusinessprofessor.com/waiver-or-release-from-contract/>

BREACH OF CONTRACT

28. What is a “breach of contract”?

A party who is not relieved from her duty of performance and fails to perform her obligations under a contract is said to breach the contract. Breach entails a failure to perform material duties in accordance with the agreement. This can include a complete lack of performance, partial performance of the material duties, or performance that fails to meet the demanded standard. A breach by one party relieves the other party’s duty of performance.

- **Discussion:** Should different types of breach be treated differently? Why or why not?
- **Practice Question:** Joseph enters into a contract with Eric to build a deck on Eric’s house. Joseph builds a deck that is weak, flimsy, and drastically varies from the design plans. Under what grounds might Joseph allege breach of contract against Eric?

29. What methods exist for resolving a breach of a contract?

There are several remedies or solutions available for a breach of contract:

- *Negotiated Settlement* - The parties may work out a satisfactory solution to most breaches of contract is resolved by the parties themselves through voluntary negotiated settlements.
- *Arbitration* - The parties may agree to submit their dispute to a neutral third party or parties to resolve the dispute.
- *Litigation* - The parties seek to enforce their contract rights in a court of law.

All of these methods are discussed in greater detail in other chapters of this text.

- **Discussion:** What are the benefits of pursuing each of the available methods of resolving a breach of contract?

30. What remedies exist for breach of a contract?

A breach of contract action may result in any number of damages:

- *Compensatory Damages* - Compensatory damages are court-awarded damages to put the plaintiff in the same position as if the contract had been performed. It includes lost profits on the contract and the cost of substitute performance. A party’s lost profits from the other party’s breach of contract are the expected gains from performance of the contract. This would generally mean the value received minus the costs incurred in performing. This calculation is known as the “expectation damages”.

- *Example:* You sign a contract to sell me supplies for my business. You back out of the contract and I have to purchase my supplies from another vendor. The cost to me to purchase the supplies from a new vendor is 15% higher than pursuant to our agreement. I have suffered damages of 15% of the contract value. Alternatively, if I backed out of the contract and my duties to purchase your supplies, you would have suffered expectation damages equal to the price of the goods minus your cost of supplying them to me.
- *Consequential Damages* - These are court-awarded damages arising from unusual losses which the parties knew would result from breach of the contract.
 - *Example:* I order cement from you to complete a large contract. I express to you that I intend to use the cement for the large construction contract and that time of delivery and quality of the goods is of utmost importance. You fail to deliver the cement and I am forced to purchase from another vendor. The cement arrives late and causes delays. I incur substantial penalties under the larger contract. Your breach of contract may have cost me compensatory damages equal to the price difference between our contract and the replacement vendor. The consequential damages, however, are the penalties incurred and any lost business as a result of your breach.
- *Liquidated Damages* - Liquidated damages are damages specified in the contract in the event of non-performance by either party. Liquidated damages are appropriate where real damages for breach of contract are likely to be uncertain. In such a case, the parties decide to specify in the contract the damages in the event of breach. Courts will enforce these liquidated damage clauses unless they seem to penalize the defendant instead of merely compensating the plaintiff for uncertain losses.
 - *Example:* I sign an agreement to provide you with consulting services. It is difficult to estimate the damage to your business if I fail to adequately perform. In the agreement we indicate that my failure to perform will result in damages of \$1,000 to you. This liquidated damages clause is likely enforceable.
- *Nominal Damages* - Nominal damages include a small amount awarded by the court to the plaintiff for a breach of contract, which causes no financial injury to the plaintiff.
 - *Note:* In a tort action, a court may only award punitive damages if there is some finding of liability of the defendant. The court may not be able to find liability based upon tort theory in the absence of identifiable harm suffered by the plaintiff. If, however, the tort action is accompanied by a contract cause of action for the same conduct, the award of nominal damages for breach of contract may support a finding of punitive damages in the related tort action.
 - *Example:* I enter into a contract to provide you with consulting services. I fail to perform and you hire someone else. In this situation, it is difficult to determine if your business incurred any damages. If you sue me, a court may award nominal damages against me indicating that I was legally wrong in failing to perform my contractual duties. A common nominal damages amount is between \$1 - 100.
- *Specific Performance* - Specific performance is a court-ordered, equitable remedy available when the subject matter of the contract is unique. A court order for specific performance directs a party to perform her duties under the contract. The court will only apply this remedy when the subject matter of the agreement is truly unique and irreplaceable. Specific performance is not available for service obligations.

- *Example:* You agree to sell me a Picasso painting that you inherited. At the last minute, you back out of the contract. I sue you to force you to sell me the painting. A court may order specific performance of the contract by ordering you to sell me the painting.
- *Rescission* - Rescission means to undue a contract and return the parties to the position they were in prior to entering the contract. This generally means returning property sold in the condition it was transferred and a return of the purchase price. This remedy is not available for executed services contracts.
- **Discussion:** How do you feel about the concept of consequential damages? Is it fair to impose that extent of liability on a party if it is not part of the subject matter of the contract? Why or why not?
- **Practice Question:** Taylor enters into a contract with Winnie to supply her with reinforced steel. Winnie is going to use the steel in the construction of a new manufacturing facility for her business. Winnie backs out of the contract when she realizes that she can get the steel 10% cheaper from a competitor. If Taylor sues Winnie, what are his options for damages?
- **Resource Video:** <http://thebusinessprofessor.com/damages-in-a-breach-of-contract-action/>

31. What is “efficient breach”?

Efficient breach occurs when a party makes a conscious decision to breach a contract after balancing the costs of complying against fulfilling the contractual obligation. This normally arises in situations where a party will incur fewer losses or make more money by breaching the contract than the party would suffer in compensatory or consequential damages if sued.

- **Discussion:** How do you feel about the concept of efficient breach? Should the decision of whether to breach a contract simply be an economic consideration or is there a moral consideration involved? Should morality or ethics play a role in business transactions? If so, to what extent and why?
- **Practice Question:** Wendy enters into a contract to sell a piece of equipment to Laura. Before the sale is finalized, Erwin offers to purchase the equipment from Wendy at a much higher price. Wendy evaluates whether to breach the contract with Laura and sell the equipment to Erwin at the higher price. What might Wendy consider in making her decision?
- **Resource Video:** <http://thebusinessprofessor.com/efficient-breach-of-contract/>

INTERPRETING A CONTRACT

32. What rules or standards do courts apply when interpreting contracts?

Courts in different jurisdictions may employ unique standards when interpreting the meaning of contract terms. Common approaches include:

- *Plain Meaning* - The majority of jurisdictions interpret contract provisions based upon their “plain meaning.” That is, if a contract term is unambiguous, the court will apply the meaning commonly applied to the term or provision.
- *Reasonable Person* - Other jurisdictions interpret contract provisions based upon how a “reasonable person” in the applicable circumstances would interpret the contract. This is known as the “objective standard.”
- *Subjective Intent* - Some jurisdictions will look to any outside evidence to determine the subjective intent of the parties.

Some other common approaches to interpreting contract provisions are as follows:

- *Express Terms* - Afford the greatest weight to the contract’s express terms.
- *Implied Terms* - Look to implied terms originating from the course of dealing, course of performance, or trade usage.
- *Specific Terms* - Give greater weight to specific terms than general terms.
- *Actively Negotiated Terms* - Terms that are actually negotiated between the parties are given greater weight than standard terms or boilerplate.
- *Totality of Circumstances* - The court will take into consideration the overall circumstances of the agreement.
- *Contract Purpose* - The purpose of the contract, if ascertainable, should be considered in interpreting the intentions of the parties.
- *All Writings* - Interpret all parts of the contract as a whole (including when the contract consists of multiple writings).
- *Context* - Words are given their prevailing meaning in the context of the contract.
- *Trade Terms & Course of Dealing* - Specific trade terms are to be interpreted in accordance with their meaning in the trade. The parties’ intentions are interpreted consistently and in accordance with course of performance, dealing, and trade usage.
- *Interpret Against Drafter* - Ambiguous terms may be interpreted against the drafter.

Jurisdictions may employ any combination of these approaches when interpreting provisions or giving weight to conflicting terms.

- **Discussion:** Do you agree with this hierarchy of contractual interpretation? Why or why not?
- **Practice Question:** Ben and Jerry enter into a contract for the sale and purchase of goods. The contract is very short and is written in plain language. Soon after business dealings begin, Ben and Jerry argue of the extent of Ben’s obligation to supply all of the goods that Jerry needs. Jerry sues Ben for breach of contract for failing to

meet his supply demands. Ben argues that the contract did not obligate him to meet this level of supply demand. In interpreting the terms of the contract, what are some of the rules that a court will employ?

- **Resource Video:** <http://thebusinessprofessor.com/role-of-state-in-interpreting-contract/>

33. What is the “Parol Evidence Rule”?

This rule or doctrine concerns the evidence that parties may introduce to the court interpreting the disputed contract. Specifically, it addresses the introduction into court of any evidence of the parties’ agreement that arose prior to the execution of the final agreement and is not included within the written document. This rule either allows or disallows a party from introducing that evidence to the court to modify or add terms to a contract. The purpose of this rule is to prevent confusion in the interpretation of the contract and fraud by any party against another.

- *Prior Communications* - The parol evidence rule primarily serves to exclude any evidence of prior negotiations (either before or contemporaneous with the signing of the contract) that has the effect of altering the express terms of the agreement. Information or communications contemporaneous with execution of the contract may be admissible in interpreting the contract, but are not admissible if they expressly contradict unambiguous, contract terms.
 - *Example:* You and I enter into a contract for the sale of goods. Later, we argue over the what goods are being sold under the contract. In a lawsuit over the matter, the parol evidence rule will cause the court not to consider our prior communications before we executed the contract if those communications contradict the contract.
- *Final Agreement* - For the parol evidence rule to apply, the contract must be the final agreement between the parties. This means the contract is an “integration”. If the party is determined to be a final expression of the parties’ agreement, the parol evidence rule is effective to limit what information outside of the writing the parties can introduce to the court in interpreting the agreement.
 - *Example:* In the above example, the court will determine whether the contract was meant to contain all of the terms of our agreement. If we specifically make reference to our prior communications in the contract, it would not be an integration. In determining whether the contract is the final agreement, the court will look to see if the contract includes an integration clause.
- *Integration Clause* - The best way to make certain that the contract is deemed a complete and final expression of the parties’ intent is to include an “integration clause.” An integration clause, also called a “merger clause,” is a provision in a contract that says that the contract is a complete and final understanding of all the terms of the agreement. In other words, these clauses state that the contract is intended to be a complete integration. Some merger clauses will specifically state that any outside information or communications contemporaneous with the execution of the contract or prior thereto should not be considered a part of the contract. Other, more specific clauses, will specifically reference outside information, documents, or communications and state whether the terms of those items are included in the final agreement. These clauses are usually conclusive unless a contract defense applies (such as fraud, duress, etc.).
 - *Example:* In the above examples, the court finds a clause that states, “This contract is the complete and

final agreement of the parties”. In that case, the court will not review our prior email communications to determine what goods are included under the contract. The court will only look at the provisions of the contract itself.

An agreement may appear on its face as simply a partial understanding of the agreement between the parties. In such as case, the contract is not an integration.

- **Discussion:** Why do you think courts want to exclude prior communications that alter or contradict the terms of the contract? Can you think of any situations in which the court should certainly review prior communications, even if an integration clause is present?
- **Practice Question:** Clayton enters into an agreement with Samson to provide consulting services. Clayton and Samson later sue each other over the extent of services Clayton is obligated to perform for Samson. Clayton argues that the contract only calls for him to do so preliminary business analysis. Samson argues that Clayton was obligated to perform far more services. He says that prior communications indicate the extent of Clayton’s intended services. What do we need to know to determine whether the court will consider the prior communications in determining Clayton’s obligations under the contract?
- **Resource Video:** <http://thebusinessprofessor.com/parole-evidence-rule/>

34. What is a “complete integration” and “partial integration”?

The term integration determines the extent to which all provisions of the contract are included in the written document. It can either be completely integrated or partially integrated.

- **Complete Integration** - A complete integration is when the contract contains all of the facts or information regarding the parties’ agreement. If the court determines that a contract is a complete integration, the parole evidence rule limits all prior or contemporaneous outside evidence that contradicts, modifies, or supplements the contract. A complete integration will generally contain a strong integration clause specifically excluding any outside information not specifically mentioned in the terms of the agreement.
 - **Example:** I enter into a contract to supply you with goods. If the court is called upon to determine the extent of our duties, the court will look to see if the document demonstrates an intent to include all of our terms in the agreement. Including a clause in the contract stating that this is the full and complete understanding of the parties will generally make the document a complete integration. As such, the court will not consider any communications prior to or contemporaneous with the execution of the contract.
- **Partial Integration** - The written document may contain only part of the information constituting the agreement between the parties. If a court determines that a contract is a partial integration, it will allow certain outside evidence that serves to supplement or explain provisions of the contract. Even with a partial integration, the parole evidence rule restricts outside evidence of prior or contemporaneous communications that specifically contradict the terms of the written contract. Partial integrations generally do not contain integration clauses. Often, the agreement itself will make reference to outside communications to clarify certain provisions of the agreement.

- *Example:* In the example above, the court determines if the contract is a complete or partial integration. In the agreement, if we make reference to prior communications or it is apparent that we intended for the agreement to include or incorporate prior communications, it is a partial integration. The court would consider any prior communications that appear to supplement or add to the written contract. The court will not consider communications that contradict the express terms of the contract.

- **Discussion:** Why do you think the court disallows the consideration of contemporaneous and prior communications of the contract is a complete integration? Should the court consider prior communications to fully understand the intent and agreement of the parties? Why or why not?
- **Practice Question:** Harold enters into a contract to supply Dana with manufacturing materials. The contract does not contain an integration clause. When a dispute arises between Harold and Dana regarding each party's duties under the agreement, Dana wants the court to consider a chain of emails between her and Harold to explain the extent of their duties. Under what conditions will the court consider the chain of emails?
- **Resource Video:** <http://thebusinessprofessor.com/contract-complete-and-partial-integrations/>

35. When does the parol evidence rule not bar the consideration of extrinsic evidence to a contract?

Extrinsic evidence or information prior to or contemporaneous with the formation of the contract cannot be introduced to contradict the contract. Nonetheless, it may be necessary to employ extrinsic evidence or information from outside of the contract for the following reasons:

- to aid in the interpretation of existing terms (for example, when an ambiguity exists),
- to show that a writing is or is not an integration,
- to establish that an integration is complete or partial,
- to establish subsequent agreements or modifications between the parties (i.e., those arising after the contract is completed), or
- to show that the terms of the contract were the product of illegality, fraud, duress, mistake, lack of consideration or other invalidating cause.

These exceptions exist to reduce misunderstanding and fraud between the parties and to promote judicial efficiency in the interpretation of agreements.

- **Discussion:** Do you agree with these rules for allowing prior communications in the interpretation of a contract? Why or why not?
- **Practice Question:** Alice enters into a contract with Hannah. They end up in court pursuant to an argument over the terms of the agreement. The contract contains an integration clause, so the court will not consider prior

communications that contradict or add to the written agreement. Alice and Hannah are arguing over the type of goods described under the contract. Hannah argues that the description of the goods is ambiguous. Under what conditions will the court review prior communications between Alice and Hannah?

- **Resource Video:** <http://thebusinessprofessor.com/exceptions-to-the-parol-evidence-rule/>

36. What is a “patent ambiguity” and “latent ambiguity”?

One important exception to the parol evidence rule is the use of extrinsic evidence to determine the meaning the parties attribute to certain terms or provisions. Generally, a court will give a term its common meaning or the meaning common in the context of the contract (such as a particular trade usage). Nonetheless, often a term or provision of the contract will be ambiguous. In such a case, ambiguities are broken into latent and patent ambiguities. Generally, outside evidence may be introduced to clear up an ambiguity that is obvious on the face of the document. This is known as a “patent” ambiguity. If a party claims that the contract contains an ambiguous term, but it is not obvious on the face of the contract, the party is claiming that a “latent” ambiguity exists. In such a case the party may be able to introduce outside evidence to show that an ambiguity exists. If the court determines that an ambiguity exists, it may consider extrinsic evidence to resolve the ambiguity. Many courts do not distinguish between patent and latent ambiguities. If an ambiguity exists, extrinsic evidence is allowed to the extent necessary to clear up the ambiguity. The parol evidence rule’s prohibition on the use of evidence to change or add to the contract remains intact.

- **Example:** You and I enter into a contract. When a dispute arises, we ask the court to resolve the dispute. When interpreting the terms of the contract the court will use established rules for interpreting the meaning of words and clauses. If the court determines that a word or clause is ambiguous when reading it (a patent ambiguity), it may allow outside information to explain the term. If the court does not read a term as ambiguous, it may allow me to introduce outside evidence to demonstrate that it is ambiguous. If I am successful in demonstrating an ambiguity, the court will then consider outside information to explain the ambiguous term.

- **Discussion:** Why do you think the court treats patent and latent ambiguities differently? Should the court consider all evidence and prior communications when determining the meaning or intent of the parties? Why or why not?
- **Practice Question:** Alice enters into a contract with Hannah. They end up in court pursuant to an argument over the terms of the agreement. The contract contains an integration clause, so the court will not consider prior communications that contradict or add to the written agreement. Alice are arguing over the type of goods described under the contract. Hannah argues that the description of the goods is ambiguous. Under what conditions will the court review prior communications between Alice and Hannah?
- **Resource Video:** <http://thebusinessprofessor.com/patent-and-latent-ambiguities-in-a-contract/>

TOPIC 11: AGENCY & LIABILITY

Overview

Agency law concerns the legal relationship by which one person acts on behalf of another. This chapter will examine the agency relationship and the legal duties owed by principal and agent. It will focus upon the scope of the agency relationship — particularly in the context of the employer-employee relationship. It will introduce the concept of vicarious liability and provide the elements necessary for a principal to be held liable for the actions of the agent. This topic will include liability for contracts entered into by the agent and torts committed by the agent.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• Agency - Agent - Principal • Types of Principal • Types of Agent • Forming Agency Relationship • Principal Duties	• Agent Duties • Employee vs Independent Contractor • Vicarious Liability • Agent Contract Authority - Actual Authority - Apparent Authority - Implied Authority	• Agent Liability • Respondeat Superior • Frolic and Detour • Terminate Agency

TOPIC 11: AGENCY & LIABILITY - QUESTIONS & ANSWERS

1. What is “agency”?

An agency relationship is one in which a party acts on behalf of and with the authority of another party. The “principal” appoints or authorizes the “agent” to act on her behalf. Thus, she is responsible for the actions of the agent taken in furtherance of her duties or per the instructions of the principal. The agent will interact with “third parties” on behalf of the principal. The agency relationship requires an understanding of the relationship between principal and agent, agent and third parties, and the principal and third parties’ roles, responsibilities, and rights.

- *Example:* I hire Betty to negotiate a business deal on my behalf. I am the principal and Betty is my agent for this purpose. Betty will act as my representative in dealing with the third parties to this business deal.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-an-agency-relationship/>

2. What are the types of agent?

The principal will lay out the “scope of the agency”, including the responsibilities and limitations of the agent. Agents generally fall into two categories:

- *Limited Agent* - A limited agent has a special purpose and limited authority to act on behalf of the principal. Unless specifically limited by the principal, actions done in furtherance of that purpose are within the scope of the agent’s authority.
 - *Example:* I hire a real estate agent to represent me in the purchase of a business. She is my limited agent for that purpose. Her authority to act on my behalf is limited to this situation.
- *General Agent* - A general agent has broad authority to act on behalf of the agent. The scope of the agency is not limited to a special purpose.
 - *Example:* Arthur is my employee. He serves a operations manager. As such, he is my general agent with regard to all aspects of operations falling under his responsibility. His authority to act as my agent is not limited to a specific task; rather, it is pursuant to his responsibilities in his position.
- *Independent Contractor* - Agency law considers an independent contractor to be a special form of agent of the principal. The independent contractor is hired to perform a service for the principal but is generally not under the direct control or supervision of the principal. In this way, the agent has very limited ability to represent or act on behalf of the principal outside of the context of the services contract.

Numerous subcategories of agent exist within these broader categories. For instance, an “agent coupled with an interest” is a type of special agent who earns compensation through performing her agency duties (rather than receiving compensation directly from the principal). For example, a sales agent who receives a commission on sales may be an agent coupled with an interest. This type of agency is subject to contract rules and cannot be terminated without violating

the legal rights of the agent or principal.

- *Note:* Other common categorizations of agents include co-agents and sub-agents. Co-agents are multiple agents who serve a single principal for the same purpose. Sub-agents are authorized agents of an agent.
- **Discussion:** Why do you think there is a distinction between a general and limited agent? How should the authority of a limited agent be interpreted? What should be the limits placed upon the authority of the general agent?
- **Practice Question:** Erin is starting an interior design firm. She hires Ann as a senior designer, and Rachel as a design assistant. She hires Rita to handle her bookkeeping and Patricia to handle her business setup and legal matters. What is the status of each of these individuals (employee, independent contractor, general agent, or limited agent)?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-scope-of-the-principal-agent-relationship/>

3. What is the agency status of an employee as compared to an independent contractor?

Employee - An employer hires an employee to work on behalf of the employer as part of or in support of the business's core functions. The employee generally works exclusively for the business in the functions for which she is hired. The employer exercises extensive control over the nature, time, and manner of work carried out by the employee. As such, the employee is a general agent of the business to the extent of her authority in the position.

- *Note:* An individual working on behalf of an employer does not have to be paid to be considered an employee. An unpaid person may be a "gratuitous employee". This may be the case when individuals are volunteering for non-profit ventures or working as part of an internship.
- *Example:* ABC Corp hires me as an internal accountant. I report to ABC Corp from 8:00 - 6:00 on 5 days per week. I work on any and all accounting functions assigned to me by my supervisor.

Independent Contractor - An independent contractor is not an employee; rather, she or it is a separate business that is hired to perform services for or on behalf of another person or business. One way of thinking of an independent contractor is that she has her own business that services the employer as a client or customer. The employer does not directly control the manner and method by which an independent contractor carries out her duties. Also, an independent contractor generally has more than one customer or client. As such, the independent contract is only a limited or special agent of the principal-employer.

- *Example:* I have my own professional accounting practice. I prepare the tax returns for any business or individual who pays me to do so. I do not have any employees. ABC Corp hires me to prepare its annual tax return. I promise to have the return completed within 1 month. I will invoice ABC Corp for my services. I am not an employee of ABC Corp. I am an independent contractor who is hired to perform a specific function for a limited amount of time. While I have a projected deadline, ABC Corp does not control the nature, time, and manner of the services I perform.

While both are independent contractors, and employees are agents of the principal. This distinction is important for

determining a principal's liability for the agent's actions. Generally, absent specific instructions to do a task leading to liability, an employer is not liable for the actions of an independent contractor taken on behalf of the principal.

- *Note:* There are exceptions where an independent contractor may subject an employer to liability for her actions. This is the case when the work performed is inherently dangerous in nature; the tasks performed for the employer are illegal; the work is non-delegable; or the employer ratifies the contractor's actions. A separate cause of action may exist if the employer was negligent in selecting a contractor to perform the duties. That is, she failed to exercise reasonable care in selecting a particular contractor. This may be the case where past performance demonstrated the contractor was unsuitable for the task.
- **Discussion:** Why do you think employees have a different agency status from independent contractors? Is there any reason or justification for treating employees and independent contractors similarly for agency purposes?
- **Practice Question:** Donald drives for Super, a company that provides a network for drivers to pick up and drop off customers who need a ride. The service is very similar to a taxi service. The individuals driving for Super have their own cars and their own insurance. They work whenever they like. The driver logs into an application that notifies her when a Super customer needs a ride. She confirms that they will provide the ride and she is off. The passenger pays Super directly and Super later remits payment to the driver. What factors in this scenario would be used to determine whether Donald is an employee or an independent contractor?
- **Resource Video:** <http://thebusinessprofessor.com/employer-vs-independent-contractor/>

4. What are the types of principal?

Principals are categorized based upon whether their identity is disclosed to third parties with whom the agent interacts on their behalf.

- *Disclosed Principal* - A disclosed principal's identity is known to third parties dealing with the agent.
- *Partially-disclosed Principal* - A partially-disclosed principal is known by third-parties to exist, but her exact identity is unknown. This type of relationship exists when there is some benefit to the principal to remain anonymous to third parties interacting with the agent.
- *Undisclosed Principal* - The existence of an undisclosed principal is unknown to a third party. The third party believes that she is interacting only with the agent.

These categorizations of principal are important in determining the rights and duties of the principal, agent, and third party.

- **Discussion:** How do you feel about the ability of an agent to act on behalf of a undisclosed and partially-disclosed principal? Is this fair to a third party? Why or why not?
- **Practice Question:** Winston is a special agent of ABC Corp hired to negotiate the purchase of intellectual property. He seeks to purchase a premium domain name from Alice. Alice is unaware that Winston wants to buy

the domain name for some third party, but does not know that he works for ABC. What type of agent is Winston? How would it affect Winston's status if Alice found out that he works for ABC? What if she did not know he was buying the domain name for a principal?

- **Resource Video:** <http://thebusinessprofessor.com/types-of-principal-in-an-agency-relationship/>

5. What is required to form a principal-agent relationship?

An agency relationship is created in the following manners:

- *Express Agreement* - A principal and agent may expressly agree to form an agency relationship. The agreement can be oral or in writing. The principal must simply confer the authority upon the agent to act on her behalf. The subject matter of the agency relationship must be legal. The agency has the express authority granted in the agency agreement and the implied authority to undertake tasks incidental to that objective.
 - *Note:* If the duties of the agent include executing a contract subject to the statute of frauds, the agency relationship may need to be in writing to be enforceable. An express agency relationship is often created pursuant to a legal document known as a "power of attorney". The power of attorney may create a general or special agency relationship.
- *Implied Agency* - An agency may be implied from the facts or circumstances surrounding an individual's actions on behalf of another. If the principal acts in a way that demonstrates an intent for an individual to act on her behalf, this may imply an agency relationship. The parties to an agency relationship do not need to understand the law of agency or understand what it means to be a principal or agent.
- *Ratification* - Ratification is a contract principle. If an individual undertakes actions on behalf of another, these actions may be outside of any express or implied authority. If, however, the principal acknowledges and accepts the agent's actions, this is known as "ratification" of the agency relationship. The principal ratifies the agent's actions, after the fact.
 - *Note:* Agency by ratification is only possible when the principal is fully disclosed.
- *By Estoppel* - If a third-party reasonably relies on an agent's representation that she has authority to act on behalf of the principal, the principal may be bound by the actions of the agent. Generally, the principal must act or fail to act in a manner that causes a third party to reasonably believe that an agency relationship exists, when in fact there is no agency. Agency by estoppel is based upon principles of fairness. It would be unfair to detriment a third party who reasonably believed that the agent had authority to act on behalf of the principle, and the principal was the source or cause of that belief.
 - *Note:* Agency by estoppel is only possible with fully-disclosed principals.
 - *Example:* Bill is James' agent. James terminates the agency relationship. Nonetheless, unbeknownst to James, Bill continues to transact with third parties on James' behalf. James fails to notify third parties of Bill's termination. James may be bound to any agreement entered into by Bill.

- *By Necessity* - Agency by necessity arises when one party makes a decision on behalf of another person who is unable to do so. The decision must be essential in nature and it must be in the interest of the principal in making that decision. As such, the law will impute a *de facto* agency relationship where no actual agency exists.
 - Example: Bill is hired to deliver Tom's goods. He drops the goods off at the fulfillment center. The center says that there is no contract in place and intends to reject the goods. Tom is out of country and cannot be reached. The goods will spoil if not accepted. Bill signs the warehousing agreement on Tom's behalf.
- **Discussion:** How do you feel about the ability to form an agency relationship without a principal expressly authorizing the agent to act on her behalf? What intent should be required before a court can find that an implied agency exists? What constitutes ratification of an agent's actions by a principal? When is reliance upon an agent's representations about her authority reasonable? Should a third party be required to verify an agent's actual authority? How great must the need be for a court to find an agency by necessity?
- **Practice Question:** Terrence hires Joe as a general manager of his business. Joe routinely purchases supplies for the business, though this authority is not in his job description. Terrence never gave Joe the authority to enter into these purchase agreements, but he routinely acknowledges Joe's actions and keeps the purchased goods. When Terrence falls sick, Joe handles all store operations, including signing some major purchase orders that Joe generally signs. These purchases were necessary to continue business operations. One of the purchase orders, however, is for the wrong type of goods. The error potentially costs Terrence's business thousands of dollars. When Terrence recovers and learns of the purchase order, he is furious and refuses to honor the purchase agreement. What are the arguments for and against Terrence's liability for Joe's errant purchase order?
- **Resource Video:** <http://thebusinessprofessor.com/methods-of-forming-principal-agent-relationship/>

6. What are the duties of a principal?

Generally, a principal owes the following duties to the agent:

- *Duty to Compensate* - An agency relationship may be paid or gratuitous. The terms of an agency may be laid out in the agency agreement. If the agency agreement does not indicate the terms of compensation, the principal is obligated to provide the agent with reasonable compensation.
 - Example: Default rules in a relationship with a sales agent dictate that the agent will earn a reasonable commission on sales induced or completed.
- *Duty to Reimburse* - The principal must reimburse the agent for a reasonable amount expended in carrying out her duties. Reasonable reimbursement includes the cost of travel, meals, lodging, incidental expenses, etc.
- *Duty to Indemnify* - Generally, a principal must indemnify an agent for liability incurred in the performance of her duties. This generally arises when the instructions of the principal subject the agent to liability to a third party.
 - Note: If an agent exceeds or acts outside of the scope of her authority, the principal may be relieved from the duty to indemnify. If the principal later ratifies the actions of the agent, she will incur the obligation to

indemnify the agent against liability.

- **Discussion:** How do you feel about the default duties owed by a principal to an agent? Why do you think these are the default standards? Do you believe there should be any other or additional duties of the principal?
- **Practice Question:** Ethan hires Naomi to serve as his buying agent. The employment agreement is very short and lists only Naomi's primary responsibilities and compensation. Pursuant to her job description, Naomi will make purchases for the business but will not disclose that she is an agent of the business. One of her business deals goes bad and a client sues her for breach of contract. What are Ethan's responsibilities in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/duties-of-a-principal-to-an-agent/>

7. What are the duties of an agent?

Agents generally have the following duties to the principal:

- **Loyalty** - An agent has the duty of loyalty to act for the principal's advantage and not to act to benefit herself at the principal's expense. An agent is expected to refrain from undertaking actions personally that would conflict with the purpose of the agency. An employee has a lower duty of loyalty with regard to opportunities that are outside of the employee's duties or responsibilities to the employer. Generally, this means that an agent may not simultaneously represent the principal and another party to a transaction.
 - **Note:** Employees are agents of the employer. If an employee does not have permission, she violates a duty of loyalty by undertaking activities for a third party that are similar to the duties of the employee in the agency relationship. This is seen as competing with the employer. If, however, she performs services unrelated to or not the type of services the employer would seek to provide to the client, she does not breach a duty by providing those services. This is true even if the employee provides those services to a client of the employer.
 - **Example:** I work for ABC Corp as a professional service provider. A potential client comes in to seek the services of ABC Corp. I cannot compete with ABC Corp by trying to convince the client to pay me to serve them personally rather than hire ABC Corp. I also have a side job selling supplies to construction contractors. This is a completely different line of business from ABC Corp. If it does not conflict with ABC Corp's services, I can offer my supplies for sale to the client without violating my duty of loyalty.
- **Duty of Care** - An agent has a duty to exercise due care and diligence when carrying out the responsibilities of the agency. This is often referred to as a duty to not act negligently in carrying out the principal's affairs.
 - **Example:** I work for ABC Corp as an accountant. I represent ABC Corp in every action I undertake as part of my employment, such as preparing client taxes. I have a duty to ABC Corp and the client to exercise reasonable care in carrying out my job duties.
- **Information & Disclosure** - The agent has a duty to protect all confidential information of the principal, such as trade secrets. Further, the agent has a duty to keep the principal fully informed of all material information

acquired as a result of the agency relationship.

- *Example:* I am a sale agent for ABC Corp. I receive an offer from a customer to undertake a joint venture with ABC Corp. I have a duty to transmit this information to ABC Corp. I acquired this information as a result of the agency relationship, and it is obviously outside of my unilateral decision-making authority.
- *Obedience* - The agent has a duty to obey the reasonable instructions from the principal.
 - *Example:* I work for ABC Corp selling insurance. ABC provides me detailed training and instructions on what types of policies to write and the client area that I can serve. I have a duty to obey these instructions as agent of my employer.
- *Accounting* - The agent has a duty to account to the principal for monies handled. Further, the agent may have a duty to account to third parties for whom money is handled. This includes situations where an agent collects too much money from a third party and is still in possession of those funds or when an agent intentionally collects funds that belong to the third party and the principal is undisclosed.
 - *Example:* I am a financial advisor for ABC Corp. I am responsible for reporting and keeping accurate records regarding all money or value transferred or received in carrying out my job duties.
- *Note:* The principal-agent relationship is a fiduciary or trust-based relationship. The agent may have any other duties as established in the agency agreement.

- **Discussion:** Should the duty of loyalty and care be the same for an agent in every situation? Why or why not? Should these duties vary depending upon whether the agent is a limited or general agent? Why or why not?
- **Practice Question:** Carol is an employee of Rob's accounting firm. She is a CPA, but she has been thinking of breaking away from the firm and starting her own practice. One day, a representative from a large corporation walks into the CPA firm and inquires about accounting services. Carol is strongly considering offering her personal services to the representative's firm? Are there any issues in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/principal-and-agent-relationship/>

8. To what extent is a principal bound in contract by the actions of the agent?

A principal is generally bound to third parties pursuant to the contracts entered into by the agent on behalf of the principal. This means that the principal is responsible for any obligations incurred by the agent that are within her authority. An agent has varying sources of authority when dealing with third parties.

- *Actual Authority* - Actual authority is the express authority from the principal allowing the agent to enter into obligations (contracts) on her behalf. It can be specific instructions to do so or generally included in her job duties.
 - *Note:* The principal is bound to third parties if disclosed, partially disclosed, or undisclosed.

- *Example:* Arnold is an employee of ABC Corp. He signs an employee agreement indicating that he will sell products manufactured by ABC Corp directly to retailers. He has express authority to enter into any contracts with retailers for the sale of ABC-manufactured goods.
- *Implied Authority* - Implied authority concerns the authority to enter into obligations that a reasonable person would imply from the agent's position, title, or past course of dealings. If an employee has the title of vice president, it implies a great deal of authority to act on behalf of the business. Further, if an employee entered into a previous contract on behalf of the principal, it may imply that she can enter into similar contracts in the future.
 - *Note:* This principle can only apply to disclosed and partially disclosed principals. There can never be implied authority to act on behalf of an undisclosed principal.
 - *Example:* Beth is hired by ABC Corp with the title of Senior Sales Manager. 123 Corp seeks to purchase a shipment of supplies manufactured by ABC Corp. Even if Beth is expressly prohibited in her employment agreement from entering into direct sales agreements, it is reasonable for a retailer to believe that a person with her title has that authority. If a retailer is unaware of Beth's limitations and Beth signs a sales contract on behalf of ABC Corp, ABC Corp will be bound by the contract. Beth may be liable to ABC Corp, but her title implies this authority to transact with third parties in this manner.
- *Apparent Authority* - Apparent authority arises from the reasonable representations of the agent to third parties. That is, when the agent represents that she has authority to enter into a contract on behalf of the principal, her actions will bind the principal if a reasonable person would believe those representations. The 3rd party's belief must generally result from some action or inaction by the principal.
 - *Note:* This principle applies to disclosed and partially disclosed principals. There can be no apparent authority if the principal is not disclosed to the third party.
 - *Example:* Gina works for ABC Corp. She has a generic title of manager. She is limited in her ability to sign purchase agreements on behalf of ABC Corp. She does, however, routinely negotiate the terms of purchase agreements with vendors. She then transmits the purchase agreements to her boss who signs them. The vendor never deals with anyone other than Gina. If Gina decides to start by personally signing the purchase agreement, ABC Corp will likely be bound by the contracts. By signing the agreements, she is representing to vendors that she has authority to do so. It is likely reasonable for vendors to believe that she has this authority, as Gina is the primary point of contact for negotiating the agreements.
- *Ratification* - While an agent may bind the principal to the extent of her authority, the principal is also bound if she ratifies the conduct of the agent that is beyond her express, implied, or apparent authority. That is, if the principal accepts or takes advantage of the agent's actions, she impliedly ratifies those actions as taken on her behalf. In such a situation, this expands the implied and apparent authority of the agent when undertaking future actions.
 - *Note:* Ratification can only take place if the principal is disclosed or partially disclosed.

In each of the above situations, a disclosed principal is liable to third parties dealing with the agent. If the agent exceeds her express authority, the third party may still have the ability to back out of the contract. The third party is generally

bound by the contract if the principal ratifies the agent's conduct before the third-party finds out about the lack of authority and withdraws.

- **Discussion:** How do you feel about the doctrines of implied and apparent authority? Should an agent have the ability to bind an agent in contract when the agent does not have actual authority to do so? Why or why not? Should the standard be different for limited and general agents? Why or why not? Should the onus be on the employer to protect itself by informing third parties of the limited authority of the agent, or should the onus be on the third-parties to verify the authority of the agent? What is your justification for this opinion?
- **Practice Question:** Kristy is an operations manager for ABC Corp. She has authority to enter into agreements for operational supplies. She does not, however, have authority to enter into sales agreements with retailers of ABC Corp products. In a couple of instances she is called upon to assist in putting together custom sales orders for large retailers. In these situations, Kristy was the primary point of contact with the retailers. 123 Corp learns about ABC Corps products through one of the retailers who previously worked with Kristy. 123 Corp contacts Kristy about putting together a custom sales package. What is Kristy's authority to deal with 123 Corp.? If Kristy enters into an unauthorized agreement with 123 Corp, under what theory might ABC Corp be bound by the contract? Why?
- **Resource Video:** <http://thebusinessprofessor.com/agent-authority-to-contract-for-business/>

9. To what extent are agents liable in contract to third parties and to the principals they represent?

An agent acting within the scope of her authority is not liable to third parties on obligations entered into on behalf of the principal. Even if the agent exceeds her express authority, her implied authority may bind the principal to the agreement and relieve her from any contractual liability to the third party. The important point is that the agent must act on behalf of the principal and disclose that relationship to the third party. If the agent is acting on behalf of a principal, but fails to disclose her agency status, it may subject her to liability to the third party. In some cases, it may also serve to bind the principal once the agency relationship is determined.

- **Note:** If the agent goes beyond her express authority, she may be liable to the principal for any obligations binding the principal to third parties. That is, the principal may be able to recover damages suffered because of the agent exceeding her authority.
- **Example:** I work for ABC Corp. I enter into an agreement with 123 Corp on behalf of ABC Corp. I am not personally obligated to perform the contract. If I fail to tell 123 Corp that I work for ABC Corp (123 Corp believes that I have my own business), I am liable to 123 Corp if ABC Corp does not perform the contract. ABC Corp is obligated to perform the contract if my entering the contract was in my express, implied, or apparent authority. If I did not have express or implied authority, but 123 Corp realized I was acting on behalf of an agent, ABC Corp may be liable if I had apparent authority. In such a situation, ABC Corp may be able to sue me for any losses suffered.
- **Discussion:** Should an agent who exceeds her express authority be liable to the principal? Why or why not? Should she be liable to the third-party? Why or why not?

- **Practice Question:** Agnes is an agent of Emory Corp, a technology company that sells subscriptions to its cloud-based software. Agnes has the general title of manager, but has no express authority in her employment agreement. Agnes routinely negotiates sales agreements with large companies that are clients of Emory Corp. Agnes enters into an agreement with Tech, LLC that is far larger than any deal Agnes previously negotiated. The agreement is very poorly negotiated and it will cause a huge loss for Emory Corp. What is Emory Corp's obligation? What are Agnes's potential obligations and liabilities?
- **Resource Video:** <http://thebusinessprofessor.com/agent-liability-to-third-parties/>

10. To what extent are principals liable for the torts committed by agents?

An individual is always liable for her own conduct. Whenever an individual is held liable for the actions of another, this is known as “vicarious liability”. In the context of agency, the agent is acting vicariously for the principal. A principal is responsible for the tortious acts of an agent pursuant to a doctrine known as “*respondeat superior*”. More specifically, an agent may create legal liability for the principal for actions taken by the agent “within the scope of the agency”. In such cases, the principal and agent are “jointly and severally” liable for the harm caused by the agent's conduct. An act is within the scope of the agency if the purpose behind the action taken is to advance the interests of the principal. As such, if any act taken by an employee in an effort to advance the employer's interest is a tort, the employer may be liable for that conduct.

- **Note:** Generally, intentional torts are generally not considered to be within the scope of an employee's duties or employment. As such, a principal will not be liable for the intentional torts committed by an employee unless the principal ordered or condoned the tortious conduct. Even if a tort is within the scope of employment, it will not relieve the agent from personal liability for her actions.
- **Example:** I am an employee of a corporation. While carrying out my duties, I act negligently and harm a third party. The third party sues the corporation and me. The corporation will be liable for my negligent act because I was acting within the scope of my job responsibilities when I committed the tort.

- **Discussion:** How do you feel about a business being held liable for the tortious activity of its agents (employees)? Does it matter if the tort is negligence, intentional, or strict liability? How do you think the court should define “within the scope of employment”?
- **Practice Question:** Mitchell is an employee of Big Corp. His primary responsibilities are to deliver company goods to retailers. When out driving to a retailer's location, Mitchell is following too closely and accidentally rear ends Bertha. Bertha sues Mitchell for negligence. What is the likely result for Big Corp?
- **Resource Video:** <http://thebusinessprofessor.com/principal-liable-for-torts-of-an-agent/>

11. What is a “frolic and detour”?

A “frolic and detour” is a general defense to vicarious tort liability. It states that the principal should not be liable for the tortious acts of the agent when the agent is acting outside the scope of her employment and for the benefit of someone other than the employer. Plainly stated, an employee who is on a frolic or detour is no longer acting for the employer.

- *Frolic* - A frolic is when an employee abandons the employer's business objectives and pursues personal interests.
- *Detour* - A detour occurs when an employee substantially deviates from an employer's instructions or rules.

Generally, both a frolic and detour must be present to relieve an employer from liability for the agent's actions.

- *Example:* An employee providing services for her employer at the location of a client is an agent acting within the scope of her employment. If, however, the employee takes the company vehicle and goes on a personal errand that is not authorized, the employee is likely outside the scope of her employment. Suppose while running these errands she gets into an automobile accident that is her fault. The employer would be able to argue that the deviation from her duties as employee was a frolic and detour and relieved her of liability for the employee's tort.
- **Discussion:** How do you feel about the doctrine of *respondeat superior*? Should a principal be held liable for the tortious acts of an agent if committed within the scope of employment? Why or why not? How would you define scope of employment? Does it matter to you if the agent was also acting in her personal interest when committing the tort? In your opinion, how much of a deviation from her job duties must an employee vary in order for it to be considered a frolic and detour? Can you think of any situations in which a frolic or detour should still subject a principal to liability?
- **Practice Question:** Mitchell is an employee of Big Corp. His primary responsibilities are to deliver company goods to retailers. When out driving to a retailer's location, Mitchell decides to stop by his house and have lunch. Big Corp has a strict policy against taking work trucks home or using company trucks for any purpose other than delivering Big Corp products to retailers. When backing out of his driveway, Mitchell hits Tom who is out jogging. Tom suffers injuries and sues Mitchell and Big Corp. What will Big Corp have to show to defend the action for Mitchell's negligence? What facts in this situation may hinder Big Corp's defense?
- **Resource Video:** <http://thebusinessprofessor.com/vicarious-liability-for-torts-of-agent/>

12. When and how does the agency relationship terminate?

The establishment, duration, and termination of the agency relationship is generally governed by the agreement between the principal and agent. In the absence of an express agreement, several default rules apply regarding the point at which the agency relationship terminates. Below are common rules for terminating the agency relationship:

- *Withdrawal by Either Party* - A principal or agent may withdraw from the relationship at any time. This legal authority is separate from the contractual right to withdraw.
 - *Note:* While withdrawal terminates the agency relationship, it may lead to liability of the withdrawing party.
 - *Example:* Daisy hires Jeb as a sales agent for her new product line. Jeb will earn a commission on sales of the product. Jeb studies the product lines, develops a sales plan, and hits the road. Shortly after the relationship begins, Daisy decides to hire Luke and fire Jeb. Daisy's withdrawal terminates the agency

relationship with Jeb. Jeb, however, may have the legal right to seek damages against Daisy for terminating the relationship.

- *Withdrawal by Both Parties* – The parties can terminate the agency relationship upon mutual consent.
- *Termination by the Principal* – Either party may terminate the agency relationship, even if it violates a contractual agreement between the parties. A principal will be subject to a breach of contract action for terminating the agency relationship if the agent's status is part of an agreement that is supported by consideration and terminating the agency relationship will harm the agent's rights.
 - *Note:* This scenario commonly arises in an agency "coupled with an interest". An agency relationship is coupled with interest when the agent has a specific interest in the subject matter of the agency, such as a consignment of goods for resale.
 - *Example:* I enter into a contract with Ernest to package and sell his products on the Internet. In exchange for my effort, I will keep in percentage of the sale value. As such, the agency is coupled with an interest and cannot be revoked without breaching a contract.
- *Renunciation by the Agent* – The agent can renounce the business of the principal and terminate her agency status and authority. This may, however, violate a contractual relationship between the parties.
 - *Example:* I enter into a contract to serve as your agent. I may terminate the agency by renouncing my duties. Unless I have a justification, my actions will likely violate my contractual obligations to you.
- *Duties of Agent Complete* – If the purpose of the agency ceases to exist, the agency relationship terminates. This often arises when the agent discharges all of her agency obligations. Further, it could arise when the subject matter of the agency no longer exists.
 - *Example:* You higher me to represent you in the sale of your real estate. The real estate is the subject of an eminent domain action and is taken by the government. The agency relationship terminates when the purpose of my agency is gone.
- *Death or Incapacity* – The agency relationship terminates upon the death or incapacity of either party.
- *Bankruptcy* – The agency relationship terminates upon the liquidation or reorganization of either party.

The above situations resulting in termination of the agency relationship are default rules. The parties may reserve any rights or restrictions on terminating the agency relationship within their agreement.

- **Discussion:** How do you feel about either party's right to terminate the agency relationship? What should the remedy be if termination of the agency relationship by a party violates a contract between the parties? Should a party have additional rights if she is harmed by the termination of the agency and the other party's rights are not? Why or why not?
- **Practice Question:** Earl runs a showroom for baby products. Gayle, the inventor of a new product, consigns a

large quantity of goods with Earl. Earl agrees to display the goods and represent them to potential retailers. Earl earns a percentage of all future sales to the retailer as compensation for his services. Can Gayle cancel the agency relationship?

- **Resource Video:** <http://thebusinessprofessor.com/when-does-agency-relationship-terminate/>

TOPIC 12: BUSINESS ENTITIES

Overview

Business entities are an integral part of business practice and economic productivity. An effective business practitioner must understand the characteristics of the major types of business entities, as these attributes can dramatically affect the nature of the business's relationships. This chapter will introduce the concept of the business entity, legal authority for business entities, and the justification for their legal recognition. It will then introduce the most common types of business entities and their notable characteristics. Examination of these characteristics will make obvious the effect of these attributes on stakeholders of the business entity. The characteristics of a business entity affect many other areas of business practices, such as accounting, management, and finance.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• <u>Business Entity</u> • <u>Importance of Business Entities</u> • <u>Closely-held & Publicly-held Business</u> • <u>Main Types of Business Entity</u> • <u>Characteristics of Business Entities</u> - <u>Default Entity & State-Filed Entities</u> - <u>Entity Maintenance</u> - <u>Continuity</u>	- <u>Ownership Structure</u> - <u>Control</u> - <u>Personal Liability</u> - <u>Compensation</u> - <u>Taxation</u> - <u>Income</u> - <u>Sales & Use</u> - <u>Payroll & Self-Employment</u>	• <u>Sole Proprietorship</u> • <u>General Partnership</u> • <u>Joint Venture</u> • <u>Limited Partnership</u> • <u>Limited Liability Partnership</u> • <u>Limited Liability Company</u> • <u>Corporation</u> • <u>S Corporation</u>
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TOPIC 12: BUSINESS ENTITIES - QUESTIONS & ANSWERS

1. What are “business entities”?

Business entities are legal organizations that exist by virtue of state law. One way to view a business entity is as a separate person. The business entity carries on business activity on its own behalf. The owners of the business entity are representatives of the entity. Business entities benefit society by allowing individuals to aggregate their resources and efforts in furtherance of a business activity. The legal entity is essentially a bundle of contracts that provides for the rights and duties of the owners and employees of the business entity. Each individual state passes its own substantive and procedural laws regarding business entities. A business must choose its state of formation or organization. The home state may be the location where the business is headquartered or it may be any other state where the business organizes and establishes a registered agent. If the business wishes to carry on business outside of its home state, it must qualify to do business and register as a “foreign” entity doing business in the other state. Carrying on business is generally defined pretty broadly to include marketing or sales activity. A business may carry on the majority or all of its business in a state or states where it is registered as a foreign entity. The business entity must comply with the laws of any state in which it does business.

- *Example:* I want to form a business entity in my home state of New York. The rules prescribed by New York will govern the formation process. I want to also carry on business in Pennsylvania. To do so, I will register my business in New York and then register as a foreign entity doing business in Pennsylvania.
- **Discussion:** Think about major businesses within the United States. Can you identify five major businesses (Fortune 100 Businesses) within the United States and the state in which they are formed? Where is the headquarters located for each of these businesses?
- **Practice Question:** Martin is from Mississippi. He forms a business entity and begins providing chartered fishing services. He wants to expand his operations to Louisiana. Can you do that given that he is organized in Mississippi? How or why not?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-business-entities/>

2. Why is studying business entities important?

Owners and managers of a business seek to organize their resources to maximize productivity and opportunities. These individuals must understand the important characteristics of the business entity to take advantage of all of the benefits associated with carrying on a business activity as a legal entity. Taking advantage of a business entity status means choosing an entity form for your business, operating within your chosen entity form, and undertaking business transactions with various entity types. Understanding business entity characteristics includes familiarizing one’s self with the ownership structure, organizational structure, potential liability, compensation methods, and tax laws applicable to the business entity. Lastly, the owners and managers of a business must comply with the procedural and substantive laws applicable to that business entity. This is generally known as business governance.

- *Note:* Numerous other requirements may exist before a business entity may carry on business in a jurisdiction. For

example, she will likely have to obtain a business license from the local government before undertaking business. She will have to do a fictitious name filing if she operates under a name other than her own name. Further, she will need to set up an employer identification number (EIN) if she plans to have employees for her business. All of this is distinct from the nature and characteristics of the business entity.

- **Discussion:** Try to outline the procedural steps necessary to form a business entity within a state. This will likely require you to go to the Secretary of State's website for your particular state. The process and rules for form any business entity type will be explained there. *Note:* The process may vary slightly, for each state.
- **Resource Video:** <http://thebusinessprofessor.com/why-is-understanding-business-entities-important/>

3. What is the difference between a “closely-held company” and a “publicly-held company”?

Business entities are often categorized as either closely-held or publicly-held. These designations are not separate types of business entity; rather, they are classifications or defining characteristics of a given business. Generally, the distinction between the two classifications concerns the number of business owners and whether the equity ownership is sold on a public exchange.

- *Closely-held Business* - A closely-held business, as the name implies, is held by a smaller or more closely related group of individuals. It is often thought of as a smaller business, such as a mom-and-pop or family business. In truth, however, the closely-held status has little to do with the size or revenue of the business; rather, it simply means that the business is not widely owned by numerous, unrelated people. Another characteristic of the closely-held entity is that it is not traded on a public market.
 - *Example:* My wife, three friends, and I own a business that specializes in dog training and boarding. We are a closely-held business because all of the ownership is held by a small group of closely-connect individuals.
 - *Publicly-held Business* - A publicly traded business is any business that is traded on a public exchange. This means that the company has gone through an initial public offering in which its shares were registered with the Securities and Exchange Commission and subsequently listed for sale to the public at large. A publicly-held or publicly-traded company is generally held, or capable of being held, by a large number of unrelated people.
 - *Example:* Elton's business is growing rapidly. He needs to bring in additional capital to expand operations. He decides to undertake a public offering and list shares of his company for sale on a public exchange. Once listed for sale to the public, Elton's business is now a publicly-traded company.
 - *Note:* A closely-held business is a private business. It is unlikely that a business could or would undertake a public offering and remain closely held. The inverse, however, is not necessarily true. Private business entities are not necessarily closely held. Some private businesses are widely held by a large number of shareholders.
- **Discussion:** Some companies choose to remain closely-held instead of seeking a large and diverse set of owners. Other companies prefer to be widely held and often undertake a public offering as part of that effort. Can you

think of reasons why a company would prefer to remain a closely-held private company versus a widely-held public company?

- **Practice Question:** Can you identify a very large closely held company that does business across the United States? Can you identify why the company is considered, “closely-held”.
- **Resource Video:** <http://thebusinessprofessor.com/closely-held-vs-publicly-held-business/>

4. What are the main types of business entities?

The main types of business entity discussed in this chapter are:

- *Sole Proprietorships* - The sole proprietorship is not considered a separate business entity, but it is the basis from which business entities are defined.
- *General Partnerships* - The general partnership is the most basic type of business entity. While the general partnership is commonly understood to be a legal business entity, some legal theorists do not regard the partnership as a formal legal entity.
- *Limited Partnerships* - This is a hybrid form of partnership that allows for a class of partner known as a “limited partner”.
- *Limited Liability Limited Partnership* - This is a hybrid form of partnership that allows professional practitioners to organize as partners with limited personal liability.
- *Limited Liability Companies* - This is the most common form of business entity in the United States. The reason for this fact is based upon the blend of informal and protective characteristics of the LLC.
- *Corporations* - The corporations is the oldest form of business entity. The corporation is generally divided based upon its tax status as C-Corporation, S-Corporation, and non-profit Corporation.

Some of the less-common types of business entity are the limited liability limited partnership (LLLP) and the professional corporation (PC). The LLLP is a special purpose entity generally used as part of special project, such as a real estate project. A professional corporation is a corporate form for small practitioner firms that is rarely used because of the unfavorable 25% flat corporate tax rate.

- **Resource Video:** <http://thebusinessprofessor.com/what-are-the-most-common-forms-of-business-entity/>

5. What are the main characteristics of a particular business entity?

There are numerous characteristics that make a business entity unique. The major characteristics of a business entity are as follows:

- *Creation & Maintenance* - The effort associated with forming and maintaining the entity;

- *Continuity* - The continuity or stability of the organization upon given occurrences;
- *Ownership & Control* - The ownership rights and control of those involved with the business;
- *Personal Liability* - The potential for personal liability of those involved with the business;
- *Compensation* - The compensation and division of profits among business owners; and
- *Taxation* - The taxation of the organization's earnings and its distributions of profits to the owners.

This list is certainly not exhaustive; however, these primary characteristics provide a great deal of necessary insight for understanding and choosing a business entity.

- **Discussion:** Why do you think these are the primary characteristics of a business entity? Can you think of any other characteristics of the business entity that would be important to understand when selecting and forming a business entity.
- **Resource Video:** <http://thebusinessprofessor.com/considerations-in-selecting-business-entities/>

6. What is “creation” of a business entity?

Creation of a business entity is the legal or procedural steps that one must undertake to bring the business entity into existence. There is a general dichotomy in the process or steps required to form a business entity.

Default Entity Status

Some business entities may arise by default without any formal procedural undertaking by the founder. That is, the business entity may arise simply by the parties undertaking some business activity with the intention of generating revenue or making a profit.

- *Example:* To form a general partnership, the only requirement beyond the physical activity of the founders is the subjective intent of the partners with regard to the responsibilities of each party and the allocation of proceeds (or losses) as they arise. Generally, in the event of dispute, a court will be charged with determining whether individuals carrying on commercial activity are a default general partnership. Notably, the sharing of losses is the greatest indicator of co-ownership of a business, as apposed to an employer-employee or contractor relationship.
- *Note:* In some cases, a court may determine that a business entity exists pursuant to the conduct or actions of the parties. Further, a court may recognize a partnership to avoid an inequitable result if an entity does not exist. This is known as “estoppel”.

Filing for Entity Status

Some business entities require a formal filing process through the state secretary of state's office. This requires the filing of documents of organization in accordance with the procedural rules adopted by the state of organization. The amount of

information and type of document(s) required will vary between states and depend on the type of entity. The general requirements for each business entity type are discussed along with that business entity.

- *Example:* Eric wants to form an LLC. He goes to the website for the Nebraska Secretary of State's Office and downloads the necessary forms. He files the information sheet and articles of organization and pays the applicable fee. Seven days later he receives a Nebraska state certificate of organization for his LLC.
- **Discussion:** Most people do not realize the commercial activity by two or more individuals defaults to a business entity status under certain conditions. Can you think of any consequences that this may have for the partners and business activity? *Hint:* think about the characteristics of a business entity discussed above. These will help give you an idea of the potential consequences of being deemed a legal business entity.
- **Practice Question:** Eric is thinking about forming a business entity for his personal consulting practice. He has been consulting for several months and is bringing in Audrey, also a consultant, as a co-owner of the business activity. He and Audrey begin operating their consulting practice before filing the applicable business organization documents. What should Eric and Audrey know about their current business entity status?
- **Resource Video:** <http://thebusinessprofessor.com/creating-business-entities/>

7. What are the “maintenance” requirements for a business entity?

Maintenance of a business entity is summarized as the administrative steps associated with starting and carrying on business as a given entity form. It entails the process of filing documents, holding meetings, maintaining records, observing formalities, and reporting necessary information to regulators. The requirements for starting a business vary considerably between entity types. Businesses entities that require formal procedures to organize also require formalized maintenance procedures. At the most basic level, these entities require the owners to file statements each year (along with annual fees) with the Secretary of State's office, to hold business meetings, to maintain records, and to report information to regulatory authorities. The state may require that an entity maintain certain records, such as meeting minutes and resolutions, ownership logs, capital accounts, financial statements, etc. The Federal Government may require that business entities file specific information related to taxation or securities issuances. State and federal reporting requirements can also be industry specific or based upon the company's size or status as privately or publicly-held.

- *Example:* A group of friends and I form a corporation. We all vote and elect each of us as directors. We then appoint me as CEO. Our creation and maintenance requirements mean following the state-required duties for filing annual information and paying fees to the state. This could include voting as directors to approve our corporate documents. As CEO, I will be charged with filing those documents with the state.
- *Note:* Generally, default business entities require little or no maintenance to continue on as a business entity. These businesses arise simply through the conduct of those involved and do not involve the formalized procedure for maintaining their operating status. While there are few formal maintenance requirements for default entities, there are still numerous tax formalities to follow. The lack of formal maintenance requirements associated with default entities often causes the owners to fail to follow other business formalities.

- **Discussion:** Why do you think the government requires business entities to undertake these maintenance

formalities? Why do you think it is important internally for businesses undertake formal maintenance? Which State and Federal agencies do you think the care about business maintenance? Hint: Think about taxation and securities law.

- **Practice Question:** Visit your state's secretary of state's website. Can you locate the information and filing required to form and maintain each type of business entity recognized by your state? How do these requirements vary between each type of business entity?
- **Resource Video:** <http://thebusinessprofessor.com/maintenance-requirements-for-a-business-entity/>

8. What is “continuity” of a business entity?

The continuity of the business entity concerns the effect on the business of a major change in the ownership and organization structure. More specifically, this question addresses what types of conduct by business owners can cause the business to dissolve. Owners of a business entity must understand the stability and durability of the organization if or when an owner leaves the business. Managers are concerned with the stability of customers and suppliers and should make certain that changes in ownership or structure do not have unintended consequences on the business operations. The primary change affecting the status of a business entity is the death or dissociation of an owner. In some instances this occurrence may be grounds for the dissolution of the business. Another dissolution event may arise through a limitation on the transfer of ownership by any individual in the business. Such a scenario may effectively dissolve the business if one individual wishes to liquidate her interest.

- **Example:** Mary, Bob, and I start carrying on business as a general partnership. We do not have a partnership agreement. When Mary decides to leave the partnership, the default rule is that the partnership dissolves.
- **Discussion:** Can you think of any situations where a business has faced serious turmoil when a co-owner leaves the company? Passes away? Declares personal bankruptcy? What were the primary issues and what was the result?
- **Practice Question:** Mike and Bryan are partners in a business venture. They have a partnership agreement. Bryan passes away and his will leaves his interest in the business to his wife, Jane. What information do you need to know to determine the status of the business entity? Why?
- **Resource Video:** <http://thebusinessprofessor.com/continuity-of-business-entities/>

9. What is the “ownership structure” for a business entity?

Ownership structure concerns the internal organization of a business entity and the rights and duties of the individuals holding a legal or equitable interest in that business. As owner of the business entity, it is important to understand how the ownership structure of a particular business entity is organized and what that means for the owner's rights.

- **Example:** A shareholder, as owner of a corporation, has certain rights. These rights are distinct from those of members of a limited liability company. Further, within the corporation, a holder of preferred stock may have different rights than the holder of common stock.

- **Discussion:** Why do you think different types of business entity allow for unique ownership structures? Why do you think ownership structure is so important for business owners?
- **Practice Question:** Can you think of any situation where ownership of the business entity became an issue between the founders or co-owners of the businesses? What was the basis of the dispute and what was the outcome?
- **Resource Video:** <http://thebusinessprofessor.com/ownership-structure-of-business-entities/>

10. What is “control” over a business entity?

This question concerns who has control over operations or authority to act on behalf of the business. Each business entity type has a default control structure and level of authority vested in individuals in those roles. In many cases the owners and managers of the business are the same people. This relationship becomes convoluted when there are owners who act as managers of the business and others who do not. The issue of overlapping ownership and control becomes increasingly important in closely-held business entities. Third parties dealing with a business entity want to be certain about the level of authority of the individual with whom they are dealing. Further, the business entity is concerned about its agents undertaking transactions that obligate the entity, such as taking out loans or entering into purchaser or sales contracts.

- **Note:** Recall from the chapter discussing agency law, the level of authority of individuals acting on behalf of a business entity affects the potential liability of the business for the acts of those agents. Business owners may undertake procedures to outline the role and authority of each member of the business. This is normally done within the business’s organizational documents. The title attributable to any owner affects the level of control and authority that she has. Failure to follow procedures to document the authority and control within the business can result in a default level of control or authority in a member of the business that is undesirable to the other owners. Further, a lack of formalized organizational structure can cause internal disputes that affect the operational efficiency of the business.
- **Example:** Owners of an LLC are known as members. I am a member of an LLC. If I am a member-manager of the LLC, I have the authority to carry on all operations and act on behalf of the LLC. If I am not a manager of a member-managed LLC, I do not have the authority to act on behalf of the business.

- **Discussion:** Why do you think structure of control is an important characteristic of a business entity? Should business owners be able to change or modify a business’s control structure? Why or why not?
- **Practice Question:** Can you find a situation where an employee or agent acted on behalf of a business without authority? Can you identify a situation where the business was contractually bound by the actions of the employee that were not authorized?
- **Resource Videos:** <http://thebusinessprofessor.com/what-is-control-of-a-business-entity/>

11. What is the potential “personal liability” of owners of a business entity?

Generally, individuals are responsible for their own conduct. The rules of agency may make an individual vicariously responsible for the acts of an agent, if that agent is acting with authority or within the scope of her employment. Some business entities limit the liability of business owners for the actions of agents of the business. This means that the owner is protected from being held personally liable for the debts (contracts) or tortious conduct of the business's employees or other owners. That is, the business owner does not risk losing her personal assets for debts created or tortious activity committed by the business or its owners. This business entity characteristic is a strong motivation for individuals to form a business entity to carry on their business activities.

- *Note:* It is important to remember that a business entity offering personal liability protection to its owners may forfeit that protection if the Secretary of State's office or the court disregards the business entity. The Secretary of State may dissolve a business entity for failing to follow entity maintenance requirements. More commonly, a plaintiff who is suing the business may attack the business entity status in an attempt to "pierce the veil". Piercing the veil is discussed further in the corporate governance chapter.
- *Example:* The owner of an LLC has two employees who deliver goods to customers. One of the employees accidentally crashes the company vehicle into a pedestrian. The pedestrian can sue the negligent driver and the LLC for damages. The driver may be personally liable for his negligent driving. The LLC may be vicariously liable for the employee's tortious act, since it was committed when the employee was acting in furtherance of the business's operations. The owner's personal assets, however, may be protected from the reach of the plaintiff.

- **Discussion:** Can you identify any situations where the owner of a business has been held personally liable (either in contract or tort) for the actions of the employees of a business? Why was the business owner held personally liable despite the limited liability protections of the business entity?
- **Practice Question:** Bert is a member of an LLC. The LLC is managed by Victoria, who is also a member of the LLC. Victoria accidentally rear-ends Gayle while driving to meet a business client. If the plaintiff decides to sue for the negligent act, will Bert or Victoria potentially be personally liable?
- **Resource Videos:** <http://thebusinessprofessor.com/limited-liability-business-entities/>

12. How is an owner of a business "compensated"?

The owners of a corporation may be compensated in two primary manners. The acceptable method of compensation depends upon the type of business entity and the role that the owner plays in the business. Some business entities allow business profits to pass through the business directly to its owners. These owners receive either a percentage of the profits based upon their ownership percentage or a percentage based upon a special allocation of business profits that differs from their ownership percentage. Other business entities (specifically corporations) compensate owners by distributing dividends from business profits. Unlike flow-through profits, payment of dividends is generally a decision by the board of directors and does not represent all profits of the corporation. That is, the corporation determines the amount of any dividends paid to shareholders and may retain any percentage of profits within the corporation.

- *Note:* A corporate employee who is also a business owner must receive a reasonable salary for her services to the corporation. Otherwise, a portion of any share of corporate profits distributed as dividends will be treated as salary. This makes a difference in how the funds are taxed to the individual. An owner of any other type of

business entity does not receive a salary and is compensated by receiving a distribution of profits.

- *Example:* I am a shareholder and CEO of ABC Corp. I will receive a salary for my services as CEO, and I will receive a dividend if any are paid to shareholders. Corporate business entities (or business entities taxed as corporations) require that an owner who also serves as an employee of the business to draw a salary from the business. The salary is separate from any distribution of dividends.
- **Discussion:** Is it common for owners of a business to also serve as employees of the business? Are most owners of a business in the US employees of the business? Please explain.
- **Practice Question:** Frank and Judy are members of an LLC. Both Frank and Judy work in the LLC and each is a 50% owner. What other information do we need to know to determine how Frank and Judy are compensated?
- **Resource Videos:** <http://thebusinessprofessor.com/compensation-within-business-entities/>

13. How are business entities “taxed”?

Understanding basic taxation concepts as they apply to each entity type will give you sufficient background to understand the important tax considerations in a transaction by a given business entity. To understand taxation of business entities, it is important to understand personal taxation as well as business taxation.

- **Resource Video:** <http://thebusinessprofessor.com/taxation-of-business-entities-explained/>

Individual Taxation - Income

Individuals pay federal and state taxes on a percentage of their adjusted gross income (AGI) in a given tax year. AGI is calculated as an individual’s gross income, minus all deductions (either the standard deduction or itemized deductions) and the individual’s personal exemption. A person’s gross income is comprised of wages or other income, dividends, and investment interest, gains, dividends, rents, royalties, etc. Deductions are numerous categories of expenses that the state and federal government exempts from taxation. A person can either claim individual deductions, known as “itemizing deductions” or claiming a “standard deduction”.

- *Note:* The standard deduction in 2016 is \$6,300 for single individuals. This changes for individuals filing jointly or as head of household. Each taxpayer also has a personal exemption is \$4,050. The state and Federal Governments also allow various credits that subtract directly from the amount of income tax liability.
- *Example:* Each year I am required to tally all of my earnings from a number of sources. I then subtract all deductions allowed by the state and federal governments. If my individual deductions do not add up to an amount greater than the allowed standard deduction, I will subtract the standard deduction. This amount is my AGI. Calculation of my income tax liability for the year will be based upon this amount.

The income tax rates for wages and other income are tiered. All individuals pay a fixed percentage on the first several thousand dollars of their AGI, a fixed percentage on the next several thousand, etc.

- *Note:* The 2016 federal tax brackets for single individuals are 10, 15, 25, 28, 33, 35, and 39.6%. The dollar amount of income that fits in each bracket depends upon whether the individual files as a single taxpayer, married filing separately, head of household, or married filing jointly.
- *Example:* Assume the rates stated above apply. I am not married and file as a single tax payer. I make \$30,000 in a year in wages. I take the standard deduction and personal exemption. My AGI is \$19,650. The first \$9,275 will be taxed at 10% for a liability of \$927.50. The remaining \$10,400 will be taxed at a 15% rate for a liability of \$1,560.00. My total federal tax liability for the year is \$2,487.50. Note that this overly simplified example assumes that I have no additional deductions for state taxes, Medicare or social security payments that would reduce my taxable income amount.

Individuals also pay taxes on gains. Gains consist of value received and recognized when an asset is sold for a higher value than the owner's basis in the property. Long-term capital gains (gains on certain assets held longer than 12 months) and dividends are taxed at different rates than other forms of gross income. Short-term capital gains are taxed at ordinary income rates. The tax rate for long-term capital gains and qualified dividends may also be tiered based upon income. While they are included in gross income, qualified dividends and long-term capital gains are subject to different tax rates from other sources of income.

- *Note:* In 2016, long-term capital gains and qualified dividends are taxed at 0, 15, and 20%. The 0% rate applies to individuals in the 10% and 15% income tax brackets. The 15% rate applies to individuals in the 20, 28, 33 and 35% income tax brackets. The 20% rate applies to individuals in the 39.6% income tax bracket.
- *Example:* I purchase a single share of stock in ABC Corp for \$5. Six months later I sell the stock for \$10. I have gains of \$5. Because I held the stock for 6 months, the gains are treated like wages and taxed at that rate. If I had held the stock for longer than 12 months, the applicable tax rate would have been the applicable long-term rate.

Business Taxation - Income

Business taxation is more complicated than individual taxation. Business entities are either not taxed at all, or they are taxed at a corporate rate. If a business entity is classified as a pass-through tax entity, it does not pay income taxes. Rather, the business owners pay taxes on any business profits. Restated, the profits or losses from the business activity pass through to the individual and are reported on her individual income tax form. Businesses that pay taxes, such as businesses taxed under Subsection C of the Internal Revenue Code, are taxed at the corporate rate. Like the individual tax system, the corporate tax rate is tiered.

- *Note:* In 2016 the applicable corporate tax rates are 10% (\$0-50,000), 25% (\$50,000 - 75,000), 34% (\$75,001 -100,000), 39% (\$100,001 - 335,000), 34% (\$335,001 - 10,000,000), 35% (\$10,000,001 - \$15,000,000) , 38% (\$15,000,001 - 18,333,333), and 35% (\$18,333,333 & up).
- *Example:* I form an LLC. I can elect with the IRS for the business to either be taxed as a partnership or a corporation. If I elect to be taxed as a partnership, the LLC will be taxed as a flow-through tax entity. The business entity will not pay income taxes; rather, all profits or losses will flow directly through to me and I will report the income on my personal income tax return and pay the applicable taxes.

Business entities taxed under Subsection C of the Internal Revenue Code (IRC) pay income taxes on profits. Corporations taxed in this manner are known as C-corporations. These taxes are treated as an expense to the corporation. They are

deducted, along with other expenses, to determine whether the corporation is profitable or has profits at the end of the tax year. Any distribution of corporate profits to shareholders is a dividend and is taxed to the shareholder at the applicable dividend rate. The shareholder reports those dividends on her personal income tax return.

- *Note:* A business taxed as a C-corporation is not required to distribute profits. These are known as retained earnings. A shareholder does not pay taxes on the income until it is distributed. In a pass-through entity, the business entity does not pay taxes. As such, owners of the business must pay taxes on the profits whether the profits are distributed or no.
- *Example:* I form a corporation and elect to be taxed under Subsection C of the IRC. The corporation brings in \$12,000 and has expenses of \$2,000 in the tax year. The corporation has taxable income of \$10,000. The applicable tax rate is 10% on this amount, equaling \$1,000. So, after taxes, the corporation has profits of \$9,000. If the corporation decides to pay a dividend to me as the sole shareholder, I will report the dividend payment on my personal income tax return and pay taxes on the dividend amount. If, however, the corporation decides to retain all of the earnings and not pay a dividend, I will not be taxed on the profits. In contrast, in a flow-through tax entity, the business entity itself would not pay taxes. Rather, all \$10,000 of profit would automatically flow through to me. I would report the entire amount on my personal income tax return and pay the applicable taxes.

- **Discussion:** Can you think of a situation where an individual would be subject to a personal income taxes on a portion of the money received from a corporation and subject to dividend taxes on other amounts of money received? Please explain.
- **Practice Question:** I am an employee and shareholder of ABC Corp. I draw a salary of \$30,000 from the corporation. At the end of the year the corporation has a profit of \$100,000. It decides to pay dividends to shareholders. Based upon the shares I own, I receive dividends of \$1,000. In this scenario, what taxable income must be reported to the Federal Government?
- **Resource Video:** <http://thebusinessprofessor.com/how-are-businesses-taxed/>

Sales Tax

Businesses that sell any sort of good are subject to sales and use tax. Sales tax is the amount that the merchant must charge to customers who purchase goods for use (rather than resale). Sales tax is generally a fixed percentage of the value of the good. Other taxes that accompany sales tax may also apply for specialty occupations, such as merchants selling luxury goods, hotels, and restaurants. The merchant must collect the tax from the customer and not simply pay the taxes from the proceeds of the sale. The taxes withheld must be deposited with the state's department of revenue on a regular basis. The taxing state is the location where the good was sold. It does not matter the location where the seller is located.

- *Example:* I buy widgets from a wholesaler and then resale those goods to the public. Each time a customer purchase a widget for \$10, I also charge the customer 6% sales tax. This means that the final amount is \$10.60. At the end of month, I transmit all sales taxes collected to the state department of revenue in which I collected the taxes. This requires that I keep track of my location when I sold the goods and the location of the customer.
- *Note:* The sales tax rules become tricky when a retailer sells over the internet in state where she does not have a physical business or significant presence. Many states allow that, if the customer is located outside of the state

where the retailer is located or has business operations, and the retailer ships the item to the customer, the retailer does not have to collect and deposit sales taxes. This can be a huge detriment to in-state retailers.

Use Tax

Use tax is a separate tax that is similar to sales tax and applies to the purchase of goods by individuals or businesses. Use tax is assessed when goods are purchased for use or consumption and sales tax is not paid on the item. This scenario may arise when a merchant purchases goods for resale, which is done free of sales tax, and then converts the item to personal use. Another common use-tax scenario is when an individual or business purchases a good in a state other than the state in which the goods will be primarily used, consumed, or located. If the sales tax assessed in the state of purchase is lower than the sales tax in the state where the goods will be used, consumed, or stored, the purchaser must pay the tax rate difference to the state where the good is used, consumed, or located.

- *Example:* Tommy decides to purchase a new truck. He lives in Wyoming, but travels to Montana to purchase the truck. Montana has no sales tax; while Wyoming assesses a 4% sales tax. If he pays \$30,000 for the new truck, he will owe use taxes of \$1,200 to Wyoming, as that is the state where he will use the truck.
- **Discussion:** Can you think of a large corporation that actively negotiates exemption for state sales tax obligations for goods sold *via* its Internet service? Why would a state grant this business relief from collecting sales tax on items sold within the state? How do you feel about the assessment of use tax? What do you think is the reasoning behind this tax?
- **Practice Question:** Aragon is a large online retailer. It is headquartered in Kentucky, but sells and ships consumer goods all across the country. In order to allow for rapid shipping, Aragon builds distribution centers in many states. Aragon ships to customers in State A, which assesses a sales tax, but has no physical presence in the state. Aragon also ships to customers in State B, which assesses a sales tax, but it has a major distribution centers in State B's capital city. Lastly, Aragon ships to customers who have PO boxes in State C, which does not assess sales taxes. These State C customers then take the goods with them for use or consumption in State D. What are the potential sales and use tax assessments in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/sales-and-use-tax-2/>

Self-Employment and Payroll Taxes

Employers and employees who receive any form of compensation as part of their employment are generally subject to payroll taxes. Payroll taxes were authorized under the Federal Insurance Contribution Act (FICA) and are made up of Social Security and Medicare taxes. Employers must withhold these taxes from the compensation paid to employees. The employer then contributes a similar amount to that withheld from the employee's compensation. The employer then deposits these funds with the Internal Revenue Service (IRS). These payments go to fund the Medicare program and the Social Security benefits that the employee will receive when she is eligible.

- *Example:* I go to work for ABC, Corp. ABC pays me a salary. Each pay period, ABC will withhold an amount of income, Medicare, and Social Security taxes. The Medicare and Social Security taxes are known as payroll taxes. ABC will contribute an amount approximately equal to the amount of payroll taxes withheld from my compensation and then deposit those funds with the IRS.

Self-employment taxes apply to individuals who are self-employed or are owners of an entity taxed as a partnership. You can think of it as the employer and the employee are one in the same. As such, the self-employed individual is responsible for paying the employer and employee portion of the payroll tax.

- *Example:* Mary and I form a partnership. We both work in the partnership. As owners of a partnership, we do not receive a salary; rather, we receive compensation by splitting the profits of the business. We are considered self-employed, as we are owners of an entity taxed as a partnership. Mary and I will have to pay self-employment taxes equal to the portion of payroll taxes traditionally paid by an employee and the employer combined.
- *Note:* An employee must fill out form W-4 to provide necessary withholding information, which is then used to determine the amount of income to withhold. The withheld wages serve to satisfy the employee's federal and state income tax obligations. In addition to payroll taxes, the employer will also withhold Federal Unemployment Tax (FUTA) and State Unemployment tax (SUTA) from the employee's wages. She deposits all of the taxes withheld at regular intervals with the IRS or state taxing authority.

- **Discussion:** It is a common scenario where employers wrongfully treat employees as independent contractors. What is the benefit to employers in doing this? What are the detriments to the employee?
- **Practice Question:** Howard and Janet are the sole owner of Searchlight, LLC. Howard and Janet work in the business and Searchlight has one employee, Taylor. Searchlight is taxed as a partnership. What are Howard and Janet's self-employment tax obligations? What are Searchlight's payroll tax obligations?
- **Resource Video:** <http://thebusinessprofessor.com/self-employment-and-payroll-taxes/>

14. What are the major characteristics of a "sole proprietorship"?

The sole proprietorship is not a true form of business entity. This is because there is no boundary between the individual entrepreneur and business entity. The entrepreneur and the business activity are one in the same. The sole proprietorship, however, is the basis for comparing other entities. The primary characteristics of the sole proprietorship are as follows:

- *Creation & Maintenance* - To create a sole proprietorship the individual entrepreneur simply has to carry on some activity with the intention of seeking a profit. It is really that simple. It arises when a single individual carries on an activity for a profit (or loss). No formal filing or documentation is required. The definition of a sole proprietorship has two primary components: 1) an activity, and 2) intent to earn a profit. This definition is very broad and covers a broad range of activities. This could make a person's actions or activity into an unintended business entity. The important thing to remember is that the entrepreneur does not have to intend to start a business and the type or manner of activity that she undertakes is irrelevant.
 - *Note:* The definition of a sole proprietorship can be somewhat misleading, as not every sole proprietorship makes a profit. This requirement is interpreted to mean any sort of activity that intends to generate revenue. There are no maintenance requirements for the sole proprietorship, as it is not true a business entity.

- *Example:* I am walking down the street and see a house that has lots of leaves in the yard. I need some extra money, so I knock on the door of the home and offer the owner to rake her leaves for \$25. The owner agrees. I am a sole proprietor and have created a sole proprietorship through my efforts.
- *Continuity* - If the entrepreneur stops carrying on the business activity, the sole proprietorship ceases to exist. The business entity will exist as long as the sole proprietor wishes to continue doing business. Ownership in the sole proprietorship cannot be transferred because the business activity is unique to the individual. This includes selling the business or passing it to one's heirs.
 - *Note:* The name, property, activity can be transferred, but the actual organizational identity is unique to the individual carrying on the business. The business activity carried on as a sole proprietorship is often passed from owner to owner. This is done by transferring the actual assets of the business.
 - *Example:* I start carrying on business as a sole proprietor. When I am ready to retire, I cannot pass my business to my heirs because the business is inseparable from me. There is no form of stock or ownership interest to transfer. I can, however, sell my naming rights, real estate, and business assets.
- *Ownership* - By definition, a sole proprietorship has one owner.
 - *Note:* A sole proprietorship cannot contain more than one owner or it becomes, by default, a general partnership.
- *Control* - The sole proprietor exercises complete control over the business entity. A sole proprietorship can have employees who work in the business. The key to this relationship is that the employees cannot hold or earn ownership interest in the business activity. This will preclude any profit sharing arrangements between the owner and employee.
 - *Note:* The owner should be careful when compensating an employee based upon the amount of revenue produced. Such compensation should be carefully structured as a bonus system on a base salary.
 - *Example:* I create a consulting business as a sole proprietorship. I employ several people to work for me. I stop working in the business and charge one of my employees with managing the firm. In this scenario, I still have complete control over the business as sole proprietor. The authority I vest in a manager is based upon the complete control I have over the business.
- *Personal Liability* - The sole proprietor is liable for any obligations or torts arising pursuant to the business activity. An individual (employee or business owner) is generally liable in tort for her own actions; however, a sole proprietor is also personally liable for the torts of any employees committed in the course of business operations. This is a form of vicarious liability.
 - *Note:* The personal risk to the business owner is perhaps the greatest disadvantage of carrying on business as a sole proprietor.
 - *Example:* I start a coffee shop and I run it as a sole proprietor. I hire several employees. One day an employee is not paying attention and spills hot coffee on a customer. She sues the employee, the business, and me personally. The employee will likely be liable for her negligent act. Further, the business will be

vicariously liable for the acts of the employee. Because the sole proprietorship does not protect the owners for liability for business obligations, I will be personally liable for any judgment rendered against the business. This means that the judgment can be satisfied (paid) from my personal assets (bank account, home, car, etc.).

- *Taxation* - Profits or losses from the sole proprietorship pass through to the business owner. The sole proprietor reports her taxable income on her personal income tax returns (Form 1040 or some variation thereof). The Form 1040 allows the individual to report any income from business operations on her personal income tax return on Schedule C. The sole proprietor does not have to prepare or file a separate tax return for the business entity.
 - *Note:* A sole proprietorship does not withhold income taxes or payroll taxes for its owners. Sole proprietors must withhold and make estimated payments to the IRS and state taxing authority to cover the tax liability attributable to business profits. Further, the sole proprietor must make estimated payments to cover self-employment taxes. The sole proprietor also has to withhold any special business taxes imposed by the state or locality. The withheld taxes must be transferred to the appropriate government agency on the appropriate schedule.
 - *Example:* I carry on business as a sole proprietor. Any business profits flow to me. At the end of the year, I will report the profits on Schedule C of my IRS Form 1040. The sole proprietorship does not file an income tax return. It does not withhold income or payroll taxes for me as owner. I must calculate the profits from the business each month or quarter and pay an estimated amount of taxes to cover my income tax and self-employment tax obligations.

- *Discussion:* Can you identify a business activity where operating as a sole proprietor is not a bad idea? Hint: Think of a combination of the following characteristics: service vs product, employees vs no employees, business premises vs none, business assets vs none, low personal tax rate vs high personal tax rate.
- *Practice Question:* In a short paragraph, can you describe the primary attributes of a sole proprietorship?
- *Resource Video:* <http://thebusinessprofessor.com/sole-proprietorships-explained/>

15. What are the major characteristics of a “general partnership”?

A general partnership is the most basic form of business entity. The primary characteristics of the general partnership are as follows:

- *Creation & Maintenance* - A general partnership is an agreement between two or more persons to share a common interest in a commercial endeavor and to share its profits and losses. There is no government-filing requirement to form a general partnership. The partnership can arise by default from the actions or activities of the partners. This general partnership definition contains similar elements to the sole proprietorship, but it requires more than one person. The agreement between the individuals does not have to be written or expressed. It can be implied from the actions of the partners. It is important to understand that a general partnership is a default entity. That is, the partners do not have to intend to create a general partnership, nor do they have to realize that a general partnership has been formed. Under the doctrine of “partnership by estoppel”, a court may deem a relationship to be a

partnership when the requisite elements are not present. This situation arises when third parties rely upon an individual representing himself as a partner or consents to another representing himself as a partner.

- *Note:* In some situations a court may determine that principles of fairness and equity require that the activities of individuals constitute a partnership. This is known as a “partnership by estoppel”.
- *Example:* I learn about an opportunity to make money by raking leaves for a local business. I approach Elsa and ask her to help me rake leaves to make money. We agree to split all proceeds from raking leaves. We have formed a general partnership.

Individuals may enter into a written agreement, known as a “partnership agreement”, establishing a general partnership. A partnership agreement is the governing document for any type of partnership. Partnership agreements are not mandatory, but it is advisable for any partnership to have an agreement governing the partnership relationship.

- *Note:* Documenting the relationship between individuals in a business activity can serve to characterize the relationship as either a general partnership or employer-employee relationship. In the absence of a formal agreement, states have default rules governing the operations of the partnership and the relationship between the partners. While the default rules are comprehensive, they often do not always align with the specific intent of the parties.
- *Example:* If you wish to hire an individual (not bring her on as a partner) and compensate her with a share of the profits, you will need to document the employment relationship. This may require special structuring of any profit sharing as a bonus paid to the employee, rather than as an ownership percentage in any profits.

A general partnership has no formal maintenance requirements. There are, however, default rules that provide for the rights of partners with regard to the partnership. This may include the right to vote for certain partnership decisions and a right to profits of the partnership. These rules are a form of governance requirement that may be considered maintenance of the business entity.

- *Continuity* - The duration of a partnership is determined by the intent of the parties. An “at-will” partnership has no stated date. The partnership will continue until the partners dissolve the business. The partners can designate a time period for the general partnership, after which the partnership dissolves. This is known as a “term partnership”. This means that the parties may have some duty to the partnership to remain partners for the pendency of the state time period. If the parties do not designate a specific purpose or time for the partnership’s existence, it is considered an at-will partnership. This means that partners can dissociate from the partnership at any time.
 - *Note:* If there is a dispute between parties over assets or income at the time of dissolution, each partner is entitled to an “accounting” of partnership assets. This is an equity action used to determine the partner’s rights to partnership assets. This right is important, as partners are generally not allowed to sue each other in court over dollar damages as a result of dissolution.
 - *Example:* I form a partnership with Maria. We specifically state that the partnership will last until the current work project is complete. We have a term partnership and we have a duty to the partnership to

remain partners until the completion of the project. If we do specifically state that the partnership ends at the conclusion of our project, our general partnership is an at-will partnership. We can both leave the partnership at any time without violating any duties to the partnership.

Any partner in a partnership may dissociate at any time. This, and certain other actions by partners, may give rise to dissolution. Absent an agreement otherwise, the following activities generally give rise to dissolution of the partnership: change in partners; winding up process; expulsion of partner that is breach of partnership agreement; it becomes impossible to continue business; or the partnership activity becomes illegal; death or bankruptcy of a partner; or pursuant to a court order for gross misconduct or willful breach of partnership agreement.

- *Note:* If partnership wrongfully dissolved, remaining partner may continue. Must settle up with withdrawing partner.

Continuity of the partnership is determined by the partnership agreement. If the partners do not have a partnership agreement stating otherwise, the partnership does not have continuity. That is, the default rule in many states is that a general partnership dissolves when a member dissociates. As such, a partnership interest cannot be transferred or passed along to one's heirs. Most states, however, allow the remaining partners to take steps to reform the general partnership and continue in business after cashing out the dissociating party's interest.

- *Note:* The transfer of a general partner's interest, death or incapacity, may give rise to a right of dissociation by other partners. An exception to the default dissolution rule is when a partner passes away or dissociates by reason of incapacity. In such a case the general partner does not automatically dissolve.
- *Example:* I form a partnership with Cliff. We state in the partnership agreement that either party may leave at any time. We include provisions for the continuation of the business and the obligation of the partnership to purchase the leaving partner's business interest. Without this agreement, the partnership would dissolve upon Cliff or me leaving.

As stated above, partners can change the default rules governing the general partnership by entering into a partnership agreement. The agreement may also designate the procedures for winding down the business or allowing the remaining partners to continue the business. It can further allocate responsibility for debts of the general partnership or allocate the proceeds upon continuation or dissolution. These types of agreements are known as "buy-sell agreements".

- *Ownership* - General partners are the sole owners of the general partnership. The parties may agree on each partner's percentage of ownership. In the absence of a partnership agreement, default partnership rules govern the relationship. By default, partners are entitled to equal ownership rights. This means that the partners share equally in profits or losses, unless the parties specifically agree to some other allocation of profits and losses. Further, the default rule is that ownership interests cannot be transferred to third parties without the consent of the existing partners. Attempting an unapproved transfer of an ownership interest is grounds for dissolution of the partnership.
 - *Example:* Katie and I form a partnership. We do not have a partnership agreement. As such, by default, Katie and I are equal owners of the partnership. We later enter into a partnership agreement that establishes me as 70% owner and Katie as 30% owner. This will replace the default rule that we are equal owners.

- *Control* - The general partners have complete control over the partnership. This means that partners have decision-making authority with regard to the governance and strategy of the partnership, as well as authority to act on behalf of the partnership as a general agent. The partners may establish a partnership agreement that changes or limits any partner's right of control or voice in the management of the partnership. This does not, however, limit the authority of a partner to obligate the partnership by entering into transactions or relationships with third parties, such as loan or sales agreements. The partnership can limit the authority of a partner to act on behalf of the partnership by specifically giving any third party notice that the partner's authority is limited.
 - *Note:* Some partnership decisions require consent of both partners.
 - *Example:* Terry and I form a partnership. Terry and I have equal ability to make decision for the partnership. If Terry wants to enter into a purchase contract, she has the authority to do so. If we decide to limit Terry's authority in a partnership agreement, this does not limit her authority with respect to third parties. I will need to provide notice of that agreement to any third parties who may interact with the partnership through Terry.
- *Personal Liability* - A general partnership is similar to a sole proprietorship in that it does not offer the business owners any form of personal liability protection. Each partner is personally liable for any debts, obligations, or tortious conduct of the business. This means that, if the business stops operating or goes bankrupt, the owners are liable for the debts and obligations of the business. In fact, each partner can be held totally liable for the entire debt of the business. This is known as "joint and several liability". Per the law of agency, the partnership is liable for the obligations established by its agents or their tortious conduct committed within the scope of employment. As such, each partner is potentially personally liable for the actions of partners and employees of the partnership. This may be true even if a partner or employee exceeds her authority under a partnership agreement or employment agreement. These facts alone make a general partnership a potentially risky entity form under which to carry on business.
 - *Example:* Eric and I form a partnership. We hire an employee, Jane. Jane is careless and injures a third party when driving the company truck. The injured party sues Jane and the business. If Jane receives a judgment against the business, Eric and I will be personally liable for the business debt. If the business does not have funds or assets to satisfy the debt, our personal assets will be at risk.
- *Compensation* - General partners are compensated by receiving a draw of partnership funds (generally profits). This is known as the partner's distributive share. By default, this draw is often representative of the percentage of ownership of each partner. The partners may, however, enter into an agreement allocating the distribution of profits or losses differently from the ownership structure. That is, a partner may receive a percentage of partnership profits or losses that is greater than or less than her ownership percentage. This must be justified based upon an economic reality of the partnership, such as one partner spending more time working for the partnership.
 - *Note:* Partners are not entitled to receive a salary based upon their ownership percentage or for services rendered to the general partnership. Only employees of the partnership who are not also partners may receive a salary as compensation.
 - *Example:* Tanya and I form a partnership with equal ownership. We have one employee, Josh. At the end of the year, the partnership has \$10,000 in earnings. The only expense is Josh's salary of \$2,000. Tanya and I will receive a distribution of \$4,000 each. Josh, who is not an owner, received a salary. It does not

matter whether Tanya and I work in the partnership. As owners we do not receive a salary.

- **Taxation** - General partnerships are not taxable entities; rather, they are pass-through tax entities. The partnership will subtract expenses and other deductions from revenue to determine the annual profits or losses. Like a sole proprietorship, partners report their share of general partnership profits or losses on their personal income tax returns. The general partnership does, however, have to prepare a tax return. This return is known as an “informational return” and is filed on IRS Form 1065. The return outlines the revenues and expenses attributable to operations. It will also outline the percentage or amount of the profit or losses to which each party is entitled. The partnership is obligated to provide individual partners with a Form K-1 outlining that partner’s share of profits or losses. These amounts are then recorded on the owner’s individual tax return.
 - *Note:* A partner is required to pay taxes on her allocated percentage of partnership profits, whether she withdraws the profits from the partnership or leaves those profits in the business entity.
 - *Example:* Barry and I form a partnership. At the end of the year, the partnership has profits of \$10,000. Barry and I are equal partners, so we are each entitled to 50% of the profits. The partnership will prepare and information return and provide K-1s to Barry and me. The K-1 will indicate that we received \$5,000 in profits, which we must report when filing our individual income tax returns.

- **Discussion:** Is there ever a situation when carrying on business as a general partnership is a good idea? Hint: Think about situations where other business entities are the general partners.
- **Practice Question:** In a short paragraph, can you describe the primary attributes of a general partnership?
- **Resource Video:** <http://thebusinessprofessor.com/general-partnership-explained/>

16. What is a “joint venture”?

Joint ventures operate similarly to general partnerships, but they are specifically formed for a limited purpose or a single project. Unlike a general partnership, the joint venture does not arise by default through the activity of the joint venturers; rather, it requires the specific intent and agreement of the parties. As such, a joint venture agreement should be in writing to avoid the interpretation of the activity as a general partnership. Accomplishing a specific goal or working on a specific project is a key characteristic of the joint venture. If the joint venture is repeated, it makes it more likely that a court would interpret the relationship to be a general partnership.

- *Note:* The joint venturers may be individuals or business entities; however, it is most commonly used by two separate business entities to undertake a special project or commercial activity. They are particularly common when one business wishes to expand operations into a new market, such as when expanding sales to a foreign country.
- *Example:* ABC Corp is interested in expanding its product sales into China. China has proven to be a difficult regulatory environment and customer market for US companies. Instead of entering the China market directly, ABC Corp decides to do a test run of its product sales with 123 Corp, a Chinese company. ABC and 123 agree to jointly sell and market ABC’s product in China for a 6 month period. At the end of the period ABC Corp can

decide if it wishes to enter into the Chinese market directly or pursue distributor or licensing relationships.

- **Discussion:** Can you identify an example of a prominent joint venture?
- **Practice Question:** When is operating as a joint venture an effective business strategy?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-joint-ventures/>

17. What are the major characteristics of a “limited partnership”?

The limited partnership is a specialized form of partnership. The purpose of the limited partnership is to allow individuals to organize into an entity form that allows the flexibility of a general partnership, while allowing for special rights, duties, and protections for “limited partners”. The major characteristics of the limited partnership are as follows:

- **Creation and Maintenance** - A limited partnership, unlike a general partnership, must be filed with a state government to come into existence. The application must state the purpose of the business and list the name and general contact information for all limited and general partners. Indicating who is a limited partner is important so as not to deceive third parties with regard to ownership and control of the business entity. Forming a general partnership also requires a written agreement between the partners that identifies and indicates the limited partner status of any limited partners. Only one general partner and one limited partner are required; however, there can be numerous limited and general partners.
 - **Note:** The partners must undertake the initial filing process and follow any required updates or filings by state government. This includes updating the records in the event of any change in ownership of the limited partnership, such as the entrance or exit of partners. Further, if a limited partner becomes a general partner, or vice versa, the records must be updated.
 - **Example:** Martin and I decide to form a partnership. Martin wants to be a limited partner and allow me to run the business as general partner. We enter into a limited partnership agreement. We then register the entity with the Georgia Secretary of State’s office. In the registration, we identify Martin as the limited partner and me as the general partner.
- **Continuity** - As for continuity, the same rules apply as those of the general partnership. Because the limited partnership will always has a partnership agreement, it generally includes provisions governing the continuity of the business in the event of dissociation by a partner. It will also outline the events that constitute an automatic dissociation event, such as personal bankruptcy of a member.
- **Ownership** - The limited and general partners own the limited partnership in whatever percentage is allocated in the limited partnership agreement. This is the same as in a general partnership. Generally, the default partnership rules regarding ownership do not apply, as the limited partnership cannot exist without a limited partnership agreement that allocates ownership interest. The main difference in ownership interest is how it arises. Generally, the limited partners receive an ownership interest in exchange for providing capital (either funds or physical resources) to the limited partnership; while the general partner generally receives an ownership interest for either capital or labor provided to the limited partnership.

- *Example:* Clark and I decide to form a limited partnership. Clark will contribute funds to the business and will act as limited partner. I will contribute effort to the business and will be a general partner. Clark and I will have equal ownership of the partnership.
- *Control* - Control is the most defining aspect of a limited partnership. As in a general partnership, general partners in the limited partnership control and have authority to act on behalf of the partnership. Limited partners, on the other hand, cannot take part in management or decision-making of the business. This prohibition includes limitations on taking part in any of the actual operations of the business. More specifically, they cannot exercise control over any activity or anyone carrying out a business activity. A limited partner that exceeds this limited authority may lose her limited partner status and be deemed a general partner. This is a scary proposition for the limited partner, as a general partner is subject to personal liability for the obligations and torts of the partnership, where the limited partner is not. As such, the limited partner is relegated to being a passive investor in the business activity.
 - *Note:* Statutes in some jurisdictions allow a limited partner to take limited part in the following activity without being converted into a general partner, such as: serving as consultant or advisor to the partnership; voting on major partnership decisions; serving as guarantor or surety of partnership liabilities; inspecting records; receiving a partnership draw based upon her ownership interest; or receiving a return of capital invested.
 - *Example:* Tammy and I form a limited partnership. Tammy is the limited partner and I am the general partner. As general partner, I am charged with controlling all operations of the business. Tammy, as limited partner, cannot take part in any of the operational decision-making. She can, however, take part in any major business decisions that affect the ownership or structure of the business entity. In essence, Tammy is a silent owner and has no authority to act on behalf of the business entity.
- *Limited Personal Liability* - The key advantage of a limited partnership is that the limited partner has limited personal liability for obligations and torts of the partnership. Specifically, the limited partner is only personally liable to the extent of her investment in the business. She cannot lose personal assets, only the assets that she has contributed to the partnership. General partners, on the other hand, face unlimited personal liability for obligations and torts of the partnership.
 - *Note:* Remember, actively participating in management will cause the limited partner to be treated as a general partner. This means losing the limited liability protection and risking one's personal assets for debts of the business.
 - *Example:* Cary and I form a limited partnership. I am the general partner and Cary is the limited partner. Mark sues the limited partnership for failure to pay a debt. He receives a judgment against the business. If the business does not have the assets to pay or otherwise satisfy the debt, Mark can seek to satisfy the judgment against my personal assets. Cary can lose the assets she contributed to the business, but Mark cannot go after her personal assets.
- *Compensation* - Compensation in a limited partnership is the same as in a general partnership. Limited and general partners are compensated through distributions of profits (partnership draw). It is common for either general or limited partners in a limited partnership to receive a special allocation of partnership profits that does

not coincide with the percentage of business ownership.

- **Taxation** - Limited partnerships are taxed similarly to a general partnership. The profits and losses of the limited partnership pass through to the owners and are reported on the owners' personal income tax statements. The notable difference between the taxation of general and limited partners is that limited partners receive their distribution of profits as passive income. That is, they have not earned the income pursuant to work effort; rather, it is pursuant to a passive investment. As such, the limited partner's income is not subject to self-employment tax (15.3% in 2016).
 - *Note:* The general partners must still pay self-employment tax on their share of partnership profits.
 - *Example:* David and I form a limited partnership. As general partner, I am active in the business. David, as limited partner, does not actively participate in business operations. At the end of the year, the limited partnership has profits of \$10,000. David's share of the profits (\$5,000) is considered passive income. As such, David does not have to pay self-employment taxes on the income. My profits, in contrast, are active. As such, I will have to pay payroll taxes up on the \$5,000 of compensation allocable to me.

- **Discussion:** Can you think of a prominent limited partnership? Why does the limited partnership entity fit well with this business model?
- **Practice Question:** In a short paragraph, can you describe the primary attributes of a limited partnership?
- **Resource Document:** <http://thebusinessprofessor.com/limited-partnership-explained/>

18. What are the main characteristics of a “limited liability partnership”?

A limited liability limited partnership (LLP) is a special, hybrid entity recognized in most states. The LLP has characteristics similar to a general partnership (GP), but has limited liability protections similar to that of a limited liability company (LLC). The main characteristics of an LLP are as follows:

- **Creation & Maintenance** - The LLP, like the limited partnership, arises by filing an application with the state Secretary of State's office. Partners are required to have a LLP agreement. Other requirements may include a description of the business and a certification that the business will obtain liability insurance. The LLP must make routine filing similar to that of the limited partnership. Like the limited partnership, there are very few internal governance requirements.
 - *Note:* States generally restrict the LLP entity to certain professions, such as accountants, attorneys, doctors, or other professional service providers.
- **Continuity** - The continuity of the LLP is similar to that of a general partnership. Since there must be a LLP agreement, it normally outlines the process or procedure for dissociation by any partner. In the absence of provisions covering dissociation from the LLP agreement, the default limited partnership rules apply.
 - *Note:* Under certain conditions, the dissociation by a partner may give cause for other partners to

dissociate. Further, dissociation of a partner may give rise to dissolution of the entity.

- *Ownership* - The partners own an interest in the LLP as outlined in the LLP agreement. Like a GP, the agreement can allocate ownership in any manner. Further, it can make special allocations of profits and losses, subject to similar tests for economic significance.
 - *Control* - Similar to a general partnership, and unlike a limited partnership, each partner in an LLP has the authority to control and act on behalf of the LLP. The LLP agreement may designate partner seniority and managing partners who control the administration functions of the LLP.
 - *Limited Personal Liability* - Each partner receives personal liability protection with regard to the actions of other partners, employees, or other agents of the LLP. Specifically, the personal assets of each partner are protected from liability from the actions of others. This relationship allows the partners to enjoy the freedoms and lack of formality associated with a LLP while also taking advantage of limited personal liability protection. As with other forms of partnership, the LLP entity is responsible for the debts and obligations of the LLP. This includes responsibility for the tortious actions of any partner, employee, or other agent of the business.
 - *Note:* A partner (in any type of partnership) is always personally liable for her own actions. Some states limit the liability protection of limited liability partners to negligence actions. In such cases, the other partners are still personally liable for debts of the LLP and intentional conduct of other partners. LLPs are often created specifically to protect partners from liability for the professional malpractice of other partners.
 - *Example:* Carter and Aly are architects and partners in an LLP. Carter works on a large building project and drafts a very poor design. The building is not structurally sound and collapses. Several individual are injured and sue the LLP. The LLP will be liable for any judgment rendered against it. Further, Carter may be held personally liable for his negligent performance. Aly, however, is not personally liable for the debts of the LLP or Carter. While the value of her interest in the LLP may be reduced because of the obligations of the LLP, her personal assets are protected.
 - *Compensation* - LLP partners are compensated similarly to general partners. Each partner receives a draw of partnership profits. The amount of the draw is either based upon the partner's percentage of ownership or on a special allocation to that partner.
 - *Taxation* - LLPs are taxed similarly to a general partnership. Profits and losses pass through to the partner based upon her share of the ownership or in accordance with the special allocation provisions of the LLP agreement. Generally, each limited liability partner is treated as a general partner. As such, income received from the LLP business activity is considered active income. This also means that income imputed to the partners is subject to self-employment taxes.
- **Discussion:** Can you think of a prominent limited liability partnership? Why does the limited liability partnership entity fit well with this business model?
 - **Practice Question:** In a short paragraph, can you describe the primary attributes of a limited liability partnership?

- **Resource Video:** <http://thebusinessprofessor.com/what-are-the-characteristics-of-a-limited-liability-partnership/>

19. What are the main characteristics of a “limited liability company”?

A limited liability company (LLC) is a state recognized entity that blends the characteristics of a GP and a corporation. The LLC has quickly become the most popular business entity form in the United States for small businesses with more than one owner. The main characteristics of an LLC are as follows:

- *Creation and Maintenance* - An LLC is created by filing articles of organization with the state secretary of state's office. The organizer must be an individual and cannot be a corporation. There must be at least one member of the LLC. If it is only one, it is known as a “single-member LLC”. Like other entity filings, the Secretaries of State charge filing fees for registration. Some states require businesses to publish notice of intent to create an LLC. Notice is generally achieved by publishing notice in a local newspaper. The LLC must make annual filings with state and make corrective filings when ownership of the LLC changes. There are very little mandatory governance and maintenance requirements for an LLC. The law does not require the LLC to have meetings or make reports to its owners. Any governance requirements are established by the LLC members and are outlined in the LLC operating agreement. This document controls the governance and internal operations of the LLC, such as holding meetings, voting rights, keeping of records, etc. At a bare minimum, LLCs must update the corporate records when any major changes take place in the business. This includes changing registered agents, moving addresses, discontinuing operations, etc.
 - *Note:* The limited maintenance requirements of an LLC are a big draw of the LLC over other pass-through tax entities that offer limited liability, such as the S corporation. An operating agreement is not required to form or maintain an LLC, and, in many cases, members of a LLC will not create one. In such a case, the state default rules regarding LLC governance apply to the business entity.
- *Continuity* - An LLC is a separate entity from its owners. The business continues until there is an act of dissolution by the owners. The operating agreement generally lays out the events that give rise to dissolution. It will generally provide for the ability of members to transfer ownership interest in the LLC, such as at the time of a member leaving (dissociation) or passing it to heirs upon death. The agreement may also determine whether dissociation of a member is grounds for dissolution. If the LLC does not have an operating agreement, the default rules restrict the transfer of LLC interests to outside parties. The default rule in most states is, if a party seeks to transfer her interest or dissociate from the entity, it is grounds for dissolution of the entity by the other parties. The business dissolves if a member dissociates from the firm, unless the other parties decide to continue the business within a statutory period of time.
 - *Note:* Dissolution requires a winding up of the business. This includes the settling of debts and the distribution of ownership interests to the parties. Most LLCs do not depend upon the default rules and address continuity within the operating agreement or within a separate buy-sell agreement. These documents will specifically outline what constitutes events giving rise to dissolution.
- *Ownership* - The owners of an LLC are known as “members”. Members hold membership units that are very similar to equity shares or stock owned by shareholders (owners) of a corporation. Each member's ownership percentage is recorded in the operating agreement. If the LLC does not have an operating agreement, the default rule is that all members of the LLC have equal ownership.

- *Note:* Some states do not require the designation of membership units. These states allow LLCs to record ownership as a percentage. This method is similar to the method of recording ownership in a partnership.
- *Control* - Control and authority to act on behalf of the LLC can be in one of two structural formats. The organizers of an LLC make an election at the time of organization whether the business will be “member-managed” or “manager-managed”.
 - *Member-Managed LLCs* - Member-managed LLCs are very similar to GPs. Each member has authority to manage and act on behalf of the LLC. The default rule is that each member has equal authority. As such, members should take great care to outline the authority and rights of members in the operating agreement. This can be used to limit the authority of the member-manager. If third parties are aware of the limited authority of a member-manager, the LLC will not be obligated if the member-manager exceeds her authority when dealing with that third party.
 - *Example:* Derek and I form a member-managed LLC. We do not have an operating agreement to limit either of our authority. The default rule is that both Derek and I have complete control over LLC operations and unfettered authority to act on behalf of the LLC. If we enter into an operating agreement that limits either of our authority, it is only effective to limit our dealings with third parties if those individuals are aware of the contractual limitations.
 - *Manager-Managed LLCs* - Manager-managed LLCs are organized more like a corporation. The members do not have the authority to control or act on behalf of the business. Manager(s) run the business and control the daily affairs. The managers of the business may also be members, or they can simply be employees of the LLC hired to run the daily affairs. The members, however, retain the authority to vote for major business decisions.
 - *Note:* State registration documents generally indicate that an LLC is manager-managed. This should put third parties on notice that a member who is not a manager does not have authority to represent or act on behalf of the LLC. This may provide a defense against any claims of apparent authority if a member attempts to interact with third parties as a manager.
 - *Example:* Veronica and I form a manager-managed LLC. We are both members, but I am designated as manager. As manager, I have total control over the daily operations of the LLC. Also, I have complete authority to interact with third parties on behalf of the LLC. Veronica, as a member, has certain decision-making rights regarding the structure or governance of the LLC, but she does not have authority to manager operations or interact with third parties on behalf of the LLC.
- *Limited Personal Liability* - The LLC entity provides personal liability protection for its members from the debts and torts of the business entity. Members and employees are agents of the LLC and their actions subject the LLC to potential liability in contract and tort. If an agent breaches an LLC obligation or commits a tort within the scope of employment, a plaintiff may sue the LLC. The LLC (to the extent of its assets) may be liable to the plaintiff. The personal assets of the members, however, are not at risk in the lawsuit. Remember, an individual is always liable for her own conduct. The limited liability protections of the business entity do not protect against personal liability of one’s own actions.

- *Note:* While limited liability is a primary reason for choosing the LLC as an operating structure, it is the subject of a great deal of confusion among business owners. The misunderstanding regards the extent of limited liability afforded by forming an LLC.
- *Compensation* - LLC compensation is based largely on the tax election. Most LLCs choose to be taxed as partners rather than corporation. As such, LLC members are compensated in accordance with partnership principles. That is, an LLC member is not entitled to compensation for her services to the LLC. Rather, she receives a distribution of LLC profits based upon her ownership percentage in the business or pursuant to some special allocation of profits. These special allocations are subject to the substantial economic effect test by the IRS.
 - *Note:* Employees of an LLC who are not owners receive a salary from the LLC. In a manager-managed LLC, managers receive a salary for their services to the LLC. If the manager is also a member, however, she does not receive a salary. A member-manager may, however, receive a higher distribution of LLC profits or special allocation as compensation for services to the LLC.
- *Taxation* - LLCs may choose to be taxed as a partnership or a corporation. See the sections on partnership and corporate taxation for further explanation.
 - *Note:* While the law is being developed, members of member-managed LLCs that are taxed as partnerships generally pay self-employment taxes on their distributions. This is true regardless of whether the member actually takes part in management. Managers in manager-managed LLCs, unless they are also members, receive wages from the LLC. The LLC must withhold payroll taxes and the manager must pay FICA taxes. A manager who is also a member must pay self-employment taxes on any distribution from the LLC, because the income is considered “active income.” In a manager-managed LLC, members who do not actively part in operations argue that their distributions are passive income and not subject to self-employment taxes. The IRS has taken the opposite view, but the issue is still largely unsettled.

- **Discussion:** Why do you think limited liability companies have become the most popular business entity within the United States?
- **Practice Question:** In a short paragraph, can you describe the primary attributes of a limited liability company?
- **Resource Video:** <http://thebusinessprofessor.com/limited-liability-companies-explained/>

20. What are the main characteristics of a “corporation”?

A corporation is one of the earliest forms of legally recognized business entity. Corporations exist under every state’s laws. The corporation is the most formalized and developed form of business entity. Its structure is developed to optimize the relationship between owners (shareholders), high-level decision makers (directors), and operational managers (executives). The main characteristics of a corporation are as follows:

- *Creation and Maintenance* - Corporations arise by filing articles of incorporation with a state government. The state issues a charter upon the application of individuals known as “incorporators”. Once the corporate charter is issued, the incorporator must take actions to form the board of directors. Once the board is formed, it must act to

ratify the incorporator's actions, adopt the bylaws, and approve a variety of corporate actions (including the distribution of stock to owners). Once all of these actions are taken, the corporation exists and is ready to carry on business. The articles of organization establish the ownership structure of the corporation and the primary rights of shareholders. The "bylaws" control the internal governance of the corporation. Corporations require a considerable amount of maintenance and the amount of formality associated with corporate maintenance increases with the size of the business. The purpose of corporate maintenance is to protect the interests of shareholders and third parties dealing with the corporation. Maintenance formalities include keeping detailed records of all actions taken. This is normally done through director and shareholder meetings or through "written consents". Both directors and shareholders must hold annual meetings. Special meetings are used for special or pressing topics. Written consents are actions approved in writing by directors or shareholders outside of meetings. Most states require that directors undertake major actions of the corporation during an annual or special meeting. Directors generally hold special meetings throughout the year to deal with special issues. At meetings directors and shareholders act through resolutions that are documented by the corporate secretary.

- *Note:* The maintenance and governance requirements are covered in more detail in the Corporate Governance chapter.
- *Example:* William and Jan decide to form a corporation. They prepare the registration documents and the articles of incorporation to be filed with the Secretary of State's office. Once the state issues a certificate of incorporation, William and Jan hold a meeting of incorporators and distribute shares to themselves as initial stockholders. They also vote to appoint themselves as CEO and Secretary, respectively. They then proceed to have a shareholder's meeting to vote and confirm themselves as directors. As directors, William and Jan vote to adopt the corporate bylaws and to undertake a laundry list of other corporate actions. The bylaws will contain all of the corporate governance requirements. At the end of the meeting, the corporation is formed and the corporation has established responsibility for complying with the state-required maintenance and the requirements of the bylaws.
- *Continuity* - A corporation exists independently of its owners. Unless the owners undertake an act of dissolution, the corporation will continue to exist. Notably, dissociation by shareholders, directors, or officers of a corporation is not grounds for dissolution. Generally, shareholders may sell or exchange their corporate interest and the business entity continues to exist. Unlike other forms of business entity, corporations have continuity by default.
 - *Note:* If desired, shareholders may vote to add dissolution provisions to the articles of incorporation or bylaws. This will change the default rule that a corporation has continuity independent of the dissociation of shareholders.
- *Ownership* - Corporations are owned by shareholders. Closely-held corporations are held by a small group of shareholders. Non-publicly-traded corporations may be more widely held, but shares are not traded on a public exchange. Public corporation shares are publicly traded on exchanges (or in over-the-counter transactions) and are often very widely held. The shareholders are entitled to receive any profits of the corporation upon sale or liquidation (after all liabilities are paid). Shareholders may be divided into classes, depending upon the type of shares they own. Most commonly, a corporation will issue two types of shares — common and preferred. Common and preferred shareholders often have different levels of entitlement. The ownership structure of a corporation can be very complex. Corporate boards often authorize various types of preferred shares that carry specific rights. These shares are used to seek certain types of investors or to assure control to certain shareholders.

- *Note:* Corporate ownership is discussed in greater detail in the Corporate Governance chapter. Also, see our Finance and Funding material for more detailed information.
- *Control* - Responsibilities within a corporation are divided among three groups — shareholders, directors, and officers.
 - *Shareholders* (owners) - Common shareholders (and sometimes preferred shareholders) have two primary types of authority. First, shareholders vote to elect the board of directors, and second, shareholders must approve any major corporate actions (e.g., amending the articles of incorporation, increasing authorized shares, adding new classes of shares, dissolving the corporation, entering into a merger, and some stock repurchases). Some of these decisions also require director approval (or at least initiation).
 - *Directors* (high-level managers) - Directors make high-level and strategic management decisions for the corporation. Basically, the board makes all material decisions that are outside of the ordinary course of business operations. For example, director approval is required for issuing shares, granting options, entering into very large contracts, opening new lines of credit, appointing new corporate officers, purchasing another business, dissolution of the corporation.
 - *Officers* (daily operations managers) - Officers are in charge of the daily affairs of the corporation. They account for all business activity not reserved for the directors and shareholders.
- *Limited Liability Protection* - Shareholders have limited personal liability for the obligations and torts of the corporation. Shareholders are only liable to the extent of their investment in the corporation. Assets of the corporation can be used to satisfy such debts, which may decrease the value of the shareholder's equity. Directors and officers are generally not liable for actions taken in the course of business; however, both may be subject to shareholder lawsuit for any actions (or approval of actions) that damage the corporation. These suits are known as "derivative shareholder actions". In this type of action, shareholders sue the directors or officers on behalf of the corporation. Officers and directors are protected from liability from negligent acts in the performance of their duties by a doctrine known as "the business judgment rule". This rule provides that an officer or director may only be held liable for her bad faith conduct. Bad faith conduct includes intentional misconduct or self-serving conduct.
 - *Note:* One special instance of personal liability in the corporation is that of the "promoter". A promoter of a corporation is the individual undertaking the task necessary to bring the corporation into existence. She will often enter into forward-looking agreements on behalf of the non-existent corporation. Once formed, the corporation will generally adopt this agreement and enter into a novation with the other party. This novation relieves the promoter of liability. If, however, the corporation never materializes or it never enters into a novation with the contracting party, the promoter remains personally liable on those contracts executed when organizing the corporation.
- *Compensation* - Shareholders who are not employees of a corporation receive compensation in the form of dividends. Corporations distribute dividends from either annual profits or retained earnings. Distributing dividends is optional and usually done pursuant to a vote of the directors. In some cases, the articles or bylaws may provide dividend rights to certain shareholders. As previously discussed, dividends are taxed at a more favorable rate than ordinary income. Further, dividends (as long as not part of the shareholder's business practices) are not subject to payroll or self-employment taxes. Employees of the corporation, including officers

and directors, receive a salary for their services. If a shareholder is also an employee, she will receive a salary for her services and dividends pursuant to her status as shareholder.

- *Note:* It is a common practice for shareholder employees to receive a low salary and receive more of their compensation as dividends. This practice avoids paying payroll taxes. As such, the IRS requires shareholder employees to receive a reasonable salary for her services to the corporation. If a salary is unreasonably low, some of the dividends received by the employee may be reclassified and taxed as wages (rather than dividends).
- *Taxation* - Corporations may be taxed either: 1) as a pass-through entity or 2) subject to double taxation.
 - *C Corporation* - A corporations taxed pursuant to Subchapter C of the Internal Revenue known as C-corporations. C corporations pay taxes on its profits. Paying taxes as a business entity is known as entity-level taxation. If the profits are distributed to shareholders as dividends, the shareholders must pay taxes on those distributions. This scenario is known as double taxation. Corporate tax rates are discussed above.
 - *Example:* Larry, Moe, and Curly form a corporation and own an equal number of shares. They are all shareholders and directors of the corporation. They elect to be taxed under Subchapter C of the IRC. The corporation has a profit of \$15,000 at the end of the tax year. The corporation will have to pay income taxes on these profits at the corporate tax rate. As directors, Larry, Moe, and Curly decide to distribute the remaining profits (after taxes) to themselves as dividends. They will report and pay taxes on these dividends on their personal income tax returns.
 - *S Corporation* - Pass-through taxation is achieved pursuant to Subchapter S of the IRC. If the corporation meets the necessary qualifications, it can elect to be taxed under subchapter S on a pass-through basis. The corporation is commonly referred to as an S corporation. This method of taxation is somewhat similar to partnership taxation, but there are some notable differences that are discussed in detailed in higher-level tax courses.
 - *Note:* If the corporation fails to qualify under subchapter S, or it does not make an “S election”, it will be subject to double taxation under Subchapter C of the IRC.
 - *Example:* Larry, Moe, and Curly form a corporation and own an equal number of shares. They are all shareholders and directors of the corporation. They elect to be taxed under Subchapter S of the IRC. The corporation has a profit of \$15,000 at the end of the tax year. The corporation does not pay taxes at the entity level. As directors, Larry, Moe, and Curly can decide whether to distribute the remaining profits to themselves as dividends. Regardless of whether the profits are distributed or no, the \$15,000 of profits will pass through to Larry, Moe, and Curly in the amount of \$5,000 each. They will report and pay taxes on these dividends on their personal income tax returns.

Regardless of whether taxed under Subchapter S or C, salaries paid to employees (directors and officers) and payments to contractors are expenses to the corporation that are deducted from income. After-tax distributions of profits to shareholders (dividends) are taxed again to the shareholder. In a C-corporation, shareholders pay income taxes on the dividends received as owners of corporate stock. In an S-corporation, shareholders pay taxes on their share of annual corporate profits whether distributed or retained in the corporation.

- **Discussion:** Why are most (nearly all) publicly traded companies organized as corporations?
- **Practice Question:** In a short paragraph, can you describe the primary attributes of a corporation?
- **Resource Video:** <http://thebusinessprofessor.com/c-corporations-explained/>

21. What are the requirements to qualify as an “S corporation”?

To qualify for S-Corporation status, the business must be a corporation and meet the following requirements:

- *Geography* - Organized in the United States.
- *Citizenship* - All shareholders must be US Citizens or resident aliens.
- *Number of Shareholders* - It cannot have more than 100 shareholders.
 - *Note:* All members of a family are considered to be one investor for purposes of this rule.
- *Eligible Shareholders* - All shareholders must be individuals, trusts, or certain other exempt organizations.
- *Ownership Classes* - The company may only authorize one class of stock (common stock).
- *Tax Year* - The company must follow an IRS accepted tax year.
- *Shareholder Election* - All shareholders must consent to the S-election.

It is fairly easy to run afoul of the S corporation requirements and lose the tax status. For example, a business may exceed the number of eligible shareholders, accidentally transfer an interest in the business to a business entity, or authorize what is deemed a second class of shares.

- *Note:* Certain banking and insurance companies are not eligible for S-corporation status.

- **Discussion:** If a business qualifies for S-Corporation status, is there any reason to choose C-corporation status over S-Corporation status?
- **Practice Question:** Tom is planning a startup venture. He knows that he is going to need outside capital from investors who will purchase an ownership interest in the business. What limiting factors should Tom know about an S corporation when deciding whether to organize as a C corporation or S corporation?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-requirements-for-an-s-corporation/>

TOPIC 13: CORPORATE GOVERNANCE

Overview

Corporate governance concerns the procedures and mechanisms associated with administering a business entity. Principles of corporate governance include legal and ethical principles controlling the governance procedures and the conduct of those administering the business. This chapter focus on the corporate entity form. It will examine the internal stakeholders and their roles in the business entity. It will examine the theories of governance applicable to the corporate entity form, the duties and procedural requirements of those administering the business, and the methods by which stakeholders may enforce those duties. Lastly, the chapter will explore numerous laws, organizational requirements, and ethical standards that affect corporate governance practice.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

- [Business Governance](#)
 - [Members of Corporation](#)
 - Shareholder
 - Director
 - Officer
 - [Closely-held Corporation](#)
 - [Privately-held and Publicly-held Company](#)
 - [Role and Purpose of Corporations](#)
 - [Agency Theory](#)
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 - Shareholders
 - [Rights](#)
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 - [Direct and Derivative Actions](#)
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 - Board of Directors
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 - [Fiduciary Duties](#)
 - [Business Judgment Rule](#)
 - [Liability Insurance](#)
 - Officers (Managers)
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 - [Fiduciary Standards](#)
 - [Major Corporate Governance Laws](#)
 - [State Laws](#)
 - [Securities Laws](#)
 - [Foreign Corrupt Practices Act \(FCPA\)](#)
 - [Sarbanes-Oxley Act \(SOX\)](#)
 - [Dodd-Frank Wall Street Reform and Consumer Protection Act \(Dodd-Frank\)](#)
 - [Industry Organization Regulations](#)
 - [Proxy Advisory Firms](#)
 - [Corporate Ethics](#)
 - [Sources of Corp Governance Issues](#)
 - [Decision-making Procedure](#)
 - [Power Struggles \(Takeovers\)](#)
 - [Hostile Takeover Strategies](#)
 - Anti-takeover Measures
 - [Shark Repellant](#)
 - [Poison Pills](#)
 - [Delay Tactics](#)
 - [Legal Lockups](#)
 - [White Knight & Pac Man](#)
 - [Alignment of Corporate Benefits](#)
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TOPIC 13: CORPORATE GOVERNANCE - QUESTIONS & ANSWERS

1. What is “business governance”?

Business governance concerns the actions and controls placed on those charged with managing a business entity. Business governance is the subject of extensive legislation and research, particularly as it pertains to the corporate entity form. Corporate governance generally concerns the internal control of a corporation as influenced or controlled by state and federal law, rules of ethics, and industry standards. It specifically focuses on the actions of managers and directors and the observance of procedural safeguards of shareholder rights.

- *Example:* Issues in corporate governance include, voting rights, meeting requirements, approval of corporate actions, record retentions, disclosure of information, and any other procedural undertakings concerning the management of the corporation.
- **Discussion:** Why do you think corporate governance is the subject of academic research rather than simply the mechanical functions of corporate governors? How does corporate governance relate to the personal attributes of entity governors?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-business-governance/>

2. Who are the members of a corporation?

The corporation is made up of shareholders, directors, officers, and employees. Shareholders are the owners of the corporation. Directors undertake the high-level management and decision-making for the corporation. Officers (and their subordinate employees) run the daily operations of the corporation. Each member of the corporation has specific rights and duties attached to her position. These rights and duties can become confusing when a single individual holds more than one position (such as shareholder, directors, and officer) of the corporation.

- *Note:* Besides shareholders, directors, and officers, there are numerous other corporate stakeholders (such as vendors, customers, other businesses, etc.) that are not members of the corporation.
- **Discussion:** Why do you think corporations are organized in the fashion with designated authority and rights? Do you feel that corporate governance should take into consideration stakeholders other than shareholders, directors, or officers? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/members-of-a-corporation/>

3. What is a “closely-held corporation”?

A closely-held corporation is owned and controlled by a small group of owners or shareholders. These shareholders hold the shares of stock necessary to elect most or all of the directors. Often, shareholders in a closely-held corporation will

elect themselves to serve as directors and appoint themselves as officers. Family-owned businesses commonly organize as closely-held corporations. In these entities, members of a single family own most or all of the outstanding shares. They also serve as directors and officers of the business. Shareholders generally have limited fiduciary duties to the corporation. With a single or small group of shareholders holding a majority of the voting shares in the corporation, minority shareholders rarely have much influence in the corporation. In such instances, common law generally holds that majority shareholders have fiduciary duties to exercise care and loyalty with regard to the corporation. This is particularly true in closely-held entities. Given the difficulty of enforcing one's rights, these standards offer little protection to the minority shareholder.

- *Note:* In some situations, minority shareholders may be able to bring a direct action against the corporation if their individual rights are harmed. Further, they may be able to bring a derivative action on behalf of the corporation against majority shareholders who fail to exercise care and loyalty in carrying out their corporate duties. In such actions, the court may assess damages against the majority shareholders or issue injunctions to halt the harmful conduct.

- **Discussion:** Do you believe that closely-held corporations should be governed or subject to the same governance requirements as widely-held or public corporations? Why or why not? Does the close connection between shareholders and the business entity affect your opinion? Why or why not?
- **Practice Question:** Can you identify the most profitable or heavily-capitalized, closely-held corporations in the United States?
- **Resource Video:** <http://thebusinessprofessor.com/closely-held-corporations/>

4. What is the distinction between a “private company” and “public company”?

A private company is a business whose ownership interest is not openly held or traded by the public at large. Company ownership is not sold in the public market. As such, all ownership interests are acquired *via* personal transactions with the company or other owners of the company. A public company, on the other hand, is a business whose ownership is openly traded in the market. Often, the ownership interest will be traded on a public “stock exchange”. If the shares are not listed on an exchange, the shares are generally available for purchase through securities brokers in what is known as “over-the-counter” transactions. Public companies are subject to far more extensive regulation than private companies. This reality often leads public companies to repurchase outstanding shares from the public market in a transaction known as “going private”.

- *Note:* Most public companies are corporations. There are, however, limited instances where shares of ownership in other types of entities are sold publicly. An example would be master limited partnership interests.

- **Discussion:** Why do you think that public and private companies are subject to different levels of regulation?
- **Practice Question:** Stock of ABC Corp is traded on a public exchange. Milly makes a tender offer to shareholders and acquires all of the outstanding shares of ABC. At this point, is ABC Corp a public or privately held company?
- **Resource Video:** <http://thebusinessprofessor.com/distinction-between-private-and-public-company/>

THEORETICAL FOUNDATIONS

5. What is the role and purpose of the corporation?

The concept of the corporation originated through governmental charter allowing individuals to carry on business collectively. Basically, the charter gave the corporate entity form legal status that was similar to personhood. The concept of the corporation as a legal person has expanded over time to the point that corporations enjoy many of the same constitutional protections as US citizens. The corporate entity also allows individuals to have a beneficial interest without being actively involved in business operations. That is, it allows for increased division and transfer of ownership interest in a business activity. It allows for the utilization of outside capital from investors (rather than just debt or capital contributions from founders) to grow business operations. The active trading of ownership in corporate entities gave rise to the formation of US stock exchanges and the private equities market.

- **Discussion:** How do you feel about the corporate entity form? Should the corporation be treated as a separate person with rights similar to those of citizens? Why or why not? How do you think the availability of capital funding relates to corporate growth and the creation of new business entities?
- **Practice Question:** How does a corporation facilitate business practice and benefit society?
- **Resource Video:** <http://thebusinessprofessor.com/role-and-purpose-of-corporate-entity-form/>

6. What is “agency theory” and why is it relevant for the business entity?

Agency theory posits that corporations act as agents of its shareholders. That is, shareholders invest in corporate ownership and thereby entrust their resources to the management of the directors and officers of the corporation. In larger corporations, there is often a sharp divergence between the short and long-term interest of officers and shareholders. This is primarily brought on by short-term demand for profits and the asymmetry of information that officers and directors possess compared with that of shareholders. The divergence of interest between officer, director, and shareholder is thought to influence the actions and decisions of officers and directors who may become detached from shareholder interests. Corporate governance rules seek to establish a legal framework similar to that of the agent-principal relationship. These rules seek to align the incentives of officers and directors with those of shareholders. They seek to establish norms and customs that prevent the adverse results of divergent corporate interests. Further, agency theory lends itself to the duties that officers or director owe to the corporation.

- **Discussion:** How do you feel about the principal-agent view of the corporate form? What are the advantages and disadvantages of this view? Do you believe that corporate governance procedures are effective in aligning officer, director, and shareholder incentives? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/agency-theory-and-stakeholder-theory/>

7. What is the “stakeholder theory” of corporate governance?

The stakeholder theory of corporate governance focuses on the effect of corporate activity on all identifiable stakeholders of the corporation. This theory posits that corporate managers (officers and directors) should take into consideration the interests of each stakeholder in its governance process. This includes taking efforts to reduce or mitigate the conflicts between stakeholder interests. It looks further than the traditional members of the corporation (officers, directors, and shareholders) and also focuses on the interests of any third party that has some level of dependence upon the corporation. Stakeholders are generally divided into internal and external stakeholders.

- *Internal Stakeholders* - Are the corporate directors and employees, who are actually involved in corporate governance process.
- *External Stakeholders* - May include creditors, auditors, customers, suppliers, government agencies, and the community at large.

These stakeholders exert influence but are not directly involved in the process. Key to the stakeholder theory is the realization that all stakeholders engage in some manner with the corporation with the hope or expectation that the corporation will deliver the type of value desired or expected. The benefits may include dividends, salary, bonuses, additional orders, new jobs, tax revenue, etc.

- **Discussion:** How do you feel about the stakeholder theory of corporate governance? Should external stakeholders have rights or even be considered in the governance process? Why or why not? To what extent does the current state of corporate governance law focus on the external stakeholder? How, if at all, do you see this trend changing in corporate governance laws and practice?
- **Resource Video:** <http://thebusinessprofessor.com/stakeholder-theory-of-corporate-governance/>

SHAREHOLDERS OF THE CORPORATION

8. What is the role of “shareholders” of the corporation?

Shareholders are the owners of the corporation. They have ownership rights in the shares of corporate stock. The role of the shareholder in the corporation is limited, however, as they have neither the right nor the obligation to manage the day-to-day business of the enterprise. Shareholder rights vary pursuant to the type of stock owned and the applicable state law. State law is heavily influenced by authoritative sources, such as the Model Business Corporations Act (Model Act). Below is an explanation of common rights afforded corporate shareholders under state law.

- *Right to Information* - Shareholders have the right to access and examine corporate records and information concerning the governance and financial performance of the entity. In public companies, much of the operational and financial information about a corporation must be reported to the public by filing with the Securities Exchange Commission. Companies must also disclose this information directly to shareholders on largely standardized reporting documents. Private companies, on the other hand, do not publicly report information. Further, there is no specific requirement to make periodic disclosures to shareholders. As such, shareholders in non-public entities must generally make requests for information. State law provides for the substantive and

procedural rights of shareholders to access and review corporate records.

- *Example:* James is concerned that directors of ABC Corp are not exercising due care in the management of the company. She may seek access to company information to further understand management's actions. This may include minutes from director meetings. The company must generally afford her access to these records.
- *Right to Vote* - All corporations must have at least one class of stock representing an ownership interest in the company. In most corporations, the basic ownership share is known as "common stock". These shares entail voting rights for the shareholder.
 - *Election of Directors* - At the annual meeting, shareholders have the right to elect directors. A corporate nominating committee of the board of directors produces a slate of directors and recommends election of a single director per available board seat. The names of nominated directors are listed on a proxy statement and sent to shareholders. The shareholders may either vote for the nominated director or abstain from voting. Under "plurality voting", a director must receive a majority of votes cast to be elected to the board. This is a very low standard when there is only one nominated director on the proxy statement. This rule has been superseded in most large corporations in favor of a rule that requires a director receive at least a majority of outstanding votes.
 - *Note:* Shareholders may also nominate their own candidates to the board. This generally requires the shareholders to justify their nomination and prepare and distribute their own proxy material. This process is known as a "proxy contest". Some state laws, as well as the NYSE and NASDAQ, both require that the members of the nominating committee be independent or not employees of the company.
 - *Example:* ABC Corp is having an election of directors. ABC appoints Tom and Jerry, who are friends of the current directors but are not board members, to the nominating committee. Tom and Jerry recommend Sarah for director. The board agrees and places Sarah's name on the proxy solicitation. I am a shareholder and receive the proxy with Sarah's name. The board follows plurality voting, so Sarah must receive a majority of all votes cast, rather than a majority of votes outstanding. I can vote for Sarah, abstain from voting, or wage my own proxy contest to recommend a director of my choosing. I disagree with Sarah as director but know that sending proxy solicitations to all shareholders would be burdensome and expensive. Further, I know that it is unlikely that I will receive more votes for my nominee than Sarah will receive, so Sarah will win anyway. I decided to abstain from voting.

Boards generally employ either "straight voting" or "cumulative voting" to elect directors.

- *Straight Voting* - This method allows a common shareholder one vote per share of common stock for each available seat on the board of directors.
 - *Example:* Gail owns 100 common shares of stock in ABC Corp. When two director seats come open, she may cast up to 100 votes to elect each director.
- *Cumulative Voting* - This method allows a common shareholder a number of votes equal to her number of shares times the number of director seats available. She may cast these votes for any

one or all of the available board seats.

- *Note:* Cumulative voting amplifies the voting power of a shareholder.
- *Example:* Tammy owns 100 common shares of stock in ABC Corp. When two director seats come open, she has 200 votes (100 shares x 2 director seats) to cast. She can cast all 200 votes for one director or split up her votes as she wishes.
- *Fundamental Changes in Corporation* - Shareholders must approve any fundamental changes to the corporation. Fundamental changes include:
 - *Mergers* - This is the situation in which two companies combine to form one. The shareholders of the company being consumed must always approve this decision. The bylaws will determine whether the shareholders of the consuming corporation must approve the transaction. If the companies will merge to form a new corporation, generally the shareholders of both corporations must approve the transaction.
 - *Note:* The corporate bylaws will lay out the number or percentage of shareholder votes required for approval. In the absence of specific rules in the bylaws, the default state-law rules will control.
 - *Sale of Assets* - Shareholders must approve the sale of all or substantially all” of the corporate assets. The idea is that this is effectively the equivalent of merger or shutting down the corporation.
 - *Dissolution* - Shareholders must approve the shutting down or “dissolution” of the corporation.
 - *Note:* Shareholder approval is not required when a state takes action to involuntarily dissolve a corporation.
- *Changes in Governing Documents* - Shareholders have the right to vote for any changes or amendments to the governing corporate documents. This includes rights to vote on:
 - *Amendments to the Charter* - Directors must initiate any changes to the articles of incorporation or charter. Once proposed, shareholders vote to approve or disapprove the directors’ proposal.
 - *Amendments to the Bylaws* - The bylaws will direct the requirements and procedure for amendment. In the absence of provisions in the bylaws addressing this issue, state corporation law will supply the default rules.

All shareholders are entitled to vote on matters presented at shareholder meetings.

- *Meeting Rights* - All state corporate statutes (as well as large public exchanges) require corporations to hold annual shareholder meetings. During these meetings, the corporation will conduct any required or desired corporate governance actions, such as electing directors. The requirement to hold meetings may be relieved for small corporations that handle these matters through unanimous written consent by the shareholders. Directors and large blocks of shareholders may call special meetings for any number of purposes. Notably, special meetings are appropriate when shareholders must vote upon a fundamental change to the corporation. Various state laws

protect shareholder meeting rights.

- *Note:* Under many state laws (specifically those conforming to the Model Act), large shareholders may have the right to call special meetings to vote on matters of immediate concern.
 - *Note:* Generally, shareholders holding 10% or more of a corporation's shares are considered large shareholder and may call a special meeting.
- *Example:* Some states require 70 days notice of any intended meeting and specific requirements that a quorum of shareholder be present or represented during any meeting.
- *Right to Make Proposals* - Certain shareholders have the right to propose specific corporate actions to be taken at corporate meetings. This is normally done through adding these agenda items to corporate proxy statements. Under state law, a shareholder holding 1% of the outstanding shares or \$2,000 worth of shares may request a proposal be placed in the corporate proxy material for shareholder vote. The primary limitation is that the shareholder proposal cannot usurp management's authority by making proposals related to ordinary business operations. If the shareholder proposal relates to the authority or rights reserved for shareholders, the result of the vote on the shareholder proposal is binding on the corporation. Proposals that are outside the ordinary authority of shareholders (i.e., it is a decision reserved to directors or officers), the proposal is not binding upon the board or officers.
- *Note:* The board may reject a shareholder's proposal for material to be included in the proxy material. State law and the corporate governance documents will determine the ability of a shareholder to make proposals above director approval. The types of proposals that shareholders may wish to make commonly include resolutions regarding environmental practices, political spending, labor practices, etc.
- *Example:* I am a corporate shareholder of ABC Corp. I own 2% of the corporate stock. I want the corporation to vote on a resolution to mandate that corporate boards consist of 75% outsiders who have no relationship with current directors or officers. As a qualified shareholder, I can require that this proposal be included in the proxy material. The election of directors is a fundamental right of shareholders. It is possible that shareholder approval of such a resolution would be binding upon the board.
- *Right to Dissent* - In most states (and under the Model Act), corporate law allows for "dissenter rights". Dissenter rights are a special group of rights designed to provide protections to shareholders in corporations that are not actively traded in the market. In a widely-held, public company, shareholders who do not agree with fundamental issues of corporate management or governance can sell their ownership interest. This is generally not an option for shareholders in closely-held and private corporations. Dissenter rights allow these shareholders to force the corporation to buy back their shares at "fair value".
 - *Note:* This right is not available for shareholders who disagree with non-fundamental aspects of corporate governance.
 - *Example:* I am very upset that the corporation allows for plurality vote in the election of directors. The board is not very receptive to shareholder input regarding the nomination committee or the qualifications of directors. As such, I may exercise my dissenter's rights and require the corporation to purchase my shares of ownership.

- **Discussion:** How do you feel about the fundamental rights of shareholders? Should the rights be more or less extensive? Why or why not? Can you think of an example of any other rights or authority that could serve to further protect shareholder rights?
- **Practice Question:** Mark suspects that the directors of the corporation have engaged in actions that are detrimental to the corporation and shareholder interests. What rights does Mark have to investigate the director's actions? If Mark is correct, what shareholder rights provide Mark with the ability to prevent this type of activity in the future?
- **Resource Video:** <http://thebusinessprofessor.com/role-of-shareholders-of-the-corporation/>

9. What are the many variations in characteristics of the “ownership structure” of the corporations?

At the time of formation, a corporation authorizes shares to issue to shareholders in exchange for capital.

- *Promoters and Stock Subscription Agreements* - Often the “promoters” of the corporation will seek promises from individuals to purchase stock in the corporation once it is fully formed. These “subscription agreements” provide certainty that the corporation will have operational capital post formation.
- *Authorized & Issued Shares* - The number of “authorized shares” of the corporation is stated in the articles of organization. This number generally far exceeds the number of shares actually issued to shareholders (“issued shares”). The corporation will retain the ability to issue more shares in the future.
- *Treasury Stock* - Sometimes the corporation will repurchase shares that have been issued. The repurchased shares are held by the corporation as “treasury stock”. There are a number of strategic reasons for repurchasing issued shares.
- *Equity Compensation* - Corporations often award additional shares to current shareholders as a form of dividend. This has the effect of transferring the value of the stock dividend from the retained earnings to the corporation's shareholder's equity or capital account.
- *Stock Split* - If the corporation has a need for additional shares, it may authorize more shares or execute a “stock split”. A stock split effectively doubles the number of outstanding shares and reduces the share value by one half. This will double the amount of treasury stock on hand and the lower stock value generally serves to make the stock more liquid.
- *Share Transfers* - Unless there is an agreement otherwise, shareholders may generally transfer their stock to others. This may require the corporation to collect the seller's shares and distribute new shares to the purchaser.

Stock can be divided into categories called “classes”, and these classes can be further divided into subcategories called “series”. Series simply indicate the time of issuance of a certain number of shares. Different classes of stock may have very different rights. For example, a class of preferred stock is different from a class of common stock. All series in a class are fundamentally the same, except for minor distinctions. Classes of stock ownership are generally categorized as follows:

- *Common Stock* - Common stock is the baseline corporate ownership interest. Common shareholders have general

voting rights but hold the lowest priority for payment of dividends in the event of distribution or liquidation of the corporation.

- *Preferred Stock* - Corporations authorize and issue preferred stock for a specific purpose. Generally, this purpose is to provide special rights to certain shareholders, such as investors and corporate founders.
- *Stock Options & Warrants* - Options and warrants provide the right to purchase a given quantity of stock at a stated price. These are used to incentivize the holders to work to raise the value of corporation shares. Also, these instruments may provide tax incentives to the recipient. These rights can be very important when the value of the stock rises above the purchase price.

There can be an infinite number of classes of preferred shares — each with unique rights. The most commonly designated special rights associated with preferred shares are as follows:

- *Dividends* - Common shareholders may receive dividends as an entitlement of corporate ownership. Preferred shareholders often receive priority of payment of dividends above common shareholders. This type of right varies, but generally a preferred shareholder will receive full payment or distributions of dividends before common shareholders receive anything. For example, “cumulative dividend rights” means that the preferred shareholder will receive full payment of any current and past, unpaid dividends before common shareholders receive payment of current dividend distributions.
- *Liquidation* - Preferred shareholders generally receive a liquidation preference. This means that the preferred shareholder will be paid first from the proceeds of any sale or liquidation of the corporation or its assets. Often, preferred shareholders will receive some stated amount or multiple of their initial investment before other shareholders receive any distribution.
- *Voting Rights* - Preferred shareholders may have any form of modified voting rights. For example, the preferred shareholder may have the right to vote for specific corporate actions or to elect specific seats on the board of directors. In other situations the preferred shareholder may not have any voting rights.

- **Discussion:** How do you feel about different classes of corporate ownership with different rights? What effect, if any, do you think it has in affording certain shareholders greater rights than other shareholders? Why?
- **Practice Question:** Tom is an investor in ABC Corp. He wants to make certain that he receives a return on his investment and that other shareholders do not benefit from corporate profits ahead of him. What stock rights might Tom secure for himself when negotiating his investment?
- **Resource Video:** <http://thebusinessprofessor.com/characteristics-of-corporate-ownership-interests/>

10. What are the “fiduciary duties” owed by shareholders of the corporation?

Generally, shareholders of a corporation do not owe fiduciary duties to other shareholders. This situation may change in closely-held corporations or in corporations where shareholders also serve as officers or director. State law varies as to the extent that a shareholder owes fiduciary duties to the corporation itself. A state is more likely to recognize shareholder duties to the corporation in closely-held corporations.

- *Note:* Some states hold that, in certain circumstances, shareholders owe fiduciary duties to the minority shareholders of the corporation. This is the case when a single shareholder or designated group of shareholders owns a controlling interest in the corporation. In such a case, the controlling shareholder may incur special duties to those minority shareholders.
- **Discussion:** How do you feel about shareholder fiduciary duties, or lack thereof? Should a shareholder have greater fiduciary duties to the corporation or to minority shareholders in a closely-held corporation? Why or why not?
- **Practice Question:** Pam is a shareholder in a closely-held corporation. She owns approximately four percent of the outstanding shares. The three other shareholders own the remaining interest equally. Do these shareholders owe any fiduciary duties to the other shareholders?
- **Resource Video:** <http://thebusinessprofessor.com/fiduciary-duties-of-corporate-shareholders/>

11. To what extent are shareholders of the corporation personally liable for obligations of the corporation?

Generally, corporate shareholders are not liable for the debts or obligations of the corporation, including legal liability for torts or contract actions. Under certain circumstances, however, a court will disregard the corporate protections and hold shareholders personally liable. This situation arises when a plaintiff sues the corporate shareholder(s) alleging that the court should “pierce the corporate veil” of protection and hold shareholders liable for the corporate debts or obligations. This claim involves the “alter ego theory”. Under this theory, a plaintiff must demonstrate that the purpose of the business entity is not to carry on business as a separate entity; rather, the corporate entity is simply a shell and should be considered one in the same with the shareholders. That is, the corporation is the alter ego of the shareholders and the limited personal liability protections should be disregarded. The court will ask the following questions in evaluating whether to pierce the corporate veil:

- *Business Formalities* - Did the business maintain formalities, such as organizational filings, meeting minutes, etc.?
 - *Example:* I am an officer and director of ABC Corp. I fail to file my state registration documents. I also fail to keep track of corporate records. I do not have established bylaws, and I fail to adhere to default governance rules. All of these facts can demonstrate an intent to use the corporation as a shell entity for my personal business activity.
- *Business Assets* - Did the business owners intermingle personal and business funds or other assets?
 - *Example:* I pay my personal mortgage from the business bank account without noting whether the payment is a dividend or salary compensation. Also, I routinely pay corporate expenses from my personal bank account without noting that my payment is a capital contribution to the corporate entity. This can demonstrate the corporation is a shell.
- *Business Capitalization* - Is the business adequately capitalized or does it have adequate liability protection in place?

- *Example:* As shareholder, director, and CEO, I routinely distribute any corporate profits to myself as a dividend. I leave very little funds in the corporation to finance operations. Further, I do not purchase liability insurance to cover potential legal liability, such as tort liability. If the court finds that the corporate entity form is intentionally underfunded, it may find that the entity is merely a shell for limited liability purposes.
- *Stakeholder Functions* - Did business members comply with or routinely deviate from their roles and responsibilities?
 - *Example:* I serve as director and officer. I make decisions as officer that should be reserved for the board of directors. I fail to submit major decisions to shareholder votes. This would show that I am not respecting corporate formalities and the entity form is a shell for my personal business activity.

A negative response in any or all of these situations could be grounds for the court to disregard the limited personal liability protections of the corporate entity.

- **Discussion:** How do you feel about the limited personal liability of corporate shareholders? What do you think is the justification for affording such personal liability protection? Should a court have the ability to pierce the veil of liability protection? Why or why not? Can you think of any other questions that could be relevant in determining whether the corporation is simply the alter ego of its shareholders?
- **Practice Question:** Clark is the a shareholder of ABC Corp. ABC Corp is being sued for the actions of an employee. Identify the conditions under which Clark could be held personally liable for the judgment against the corporation.
- **Resource Video:** <http://thebusinessprofessor.com/shareholder-personal-liability-for-corporate-obligations/>

12. How can shareholders enforce their rights?

Shareholders may generally enforce their rights against the corporation (or its officers and directors) in one of two ways.

- *Direct Actions* - A shareholder may directly sue the corporation, an officer, or director if one of these individuals takes actions that result in direct harm to the shareholder. This situation is rare, because it's difficult for a shareholder to demonstrate that she has suffered a specific harm as a result of actions by the officers or directors.
 - *Example:* ABC corporation denies a shareholder the right to convert her preferred shares into common shares in accordance with her contract rights. The shareholder may personally sue the corporation, officer, or director for the harm she suffers.
- *Shareholder Derivative Suits* - In this type of shareholder litigation, the plaintiffs allege that the corporation itself was harmed by a defendant's conduct. Shareholders sue the corporation's directors or officers, alleging a breach of fiduciary duties of loyalty or care to the corporation. Any damages to the shareholders are indirect through the overall negative impact on the corporation.
 - *Example:* ABC Corporation CEO makes reckless decisions in several large corporate deals. These

decisions have caused a significant decrease in stock price. Shareholders are angry and sue the CEO on behalf of the corporation. If the shareholders win, the corporation will receive a judgment against the CEO. All shareholders benefit equally from the litigation by recovering damages for the corporation.

- **Discussion:** How do you feel about a shareholder's options for protecting and enforcing her rights? Does the ability to bring a direct action or a derivative action adequately protect shareholder rights? Why or why not?
- **Practice Question:** Mike is a director and CEO of Murphy Corp. When Mike decides to retire, he chooses his friend David to replace him as CEO. Mike has such control and power over the board that they hire David and offer him an incredible contract without seeking the expertise of executive compensation consultants. After one year of poor performance, the Board fires David and learns that it will have to pay out the value of his contract. Shareholders are angered by the poor performance and David's payout. What are a shareholder's options to protect her rights?
- **Resource Videos:** <http://thebusinessprofessor.com/shareholder-direct-and-derivative-actions/>

13. What is the process for shareholders bringing a "derivative action"?

A derivative action is a lawsuit against officers or directors brought by shareholders on behalf of the corporation. That is, the shareholders act as representative plaintiff for the corporation and sue the officers or directors for their actions resulting in harm to the corporation. While the objective of such a lawsuit is to halt certain actions by the defendants, any damages recovered in the action belong to the corporation (not the representative plaintiffs). The shareholders benefit indirectly as owners of the corporation.

Shareholders begin the derivative action process by making a request to the board of directors to bring a legal action against the alleged wrongdoer. This is called "making demand" on the board. The board will then take one of the following actions:

- **File Suit** - The board may grant the request of the shareholders and file a legal action against the officer or director allegedly causing harm to the corporation.
 - *Note:* If the board brings a legal action, the individual shareholder cannot bring a direct action.
- **Reject the Shareholder Demand** - The board may determine that bringing a legal action is not in the best interest of the corporation. The board impliedly rejects the demand or fails to respond to the demand within the statutory period (or a reasonable time). The decision of whether or not to bring a legal action is subject to the business judgment rule. As such, a board's decision of whether or not to sue is generally binding, unless the shareholders can demonstrate that the board is biased (not disinterested), not acting in good faith, acting recklessly, or acting to intentionally harm the corporation.
- **Appoint a Special Litigation Committee (SLC)** - In some situations, the board will designate a special committee of disinterested directors to make the determination of whether to bring a legal action. Generally, this shields the board from allegations of bias, bad faith, or failing to meet the standards of the business judgment rule. It is difficult for shareholders to overcome a SLC's decision and this may foreclose the ability to bring a derivative action.

In certain circumstances, shareholders may file suit without making demand to the board. If they can show that the directors have a conflict of interest, lack the independence to act in the best interest of the corporation, or have otherwise violated the business judgment rule, the court will allow shareholders to bring the derivative lawsuit without the board of directors' approval. In other words, the court will rule that "demand is futile."

- *Note:* As a practical matter, once a court rules that demand is futile, the shareholders have an advantage in the lawsuit, and the case almost always settles. On the other hand, if the court requires the shareholders make demand to the board, they are not likely to prevail and typically withdraw the case.
- **Discussion:** How do you feel about the requirement to make demand to the board of directors to bring a lawsuit for the alleged legal violation? What standards do you think should apply to the board when making the decision of whether to pursue a legal action or no? What do you think a shareholder must show to convince the court that the board that demand is futile?
- **Practice Question:** Thomas is upset by some decisions made by the CEO with regard to the sale of corporate assets. The CEO is also chairman of the board of directors. Thomas believes that the actions have significantly injured the corporation and its shareholders. If Thomas decides to bring a derivative action against the CEO, what is the process(es) that Thomas may follow in bringing the suit?
- **Resource Video:** <http://thebusinessprofessor.com/shareholder-derivative-action-process/>

14. What are corporate vote "proxies" and how are they used?

Shareholders may vote their shares through a "written consent" or by casting their vote at a shareholder meeting. Written consents avoid the need to call a meeting, but any matter voted upon must receive unanimous written consent to be approved. In corporations with large numbers of shareholders, it is unlikely that all shareholders will attend the meetings and unanimous written consent is not likely. Thus, shareholders have the right to appoint someone to vote for them at a shareholder meeting. Both the appointed individual and the card that the shareholder signs to appoint the substitute voter are often called a "proxy". For purposes of this material, we will refer to a shareholder proxy as the card used to appoint an individual to vote the shareholder's interest. The proxy is used to solicit shareholder response and votes on a particular proposal. The shareholder may grant the proxy in favor of a particular action, such as a vote in favor of her desired candidate or corporate action. Under SEC rules, publicly-traded companies are not required to solicit proxies from shareholders, but virtually all of them do. This is the only practical way to obtain the requisite number of shareholders at a meeting to hold a vote and take action. This reaching this minimum number of shareholders present is known as obtaining a "quorum". The company must accompany all "proxy solicitations" with financial statements and a disclosures statement, known as a "proxy statement". The proxy statement contains lots of information about the corporation and any proposed actions. Much of this information is disclosed to shareholders in the annual statement and to the public *via* filing with the Securities Exchange Commission.

- *Note:* Some corporations pass what are known as "proxy access bylaws". Under proxy access bylaws, shareholders have greater ability to place information in the proxy materials sent to shareholders. Notably, large shareholders may propose individuals for election to the board of directors and these names must be included in the proxy material. These outsider nominees compete directly against directors nominated by the existing board or director nominating committee. It is, therefore, possible for an outside nominee to be elected to the board without the expense and drama of preparing separate proxy materials. So far, only a handful of companies have adopted

proxy access bylaws. Shareholders have the right to require the company to take a vote at the annual meeting on changing company bylaws to permit proxy access. The proposal passes if a majority of shareholders vote in favor.

- **Discussion:** How do you feel about the ability of shareholders to appoint a voting representative? Do you think corporations should be able to meet quorum requirements for shareholder meetings through proxies? Why or why not? Why do you think corporations are required to make such extensive disclosures along with proxy solicitations? Why do you think proxy access is not a widely adopted practice?
- **Practice Question:** You are corporate secretary and are in charge of the administration of shareholder meetings. What process might you follow to make certain a quorum is established at the annual shareholder meeting? What information must you provide to shareholders in this process?
- **Resource Video:** <http://thebusinessprofessor.com/corporate-proxies-and-shareholder-votes/>

15. What is “shareholder activism” and what is the significance of “institutions as shareholders”?

Shareholder activism refers to the situation where large shareholders of a company exert influence or control over the actions of the directors or officers of the corporation. Activist shareholders are generally concerned with improving returns on their investment through improved corporate performance or other structural changes. They may attempt to influence the company to make certain operational or governance decisions, to adopt goals or causes that the activist investor values, or to undergo a merger, acquisition, divestment or other structural change.

- **Example:** Yowser Corp is a online media and Internet search company. Yowser also has major asset holdings, such as a large stake in China Retail Online. Yowser has been declining in profits in recent years. Yowser has several activist shareholders who seek to maximize their profits. They seek to encourage the board to streamline the product offerings and to divest Yowser’s ownership stake in China Retail Online. This will return a healthy dividend to shareholders, but the board fears that it will gut the company. The activist shareholders threaten to replace directors who appose the proposed plan.

Activist investors play an increasingly important role in corporate governance. In the 1920s, approximately 20% of US stocks were owned and held by institutions. Today, nearly 80% of US stocks are held by institutions (mutual funds, pension plans, hedge funds, banks, foundations, endowments, and other investment companies). Individual wealth is largely held by these third-party firms that invest a portion of those funds in corporate shares. Large corporations often directly invest their retained capital in corporate shares of other corporations, or they pay third-parties (such as State Street Corp.) to invest those funds on their behalf. This results in an inordinate amount of corporate stock holdings resting with institutional investors. This model of investment seeks to insulate the underlying investor from the risks associated with investing. More specifically, it spreads risk more evenly across large groups of investors and does not rely solely on one investment class. There is worry, however, that these arrangements place too much authority in the managers of these investment funds with regard to corporate decision-making.

- **Note:** The inordinate amount of authority that comes from holding large quantities of voting stock in corporations creates the fear that corporations and institutional investors will enter into self-serving arrangements to maximize their mutual interests. Corporate governance mechanisms attempt to mitigate this threat and protect the rights of all shareholders.

- **Discussion:** How do you feel about activist investors? Should these investors be allowed to wield so much power over the organization? Why or why not? Does it affect your opinion whether the activist investors are individuals investing personal wealth or investment funds investing the wealth of others? Why or why not?
- **Practice Question:** Daryl is a finance manager. He is not happy with the management performance in ABC Corp. He is contemplating raising an investment fund with the purpose of establishing an ownership stake in the company. What are Daryl's objectives and how would he be able to achieve them through this process?
- **Resource Video:** <http://thebusinessprofessor.com/activist-shareholders-and-institutional-investors/>

BOARD OF DIRECTORS

16. What is the role of “directors” of the corporation?

Corporate governance procedures under state law and the Revised Model Business Corporation Act regulate the actions of boards of directors. The Organization for Economic Cooperation and Development, Principles of Corporate Governance (2004) describe the responsibilities of the board; some of these are summarized below:

- *Informed* - Stay informed of corporate affairs;
- *Ethics & Good Faith* - Act ethically and in good faith;
- *Duty of Care* - Act as a reasonable person would in the situation;
- *Duty of Loyalty* - Act in the corporation's best interest by avoiding self-dealing or usurping a corporate opportunity;
- *Planning & Guidance*- Control high-level corporation decision making, such as budgeting, strategic considerations, distribution of dividends, proposal for changes in corporation structure, etc.;
- *Executives* - Hire, determine compensation of, and oversee managers;
- *Election Process* - Oversee the process for nominating and electing directors;
- *Disclosure & Reporting* - Review and certify the accuracy of all required corporate reporting.

The amount of board responsibility varies a bit in closely-held firms. State law often allows a heightened role of directors in the daily management of operations.

- **Discussion:** Why do you think boards of directors are vested with the above-referenced responsibilities? Should there be more or less overlap in the responsibilities of shareholders and directors? Why or why not?
- **Practice Question:** Serena is elected to serve on the board of directors of ABC Corp. What will be her primary duties and responsibilities in this role?

- **Resource Video:** <http://thebusinessprofessor.com/role-of-directors-in-a-corporation/>

17. What is the composition of the “board of directors”?

The size of the board and the process for electing directors are laid out in either the articles of incorporation or the bylaws. There are generally few requirements in these governing documents with regard to who can be a director of the corporation. Corporate governance documents generally place few or no requirements with regard to the skill, knowledge, or general competence of board members. There are, however, numerous laws and organizations that control the composition of boards of directors of public companies. These laws and organizational rules include:

- the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank),
- the Sarbanes-Oxley Act of 2002 (SOX),
- the Securities Exchange Act of 1934, as amended ('34 Act),
- rules of the U S Securities and Exchange Commission (SEC), and
- the listing standards of the NYSE and NASDAQ.

The most notable requirement of boards imposed either by law or by exchange rules is that a majority of directors on a board be “independent”. The word independent is defined to mean directors who are not officers of the corporation or officers or directors of any parent or subsidiary companies. As such, independent directors are generally chosen from the executive ranks of boards of non-related public or large corporation. Another specific requirement regards corporate committees. Most notably, corporate committee members (particularly special committee members) must be disinterested in their assigned tasks. The objective behind requiring boards to have special committees is to isolate interested directors from controlling the internal workings and decision-making of the entire board. The required types of committee include:

- *Director Nominating Committee* - Charged with nominating directors for election to the board by shareholder vote;
- *Corporate Audit Committee* - Coordinates the process of audit by external auditors; and
- *Executive or Director Compensation Committee* - Tasked with developing compensation packages for officers and directors.

- **Discussion:** Why do you think laws and securities exchanges place requirements on the composition and character of boards of directors? Do you agree with the requirement that a majority of directors be independent? Why or why not?
- **Practice Question:** What are the primary corporate governance requirements affecting the composition of the board of directors?
- **Resource Video:** <http://thebusinessprofessor.com/composition-of-board-of-directors/>

18. What standards govern the actions and decisions of the board of directors?

Aside from requirements stated in the articles of incorporation, bylaws, and detailed governance provisions laid out in the previously-referenced laws, boards of directors owe fiduciary duties to the corporation. Fiduciary duties include a duty to act in good faith in all actions, a duty of loyalty, and a duty of care.

- *Duty of Care* - Directors owe a duty of care to the corporation. The duty of care requires officers and directors to act in the best interests of the corporation and to use the same care that an ordinarily prudent person would exercise in a similar situation. This standard is similar to a negligence standard in tort cases. The duty of care requires that directors make decisions in line with three principles:
 - *Legality* - Generally, decisions by directors that violate the law also breach a duty of care to the corporation.
 - *Note:* This is true even if the illegal action is taken for the benefit of the corporation.
 - *Rational Business Purpose* - Directors must make decisions, particularly those committing resources of the corporation, based upon a rational business purpose. Most courts assume that decisions made by directors are based upon a rational business purpose.
 - *Note:* This is a very low standard, as any action could constitute a rational purpose.
 - *Informed Decision Making* - Managers must take reasonable steps to research or seek information about a situation before making a decision or taking action. An informed decision that harms the company will generally not result in liability for the director if not done recklessly or with the intention of harming the corporation.
- *Duty of Loyalty* - Managers have an obligation to act in the best interest of the corporation and without personal conflict of interest. More specifically, directors cannot take actions or make decisions that benefit themselves at the expense of the corporation. The duty of loyalty protects against self-dealing and usurping of corporate opportunities by directors.
 - *Self-Dealing* - If a director engages in self-dealing, she may be liable to the corporation for damages resulting from the action. The business judgment rule does not protect directors from liability for self-serving actions; however, corporate law does not entirely prohibit self-serving transactions. The court is charged with determining whether a transaction constitutes self-dealing and should lead to liability for the director. An affirmative answer to any of the following inquiries may avoid director liability for an otherwise inappropriate transaction:
 - *Director Approval* - Was the director's action reviewed and approved by a majority of independent directors?
 - *Note:* An approval vote from disinterested directors makes it more likely to not constitute self dealing, but it is not determinative.
 - *Shareholder Approval* - Did the disinterested shareholders approve it?
 - *Note:* If the transaction is approved by a majority of disinterested shareholders, it will not

be considered self dealing. The reasoning is that shareholders are those sought to be protected. Shareholders can vote to approve transactions that limit their own benefits?

- *Fairness* - Is the transaction fair to the corporation? That is, the corporation must not lose or forgo a right or benefit at the expense of the director's action. The court will look to determine whether the value provided to the corporation was reasonable in comparison to the value gained by the directors.
- *Example*: I am director of ABC Corp. The board is in search of land to construct a new manufacturing facility. I purchase a parcel of land that would work perfectly and immediately sell it to the corporation for a huge profit. Several members of the board approved the transaction, but the board did not submit it for shareholder approval. This is obviously a self-serving transaction. If the transaction is later challenged by shareholders, the court will closely evaluate whether the purchase price and other terms of service were fair to the corporation.
- *Corporate Opportunity* - The corporate opportunity doctrine prohibits officers, directors, and controlling shareholders from excluding their company from favorable deals. This generally means that directors cannot compete with the corporation. Competing means providing a good or service that the corporation provides. Competing with the corporation may also include providing a good or service to a prospective customer or client of the corporation where the client originally approached the corporation for that good or service.
- *Note*: A Director may avoid liability to the corporation by showing:
 - *Offer to Corporation* - The director offered any opportunity to the corporation and a majority of disinterested directors or shareholders agreed to turn down or not pursue the opportunity; or
 - *Not a Corporate Opportunity* - The alleged opportunity was either not an opportunity at all or the corporation generally had no right or claim to it.
- *Example*: I am a director of ABC Corporation. ABC provides tax and auditing services to clients. If a current client approaches the corporation about payroll services, I cannot provide those services to the client personally without offering it to the corporation. It would equally be a violation of my duty of loyalty if I personally offer tax and auditing services to the public while sitting on ABC's board.

- **Discussion**: How do you feel about a director's duty of care? Should the standard of care owed to the corporation be higher or lower? Why? How do you feel about the director's duty of loyalty? Should self-interested transactions by directors be allowed? Why or why not? Does the limitation on usurping corporate opportunities go too far in limiting the abilities of directors or should it be more protective of the corporation? Why?
- **Practice Question**: Winston is a director of ABC Corp. He is also the president of a local mortgage company. As a director of ABC Corp, Winston is a member of a special committee that makes recommendations for corporate investments. Specifically, he helps evaluate certain classes of investment for the corporation to purchase. He recommends the corporation purchase collateralized loan obligations as safe, high-yielding investments. His

mortgage company sells the corporation several million dollars in bundled, collateralized loans. The corporation pays a premium for the loans because the underlying mortgages are all local. Later, the housing market crashes and ABC Corp loses lots of money. What are potential grounds for Winston's liability to the corporation?

- **Resource Video:** <http://thebusinessprofessor.com/standards-governing-actions-of-corporate-directors/>

19. What is the “business judgment rule”?

The business judgment rule is a principle that applies to officers and directors acting within the scope of their positions. Directors of a corporation have a fiduciary duty to act in the best interest of their stockholders. This includes exercising due care and having a business justification for their decisions and actions. The duty of care requires officers and directors to be informed and avoid acting negligently in the execution of their responsibilities. The business judgment rule takes steps to further protect directors from liability for their decisions or actions if they acted in good faith. Basically, it raises the standard of care for holding a director liable for actions or decisions that cause a loss to the corporation. A director that takes an action or makes a decision that is negligent or reckless may be shielded from liability if they acted in good faith. Acting in good faith simply means that the officer or director genuinely believed that her decision was appropriate and in the interest of the corporation. The major limitation on the protections of the business judgment rule is when the officer or director either acts to intentionally harm the corporation or breaches her duty of loyalty.

- *Example:* I am a director of ABC Corp. I sell authorize the sale of corporate assets to members of my family at a very low price. This could be considered a self-dealing transaction. The business judgment rule will not protect me from liability for my actions if those actions are challenged by shareholders for causing a loss to the corporation.
- **Discussion:** How do you feel about the additional protections of the business judgment rule for directors? Should directors be protected from liability when making negligent or reckless decisions? Why or why not? Why do you think the law exempts director actions or decisions that breach the duty of loyalty from protection?
- **Practice Question:** Francis is director of ABC Corp. He, along with other directors, makes the decision to invest significant corporate assets in short-term construction loans. The loans are very high risk but yield high annual returns. Several of Francis's family members own a substantial interest in many of the construction companies benefiting from the loans. If several of the loans default and cause a loss to ABC Corp, will the business judgment rule protect Francis from personal liability? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-business-judgment-rule/>

20. What other protections exist for directors acting in their official capacity?

Directors (and officers) of corporations often have a layer of protection from personal liability beyond the business judgment rule. Many corporations purchase “director and officer insurance” (D&O insurance) that provides the corporation (and possibly the director or officer) with indemnification for liability for actions or decisions made in its official capacity. D&O insurance generally only applies to breaches of the duty of care. The irony of this situation is that shareholder funds are used to purchase insurance protecting officers and directors from personal liability to shareholders.

- *Note:* Public policy and state statutes often limit indemnification of officers who breach the duty of the loyalty to the corporation.
- **Discussion:** How do you feel about the ability of a corporation to purchase insurance to indemnify it against liability caused by the actions of directors or officers? Does it matter to you that the insurance may indemnify the director or officer from personal liability? Why or why not? Does it affect your opinion knowing that the premiums for the insurance are paid by corporate funds (which belong to shareholders)? Why or why not?
- **Practice Question:** Harold is CEO of ABC Corp. He makes personal loans to family members from corporate funds. The company sustains a loss when the borrowers default on the loans. Shareholders are angered by this and seek a derivative action against Harold. The corporation purchased director and officer insurance to cover Harold's activities as CEO. Will this protect Harold from potential liability? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/director-and-officer-liability-insurance/>

MANAGERS

21. What is the role “managers” in the corporation?

Managers control the daily operations of the corporation. The senior managers are the officers of the corporation. The most senior positions are often directly chosen by the board of directors. The board then defers to the judgment of these officers with regard to all decision making and actions taken on behalf of the corporation. This includes allowing officers to fill the subordinate management positions in the corporation. The corporate management structure generally includes any of the following senior-level positions:

- *Chief Executive Officer* - The senior management position is generally centered in a single individual, the chief executive officer (CEO). This person is ultimately responsible for all corporate operations. Other executive officers, such as the chief operating officer or chief financial officer, may report to the CEO.
- *Corporate Secretary* - The corporate secretary is the only mandatory corporate official. The board appoints and confirms the corporate secretary. She is charged with maintaining all corporate records, maintaining the minutes for shareholder and director meetings, certifying corporate documents, and orchestrating director and shareholder meetings (including all formal actions taken at the meeting).
- *Chief Financial Officer* - The CFO generally oversees all accounting and finance operations for the corporation. Oversight of the accounting process is critical, as the majority of the information disclosed to shareholders and the SEC derives from corporate accounting. Corporate finance deals with how operations of the corporation are financed, including the sources of capital and the budgets allocated to each department in the company.
 - *Note:* The chief corporate accountant (the “controller”) reports to the CFO.
- *Chief Operating Officer* - The COO generally oversees all aspects of corporate operations. The role of the COO will vary considerably depending upon the nature of the corporate business. Often these individuals are subject-matter experts in the company's business practice and have extensive training in operational efficiency methods.

Other executive positions may be in charge of marketing, information or communication, technology, innovation, etc.

- **Discussion:** How do you feel about the board of director's authority to select senior management? Why do you think corporations typically hire executives in this operational structure to oversee the primary corporate functions? Can you think of any structures that could arguably operate better than this structure?
- **Practice Question:** What is the role of the chief executive officer and corporate secretary, and how do their roles relate to corporate governance?
- **Resource Video:** <http://thebusinessprofessor.com/role-of-managers-of-the-corporation/>

22. What standards govern the actions of corporate managers?

Like the corporate directors, officers of the corporation owe fiduciary duties to the corporation. Officers must demonstrate loyalty and care in carrying out their responsibilities. The standard of care that an officer must observe in carrying out her duties varies considerably given the wide array of officer responsibilities; but, the officer must generally be informed and not act negligently. Similarly to corporate directors, officers are protected in their actions by the business judgment rule. Further, most corporation purchase insurance to indemnify officers and directors for any personal liability for actions taken on behalf of the corporation.

- **Note:** Recall from the previous discussion of the business judgment rule, the primary limitation is that the insurance does not indemnify against breaches of the duty of loyalty.
- **Discussion:** How do you feel about the standard of care owed by officers to the corporation? Should the business judgment rule protect officers in their decisions and actions in the same manner that it protects directors in their decisions? Why or why not?
- **Practice Question:** Amy is CEO of ABC Corp. She decides to hire her cousin as the corporate COO. Her cousin has little experience in the position. When operations begin to lag, the board forces her hand in firing her cousin. The terms of his employment entitle him to 3 years worth of compensation if fired for any reason. The board is angry that Amy did little to vet her cousin prior to hiring him and that his compensation package was poorly negotiated. What standards will apply in determining whether her conduct breaches a duty owed to the corporation.
- **Resource Video:** <http://thebusinessprofessor.com/standards-governing-actions-of-corporate-officers/>

LAW AND CORPORATE GOVERNANCE

23. What state and federal laws primarily contribute to corporate governance?

Regulation of corporate governance practices is a mixture of state and federal law and organizational requirements. Below is a list of the primary state and federal laws and stock exchange rules contributing to corporate governance:

- state-specific corporate laws (particularly Delaware law and Model Business Corporation Act states),
- the Securities Exchange Act of 1934 ('34 Act) and SEC Rules,
- the Sarbanes-Oxley Act of 2002 (SOX)
- the Foreign Corrupt Practices Act (FCPA)
- the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank),
- the listing standards of the NYSE and NASDAQ
- the advisor rules from Proxy Advisory Firms.

Each of the above sources of regulation are discussed in detail below.

- **Discussion:** If corporate entities exist by virtue of state law, why do you think that there are so many federal laws and private organization standards concerning corporate governance?
- **Resource Video:** <http://thebusinessprofessor.com/state-and-federal-corporate-governance-laws/>

24. What is the role of state law in corporate governance?

State corporate law is the primary law governing corporate governance and operations. Each state passes its own statutory corporate laws and develops its own common law surrounding those statutes. Shareholders seeking to bring actions to enforce their rights must generally do so under state law. Many state legislatures, rather than independently drafting corporate statutes, adopt the Model Business Corporations Act (MBCA) as the default corporate law in that state. The MBCA is a model set of laws prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association. Twenty-four states have chosen the wholesale adoption of the MBCA. This practice has added a degree of uniformity to state statutory law across state borders.

A corporation may incorporate in any state, whether or not the corporation carries on business in that state. This is a common practice when a corporation wishes to take advantage of a state's favorable legal environment for businesses operations. The most common state for incorporation by businesses that operate primarily outside of that state is Delaware. That is, many corporations (particularly public corporations) incorporate in Delaware but establish their headquarters in other locations. Delaware does not follow the MBCA, and corporations organizing in Delaware do so with the purpose of availing themselves with Delaware's corporate governance provisions and court system. Delaware allows for several legal benefits that make it a popular choice for companies headquartered in other states, including:

- *Developed Corporate Law* - Delaware has an extensive body of corporate law (statutory and common law) that is generally considered to be more thoroughly developed than other states. While the point is debatable, many argue that the Delaware body of corporate law is more favorable to managers (officers and directors) than shareholders.
- *Legislative Responsiveness* - The Delaware legislature prioritizes corporate law by reacting quickly to propose legislation dealing with important issues. This is important when gaps in statutory law could lead to uncertainty in corporate governance or procedure.

- *Chancery Court* - Delaware has a dedicated chancery court to hear corporate law matters. This is an executive court controlled by chancellors (judges) who are experts in corporate law. The chancery court does not allow for jury trials, so the chancellor serves as fact finder in legal disputes before the court.

All of the factors provide greater degrees of certainty and comfort to corporate managers and directors.

- **Discussion:** Why do you think corporations prefer to have a well-developed body of corporate law? Why do you think corporations prefer to adjudicate legal disputes involving corporate law before a chancellor rather than a jury? Why do you think that the legislature is so responsive in acting upon corporate law issues? (Hint: Think about the nature of statutory law versus common law.)
- **Practice Questions:** Why do many corporations organize in Delaware as apposed to their primary states of operation?
- **Resource Video:** <http://thebusinessprofessor.com/state-law-and-corporate-governance/>

25. What is the role of “securities laws” in corporate governance?

Federal securities laws are generally concerned with corporate compliance. The primary federal securities laws are the Securities Act of 1933 ('33 Act) and the Securities Act of 1934 ('34 Act). State law also governs the sale or exchange of securities, but state law largely mimics or piggybacks upon federal securities law. The '33 Act primarily controls the initial issuance of securities. In private corporations, the '33 Act places numerous governance requirements on corporate stakeholders during the issuance process. The '34 Act places significant requirements on the reporting and disclosure of information by publicly-held corporations. These provisions include mandatory reporting to the Securities and Exchange Commission, as well as disclosure requirements to corporate shareholders. The corporate directors and officers are primarily tasked with making and ensuring the accuracy of all securities-related disclosures. Notably, the '33 and '34 Acts allow for a cause of action by shareholders against the corporation or its agents for failure to make disclosures, omissions, or material inaccuracy in a disclosure. These causes of action are based upon negligent misrepresentation and fraud (intentional misrepresentation) in connection with the purchase or sale of corporate securities. The causes of action available to shareholders under the '33 Act and '34 Acts are discussed in greater detail in a separate chapter.

- **Discussion:** Why do you think corporate compliance with securities law is an important consideration in corporate governance? How does compliance affect each stakeholder (shareholder, director, officer) in the corporate governance regime?
- **Practice Questions:** What are the corporate governance requirements relevant to federal securities laws?
- **Resource Video:** <http://thebusinessprofessor.com/corporate-governance-and-federal-securities-laws/>

26. What is the “Foreign Corrupt Practices Act” (FCPA) and how does it affect corporate governance?

The Foreign Corrupt Practices Act (FCPA) places limitations on the ability of the corporation to pay incentives or bribes to foreign governments and corporate officials to secure business advantages. The regulations place specific requirements

on corporate accounting departments to account for foreign payments and on corporate directors and managers to adequately disclose those payments to regulators and shareholders. Failure to do so may result in criminal and civil penalties.

- **Discussion:** How do you think the FCPA affects decision making and actions by officers and directors of corporations seeking to do business internationally?
- **Practice Question:** What are the primary corporate governance issues implicated by the Foreign Corrupt Practices Act?
- **Resource Video:** <http://thebusinessprofessor.com/corporate-governance-and-the-foreign-corrupt-practices-act/>

27. What is the “Sarbanes-Oxley Act”?

The Sarbanes-Oxley Act (SOX) is the primary federal law governing corporate governance and accountability across multiple aspects of corporate business practice. SOX specifically regulates markets, brokers, dealers, accounting and auditing, on-going government and shareholder disclosure by reporting companies, insider trading, anti-fraud, proxy regulation and so forth. SOX established a new regulatory body, increased the authority of existing regulators, as well as imposed regulations beyond those of the self-regulating, industry organizations. The primary objectives of SOX are to promote:

- *Fairness to Shareholders* - SOX requires or promotes governance provisions that protect shareholder rights and allow shareholders to exercise those rights through governance procedures, such as shareholder meetings.
- *Fairness to Stakeholders* - SOX requires or promotes governance provisions that take into consideration the interests of employees, suppliers, buyers, and the local community.
- *Heightened Director and Board Responsibilities* - SOX places specific requirements on the composition of boards of directors, including skill and independence requirements. Notably, in an effort to promote director independence in decision making, SOX requires corporations to employ employee committees for special purposes.
 - *Example:* SOX requires boards appoint an audit committee where all members are independent of corporate operations (not officers of the corporation) with at least one financial expert as a member of the committee.
- *Director and Officer Ethics* - SOX imposes additional obligations on corporations to establish and maintain ethical standards for officer and director conduct and decision-making.
 - *Example:* SOX prohibits the corporation from making personal loans to corporate executives or their families.
- *Disclosure and Accountability* - SOX places requirements on boards to increase transparency in corporate governance practices. This includes implementing procedures for ensuring accurate accounting practices and public disclosure mechanisms.

- *Note:* SOX requires internal review procedures and independence of external auditors that report directly to the corporation's independent audit committee. Further, SOX requires that key officers of the corporation (the CEO and CFO) certify the accuracy of the financial statements and that internal financial controls are in place and subject to the independent audit committee's review.

Accounting and Disclosure Procedures - SOX imposed a number of reforms on the accounting and financial reporting requirements of public companies. The primary requirements are as follows:

- *The Public Company Accounting Oversight Board (PCAOB)* - SOX established the PCAOB to regulate auditors charged with reviewing the accounting procedures and disclosure statements of public companies.
 - *Note:* Prior to the establishment of the PCAOB, public company auditors were self-regulated or subject to the standards imposed by private institutions, such as the Financial Accounting Standards Board (FASB) or American Institute of Certified Public Accountants (AICPA).
- *External Auditing Firms* - SOX now requires that a firm in charge of auditing the corporation refrain from serving as independent consultants to that same firm. This includes refraining from bookkeeping, system designs and implementation, appraisals and valuations, actuarial services, human resources functions, and investment banking services for the audited company. Further, the corporation must change auditing firms at least every 5 years. There are also restrictions on the ability of company executives to have worked for the auditing firm within the prior year.
 - *Note:* Prior to SOX, external auditing firms could simultaneously serve as consultants to the corporation that it is auditing. This created an inherent conflict of interest. Further, allowing corporations to employ the same auditors for extended periods increased the likelihood that on-going, improper accounting practices would not be discovered. Without periodically rotating in new auditors, there was no real check on the accounting firm.

Securities Regulations - Much of the regulatory process prescribed by SOX is carried out by the Securities and Exchange Commission. SOX includes provisions that strengthen the ability of the SEC to oversee corporate governance matters and enforce violations.

- *Example:* SOX established a criminal charge for conspiring to commit securities fraud. It also increased the criminal and civil penalties for committing securities fraud. SOX provides additional protections against discrimination for those reporting conduct that violates the securities laws ("whistleblower protection").
- **Discussion:** What do you think was the driving force behind the passage of SOX? Why do you think focused on accounting standards and securities regulations to promote its objectives of fairness and ethics?
 - **Practice Question:** What are the primary corporate governance requirements and objectives of these requirements under the Sarbanes-Oxley Act?
 - **Resource Video:** <http://thebusinessprofessor.com/corporate-governance-and-the-sarbanes-oxley-act-sox/>

28. What is the “Dodd-Frank Wall Street Reform and Consumer Protection Act” (Dodd-Frank)?

Dodd-Frank was passed in response to the financial downturn beginning in 2007. While Dodd-Frank imposed extensive controls on banks and other lending institutions, it also prescribed corporate governance procedures designed to protect shareholder interests. Notable provisions of Dodd-Frank include:

- *Proxy Rights* - Requires corporations allow shareholders have greater ability to nominate directors for election to the board in corporate proxy material.
- *Proxy Disclosures* - Requires corporations to make more extensive shareholder disclosures in all corporate proxies.
- *Shareholder Voting Rights* - Entitles shareholders to a non-binding vote on certain corporate governance issues.
 - *Note:* Shareholders may be entitled to cast votes on the proposed hiring and compensation of corporate executives. While these votes are not binding, they do allow the shareholders to openly evaluate and express their opinions on corporate governance matters.

- **Discussion:** Why do you think a Act that intends to protect the market against financial downturn imposes shareholder rights provisions on corporations? Can you explain how any of these provisions help make securities markets more stable?
- **Practice Questions:** What specific corporate governance procedures are required by the Dodd-Frank Act?
- **Resource Video:** <http://thebusinessprofessor.com/corporate-governance-and-the-dodd-frank-act/>

29. What industry organizations place standards on corporate governance?

- Public securities exchanges have extensive governance requirements for companies listing securities for sale with the exchange. Perhaps the most known US exchanges are the New York Stock Exchange (“NYSE”) and NASDAQ Stock Market (“NASDAQ”). Common exchange provisions require:
 - *Director Independence* - Exchanges require that listed companies maintain director independence, which includes independence from management and financial relationships with the corporation;
 - *Committees* - Companies may be required to comply with strict committee requirements, such as appointment of specific committees with director independence and defined charters (such as governance committee, audit committee, compensation committee);
 - *Shareholder Votes* - Companies may be required to allow shareholder vote on specific matters, such as modifications of governance conditions and equity distributions;
 - *Equity Structure* - Companies may be required to adhere to specified equity structures that limit the rights of various classes of shares;

- *Management Restrictions* - Companies may be required to hold separate director meetings that exclude directors who are also managers; and
- *Public Disclosures* - Companies may be required to comply with standards for public disclosure of information, including the manner and frequency of disclosure.

The regulatory authority of exchanges comes from the exchange's ability to control which companies are listed on the exchange. Exchanges may reprimand, suspend, or bar companies from listing their shares for violations of exchange rules.

- **Discussion:** Why do you think securities exchanges are concerned with corporate governance matters? Can you explain how each of the above areas of regulation support this objective?
- **Practice Question:** What are the some of the primary governance requirements placed on corporations by industry organizations?
- **Resource Video:** <http://thebusinessprofessor.com/corporate-governance-and-industry-standards/>

30. What are “proxy advisory firms” and what is their effect on corporate governance?

Recent changes to corporate governance laws allow shareholders increased ability to add information to corporate proxies. As a result, proxy advisory firms have assumed an important role in the shareholder proxy solicitation and notification process. These firms propose governance standards for corporations. They encourage corporations to adopt and comply with those standards by sending information to all corporate shareholders about the corporation's governance. These standards will indicate when directors adhere to or deviate from the proposed governance standards. They may also include a recommendation for director elections. This practice pressures directors to conform to governance standards or face a recommendation from the advisory firm against election or re-election. These firms serve a very important function by informing shareholders who otherwise lack the ability or motivation to learn about directors proposed by the nomination committee of the corporation.

- *Note:* Activist shareholders may employ proxy advisory firms to promote their agenda to shareholders.

- **Discussion:** What is the advantage to activist investors who employ proxy advisory firms? Do you think that these firms can have positive or negative effects on corporate governance? Why or why not?
- **Practice Question:** How doe proxy advisory firms influence the corporate governance process?
- **Resource Video:** <http://thebusinessprofessor.com/corporate-governance-and-proxy-advisory-firms/>

31. What is the role of ethics within corporate governance?

Corporate codes of ethics are internal measures aimed at ensuring fair and honest conduct by members of the corporation. The corporate law objective to promote openness of information is echoed in codes of ethics. The main problems with

codes of ethics are that they do not force compliance and there is very little consequences for individuals failing to adhere to their provisions. As such, corporate actors routinely avoid these provisions in favor of self-interested actions.

- *Note:* These codes, however, may serve as the standard by which corporate members are judged in the event of direct or derivative actions against the corporation or the member.
- **Discussion:** Why do you think corporations establish codes of ethics? Do you think they are effective? Why or why not? Should there be repercussions for failure to adhere to corporate ethics policy? Why or why not?
- **Practice Question:** How do rules of ethics affect corporate governance practice?
- **Resource Video:** <http://thebusinessprofessor.com/corporate-governance-and-ethics/>

CAUSES OF CORPORATE GOVERNANCE ISSUES & TECHNIQUES FOR EFFECTIVE PRACTICE

32. What are some of the major causes of corporate governance issues?

The primary characteristics of the corporate governance regime that causes issues or conflicts between shareholders and the corporation are as follows:

- Access to Information
- Decision-Making Procedure
- Competition for Authority
- Interest and Benefit Misalignment

Each of these drivers of corporate governance issues is discussed below.

33. How does shareholder access to information give rise to issues in corporate governance?

Shareholders own the corporation and control the election of directors. While this structure should effectively check the decision making and actions of directors, the lack of shareholder information about the actions and decisions of directors prevents them from making accurate decisions and often causes apathy with regard to exercising their voting rights. The lack of information is amplified by the fact that nomination committees within the corporation often have unilateral authority to recommend a director for election to the board. Couple this with the fact that shareholders have limited access to proxy material to make shareholder proposals, it makes it unlikely shareholders will be effective in influencing director actions. In light of this reality, shareholders must either possess a large share of corporate ownership or assemble into voting groups to have any real influence on the actions and decision-making of directors. A large shareholder or large voting block has the ability to pass resolutions and control the election of directors. It is often difficult, however, for shareholders to effectively aggregate into a strong voting block in the corporation. One reason is the lack of available information and the high cost of obtaining and monitoring that information. For this reason, increased shareholder access to proxy material, additional shareholder voting rights, and the role of proxy advisory firms has become very important.

- **Discussion:** What do you think are the potential advantages and disadvantage to allowing shareholders greater access to corporation information? What would be the potential effect on the corporation? Other stakeholders?
- **Practice Questions:** What are the primary reasons for shareholders having limited access to information, and how does this lead to conflicts between shareholders and investors.
- **Resource Video:** <http://thebusinessprofessor.com/lack-of-information-and-corporate-governance-issues/>

34. What corporate decision-making procedures give rise to issues in corporate governance?

The structure and process for decision making within the corporation can lead to conflicts between officers and directors and shareholders. Below are common decisions or processes that give rise to conflict:

- **Corporate Approvals** - Certain approval rights for board actions are reserved to shareholders. That is, shareholders must approve the decision of directors. These checks on authority can often cause tensions between shareholders and those in charge of corporate governance. This conflict is exacerbated by the fact that shareholder voting must often be initiated by a proposal from the board of directors.
 - *Example:* An attempt by shareholders to amend the bylaws or articles of organization must begin with a proposal from the board of directors. Further, a proposed merger, acquisition or spin-off must be approved by a majority of shareholders.
- **Capital Distribution** - Shareholders, as owners of the corporation, receive a financial benefit through either a distribution of dividends from corporate profits or an appreciation of their ownership interest. As you will learn in finance, appreciation of the value of stock is generally based upon the expectation of future dividends from corporate profits. Directors are charged with the decision of whether, when, and the amount of dividends to distribute to shareholders. This fact often causes conflict between large shareholders and directors.
 - *Example:* Adam is a large shareholder who purchased stock in the corporation for the expected dividend. The corporation is going through some strategic transitions and expects to withhold all dividends and retain capital to acquire competitors. These acquisitions are risky and run counter to Adam's objectives in holding the stock.
- **Proxy Statements** - The control that the board of directors (and the nominating committee) exercises over proxy material creates a conflict between director preferences and the ability of shareholders to make proposals for approval to shareholders at large.
 - *Note:* Directors, even those on a nominating committee, often have loyalty or are indebted to the individuals who assisted them in becoming a part of the board. These directors may feel pressure to nominate potential directors who have the support of the individuals who supported them.
 - *Example:* Eric is CEO and a director on the board of ABC Corp. He supported several of the independent board members in their election to the board. These directors typically work at board meetings for 3-5 days per month and receive tens to hundreds of thousands of dollars per year in salary and benefits for their service. As such, the directors owe a significant debt of gratitude to the CEO. It is unlikely that these directors will fail to support the CEO's future nominees to the board.

- *Written Consents* - Directors and shareholders have the ability to act pursuant to written consents instead of holding a formal meeting to take a vote. These votes require either a majority or unanimous vote from directors or shareholders. Taking actions without meeting reduces the level of information distributed and can lead to conflicts between interested parties.
 - *Example:* The board of directors for ABC Corp intends to make a decision on a major environmental cleanup project. It submits the proposed project to shareholder vote. Instead of holding a meeting, they accept votes through written consent. The majority of votes cast were adamantly against the proposal and it fails to pass, as it would decrease short-term corporate profits.
- *Supermajority and Unanimity Requirements* - Often shareholders and directors establish governance standards requiring unanimous or supermajority approval of certain corporate actions. These requirements may lead to conflict and stalemates between interested parties with regard to corporate decisions and actions.
 - *Example:* Earl is a major corporate shareholder. He strongly supports a proposed corporate merger that has been submitted to shareholders for approval. Several smaller shareholders have decided that they do not support the deal. Because the board employed unanimous shareholder approval rules, the proposed merger will not receive shareholder approval. Earl is now furious and is considering his options for forcing out directors who refuse to support an amendment to the unanimous shareholder approval requirements.

- **Discussion:** Do you see a common thread among the procedural aspects that give rise to corporate governance issues? Why do you think this is the case? Of the governance procedures listed above, do believe that any should sway in favor of director or shareholder? Why or why not?
- **Practice Question:** What corporate governance rules or procedures for decision making give rise to conflicts between shareholders and directors?
- **Resource Video:** <http://thebusinessprofessor.com/decision-making-and-corporate-governance-issues/>

35. How does competition for authority within the corporation give rise to issues in corporate governance?

The corporate structure is designed to establish limited authority in shareholders, directors, and officers. While the general responsibilities of each are clearly established, the strength of influence on decision making is often distorted by the amount of authority demanded or exercised by each stakeholder.

- *Internal Power Struggles* - The most notable power struggles come between the board of directors and shareholders. These matters are often settled through shareholder votes or derivative actions by shareholders against the board. In this process, shareholders may seek to assert additional control over director decision making; while directors often seek to diminish shareholder input.
 - *Note:* Shareholders do not approve of a strategic course for the corporation as decided by the directors. Shareholders seek to exert influence over the directors to influence their decision making or request that certain actions be submitted to shareholder vote for approval. If the directors decline to follow shareholder urging and it leads to a corporate loss, shareholders have the option of bringing direct or

derivative actions against the directors. Further, shareholders may seek to unseat uncooperative directors at election time.

- *Friendly Takeovers* - A common point of conflict may arise between the existing board of directors and prospective acquirers (purchasers of a controlling percentage of outstanding shares) of the corporation. This transaction is known as a corporate “takeover” or “buyout”. A takeover is where third parties purchase the outstanding shares of corporate stock and thereby gain control of the corporation. The prospective acquirer(s) may be unrelated third parties, managers, or existing shareholders. The acquirer may petition the board of directors to accept a takeover bid. If the board endorses the offer, it will submit the proposal to existing shareholders. If a majority (or supermajority) of shareholders approve the purchase, the board will repurchase all of the outstanding shares from shareholders at the proposed price. The shares are then surrendered to the acquiring firm. If, however, the board or shareholders reject the acquirer’s offer, the acquirer may seek alternative methods to acquire control over the corporation, such as through a “hostile takeover”.
- *Note:* In some cases, a takeover can appear to be friendly but is really hostile. For example, a “bear hug” is a situation where an acquirer offers a purchase price to the board that is far above expected value. The board may be required to accept or endorse the offer in order to meet its obligations to represent the best interest of shareholders.
- *Example:* I am an activist investor. I see opportunity for creating value in ABC Corp. I make a tender offer to the board to purchase all (or a majority) of outstanding corporate shares. Directors will evaluate the offer and either accept or reject it. In some case, directors are obligated to submit the offer to shareholders for approval or rejection.

- **Discussion:** Why do you think power struggles between shareholders and directors often lead to corporate governance issues? Do you believe that the default division of corporate responsibilities is efficient in avoiding or reducing these types of struggles? Why or why not? How do you feel about the concept of a takeover bid from prospective shareholders? Should directors be obligated to submit any offer to shareholders for approval or rejection? Why or why not?
- **Practice Question:** Karl is an activist investor who regularly assumes a large ownership stake in corporations in order to make changes in the corporations that will drive value and produce a return on his investment. He looks at ABC Corp and believes that the CEO is causing a loss of corporate value. He believes that he could replace the CEO with a higher performer and instantly create significant value in the corporation. He could then sell his shares and make a hefty profit. What are Karl’s first steps in achieving his objectives?
- **Resource Video:** <http://thebusinessprofessor.com/power-struggles-and-corporate-governance-issues/>

36. What is a “hostile takeover” and what effect does it have upon corporate governance?

A hostile takeover is where a third-party acquirer seeks to purchase a controlling number of outstanding shares without the endorsement or approval of the target company’s board of directors. Prospective shareholders can carry out their objectives through a number of methods.

- *Strategies for a Hostile Takeover* - Acquirers often employ numerous methods to circumvent the board and affect

the intended acquisition.

- *Tender Offer* - The primary method of acquiring a controlling share of a corporation's stock without the approval of the board is done through an open offer to shareholders to purchase shares at a given price. This is known as a "tender offer". Once the acquirer obtains a sufficient number of shares, it will begin to elect new directors to the board of directors. The new directors will represent the interests of the acquirer. This effectively puts the acquiring shareholder in control of the corporation.
 - *Note:* Tender offers are regulated by federal law. The Williams Act requires that an attempted tender offer be registered with the SEC.
 - *Example:* 123 Corp wants to buy ABC Corp. 123 Corp registers with the SEC and makes an open offer to all ABC Corp shareholders to purchase their shares at \$72 per share. The offer is contingent upon 123 Corp receiving a commitment from a certain number of shareholders to sell their shares. If 123 Corp is successful in acquiring a majority of outstanding corporate shares, it will then begin electing directors who will approve 123 Corp's acquisition plan.
- *Proxy Contest* - A potential acquirer may attempt to convince existing shareholders to replace the current directors with directors that support the acquirer's objectives. This is done by placing the name of the acquirer's proposed director nominee in the shareholder proxy material. If the proxy material is successful, a majority of shareholders will elect the acquirer's director(s), who will then work to effectuate the takeover plans.
 - *Note:* Acquirers must often initiate litigation to enforce shareholder proxy right provisions. As previously discussed, these provisions effectively strengthen shareholder access to proxy material. It allows the acquirer to provide shareholders with the option of approving the acquirer's objectives.
 - *Example:* 123 Corp makes an offer to ABC Corp's board to purchase all outstanding shares of ABC Corp at \$23 per share. ABC Corp refuses the offer. 123 Corp purchases a large block of shares of ABC Corp and thereby has shareholder rights. 123 Corp then exercises its right to add its recommended directors to the corporate proxy material. This allows shareholders to vote for 123 Corp's proposed directors. If successful, the 123 Corp proposed directors will vote to approve 123 Corp's acquisition plan.
- *Creeping Tender Offer* - In some cases, an acquirer may begin to slowly acquire corporate shares on the public market. Once the shareholder reaches a sufficient number, it can begin the process of replacing existing directors with directors who will support the acquirer's objectives.
 - *Note:* Depending upon the amount and how quickly a potential acquirer purchases shares, it may have to register its intent with the SEC. In any event, acquisition of a certain percentage of corporate shares triggers a number of disclosure requirements.
- *Bear Hug* - In some cases, a takeover can appear to be friendly but is really hostile. For example, a "bear hug" is a situation where an acquirer offers a purchase price to the board that is far above expected value. The board may be required to accept or endorse the offer in order to meet its obligations to represent the

best interest of shareholders.

- *Example:* ABC Corp wishes to purchase 123 Corp and merge operations. ABC Corp realizes that the board of 123 Corp is not interested in a merger or acquisition. As such, ABC Corp offers a very high purchase price for the 123 Corp shares. The board must consider this proposal. If 123 Corp rejects the offer, shareholders who are unhappy with the decision may bring a derivative action against shareholders or vote against them in future director elections.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-hostile-takeover/>

- *Anti-takeover Measures* - When an acquirer attempts a hostile takeover, boards of directors commonly institute measures to thwart the acquirer's attempts to gain control of the corporation. Some common measures employed are as follows:

- *Shark Repellants* - These provisions strengthen the board and make it increasingly difficult for the acquirer to effectuate its plan of replacing current directors.
- *Staggered Boards* - The election of directors is staggered over a multi-year period. A certain number of directors will be elected at each annual meeting. This will lengthen the amount of time it would take a bidder to gain full control over the board.
 - *Example:* ABC Corp has 9 directors. Only 3 directors come up for election each year. At a bare minimum, it would take two years before a majority shareholder would be able to elect 5 directors and obtain a majority on the board.
- *Super-majority Voting* - This means that the proposed action requires a higher number of shareholder votes than a simple majority. This will mean that the hostile acquirer must purchase or obtain a proxy from a larger number of shareholders in order to effectuate the takeover.
 - *Example:* ABC Corp amends the articles of organization or bylaws to require an 80% approval of shareholders for any merger, acquisition, or sale of substantially all of the corporation's assets. This means that an acquirer would have to acquire a much larger share of the outstanding shares in order to effectuate the takeover.

- **Resource Video:** <http://thebusinessprofessor.com/hostile-takeover-defense-shark-repellant/>

- *Poison Pills* - These provisions have the objective of raising the cost of acquisition to the acquirer in hopes of making the acquisition prohibitively expensive.
- *Preferred Share Issuances* - The board may approve a preferred class of shares that grant extensive rights to existing shareholders. The preferred shareholder may generally exercise her rights in the event of a takeover offer or a purported acquirer obtains a controlling block of

shares.

- *Note:* Types of preferred share issuances include “flip-over plans” and “flip-in plans”. The flip-over plan allows the preferred shareholder to convert or purchase common shares at a very low cost. In flip-in plans, the shareholder can force the corporation to repurchase the preferred shares at a premium. Both of these provisions cost the acquirer lots of money.
- *Dual Class Recapitalization* - The board distributes a new class of equity to stockholders with superior voting rights but inferior dividends or marketability. The new shares allow shareholders to exchange these shares for some multiple (2x, 3x, etc.) of ordinary common stock. This will augment the voting power of existing managers and make it more difficult for an acquirer to obtain a controlling block of shares.
 - *Example:* I receive preferred shares that allow me numerous votes per share and the ability to convert the preferred shares into large numbers of common stock. This gives me an inordinate amount of voting power for the price of the share.
- *Employee Stock Ownership Plans* - This plan may allow employee (particularly executive) stock plans to vest at an accelerated rate. These types of plans are known as “golden parachutes”. They force the acquirer to purchase far more shares at a higher valuation.
 - *Example:* I am CEO of ABC Corp. In my employment contract, I reserved the right to receive 10 years worth of compensation in stock options that vest immediately if I am relieved from my position without cause. If ABC Corp is acquired in a hostile takeover and I am replaced as CEO, this could cause substantial expenses to the corporation. If this provision is included in the contract of enough senior managers, it could make an acquisition unattractive.

- **Resource Video:** <http://thebusinessprofessor.com/hostile-takeover-defense-poison-pill/>

- *Buying Off Acquirer* - Often the corporation will attempt to provide benefits to the acquirer that will incentivize it to give up its efforts. These efforts are generally not in the best interest of existing shareholders and can lead to litigation.
- *Target Share Repurchase Plans (Greenmail)* - In some cases the corporation will attempt to repurchase of block of shares held by an intended acquirer. The acquirer heavily profits from the repurchase. This effectively eliminates the acquirer from continuing with the acquisition plan.
 - *Example:* I purchase a large block of shares in an effort to acquiring a controlling interest in the corporation. The corporation repurchases the shares at a 25% premium above my purchase price. I sell the shares and abandon my share acquisition efforts.
- *Standstill Agreements* - The board may offer to pay an acquirer to halt the acquisition of

additional shares for a state period of time. The provision may also require the acquirer to vote its shares for the current board of directors. This will give the corporation time to implement additional anti-takeover measures.

- *Example:* ABC Corp pays Karl to cease acquiring additional shares in ABC Corp for 12 months. This allows the directors the opportunity to propose changes to the governing documents to implement additional anti-takeover measures. Often these measures require existing stockholder approval, so the standstill agreement will require Karl to vote for the implementation of these provisions.

- **Resource Video:** <http://thebusinessprofessor.com/hostile-takeover-defenses-delay-tactics/>

- *Legal Lockups* - The corporation may be able to halt or delay the acquisition by making it less lucrative to the acquirer or making it illegal under existing law.
 - *Asset Restructuring* - The corporation may be able to acquire assets that the acquirer does not want or that will create antitrust problems. Alternatively, the corporation could sell valuable assets that the acquirer desires, thus making the acquisition less valuable.
 - *Example:* ABC Corp sells valuable assets to a friendly, third party. If the acquirer is doing so in hopes of creating value through a strategic acquisition of corporate assets, the sale of these assets may reduce the strategic value of the firm for the acquirer.
 - *Litigation* - The corporation may seek a legal action through the FTC or SEC alleging that a merger or takeover violates antitrust or securities laws.
 - *Example:* ABC Corp purchases a competitor of the acquiring firm. If the acquirer effectively gains control over ABC Corp, the Federal Government may review the acquisition to make certain it does not violate antitrust law. If the acquisition results in a concentration of market power in the acquirer, the government may block the acquisition.

- **Resource Video:** <http://thebusinessprofessor.com/hostile-takeover-defenses-asset-or-liability-tactics/>

- *Alternative Acquisition Defenses* - In some cases, a corporation may seek to acquire or be acquired in an alternative arrangement that thwarts the acquirer's efforts.
 - *White Knight Defense* - In some cases the board may go so far as to endorse acquisition by a different acquirer. The endorsed acquirer does so to avoid the corporation falling into the hands of the original intended acquirer. This process is known as a "white-knight" defense to a hostile takeover.
 - *Example:* ABC Corp has a close relationship with 123 Corp. In order to fend off an

acquirer, ABC Corp endorses a merger or acquisition by 123 Corp. This may make acquisition of shares too expensive and impractical for the acquirer.

- *Pac-Man Defense* - The target corporation may seek to acquire the acquirer, if the acquirer is a public corporation with stock available for purchase. This is a sort of counter attack that may thwart the takeover effort.
 - *Example:* 123 Corp makes a tender offer for ABC Corp shares. ABC Corp board is not interested in combining with 123 Corp. They do, however, recognize that a combination could product substantial value. ABC Corp, in turn, makes a tender offer for 123 Corp stock. If this offer eclipses the expected increase in share value of 123 Corp after acquiring ABC Corp, then ABC Corp may be able to successfully fend off 123 Corp's offer.

- **Resource Video:** <http://thebusinessprofessor.com/hostile-takeover-defenses-white-knight-and-pac-man/>

The above list is not exhaustive, but it provides larger categories for types of defenses employed by boards of directors to thwart takeovers. In some cases, these takeover attempts are directed against existing shareholders or managers that seek to gain control of the corporation. A management takeover is generally carried out as a 'leveraged buy-out'. A leveraged buyout is when managers use a combination of debt and private investment capital to purchase a controlling interest of the corporation. Generally, debt used to purchase the corporate shares is secured by assets of the corporation.

- **Discussion:** How do you feel about the ability of third parties to undertake a hostile takeover? Do you believe that hostile takeovers are a benefit or detriment to existing shareholders? Should directors be able to fight against the takeover? Why or why not?
- **Practice Question:** If Karl wants to acquire a controlling interest in ABC Corp and the board rejects his tender offer, what are his options for undertaking a hostile takeover? If the corporate directors seek to defend against Karl's takeover efforts, what are their options?

37. How does the alignment of benefits and interests cause corporate governance issues?

Officers, directors, and shareholders often have competing interests as stakeholders of the corporation. Examples of such conflicts are as follows:

- *Officer-Directors* - The board of directors is charged with hiring the chief executive officer (and potentially other executives). An inherent conflict exists when the CEO is also a director of the corporation. This conflict is especially evident when the CEO is chairman of the board or a large shareholder. The responsibilities and interests inherent in each of these roles often times conflict.
 - *Example:* Mark is CEO and a director of ABC Corp. He receives several million dollars per year in compensation for his role as CEO. When the corporation receives an offer from a hostile takeover, he opposes the sale of the corporation because he will lose his job. Even though he is charged as director

with representing the best interests of shareholders, he votes his personal interest in opposing the merger.

- *Officer-Director Compensation* - The board of directors is charged with hiring and approving the compensation of officers. Further, members of the board set the compensation of other board members. Compensation for these individuals is generally a mixture of money and stock (or stock options). Executives commonly receive bonuses based upon short-term corporate performance. Incentivizing officers and directors in this fashion often creates incentives toward short-term profits, rather than long-term performance. Further, in the current corporate structure, the selection of a CEO is often influenced by the controlling shareholder(s). In turn, the CEO often influences the selection of director candidates. This reality is much of what SOX and Dodd-Frank seeks to remedy.
 - *Example:* Dillon is CEO and director of a corporation. He is on the nomination committee, which proposes the names of directors for election to the board. Directors receive extensive benefits and membership on the board is highly desirable. He makes it known to all nominees that he supports that he expects to remain as CEO. When it is time to appoint a CEO and select a compensation package, the directors that Dillon nominated support Dillon and propose a very lucrative compensation package.
 - *Improper Relationships* - Officers and directors owe fiduciary duties to the corporation. Particularly, officers and directors owe a duty of loyalty. That is, they cannot usurp corporate opportunities or seek personal gain at the expense of the corporation. Officers and directors are in control of extensive corporate assets and resources. This environment lends itself to the improper receipt of benefits by these individuals.
 - *Examples:* Common examples of improper relationships may include: close personal relationships between officers and directors, personal loans from the corporation to officers or directors, improper use of corporate assets, misallocation of corporate funds, corporate donations to political activities, etc.
- **Discussion:** Do you believe that the alignment of benefits can create conflicts of interest in the corporation? Why or why not? How do you feel about individuals holding multiple stakeholder positions within the corporation? Does this implicate the duty of loyalty? Why or why not?
 - **Practice Question:** Tammy is a major shareholder, chairman (director), and CEO of ABC Corp. Can you provide examples of the types of incentives that may conflict in each of her roles?
 - **Resource Video:** <http://thebusinessprofessor.com/alignment-of-benefits-and-corporate-governance-issues/>

TOPIC 14: SECURITIES LAW

Overview

Securities is a broad term that basically refers to any form of ownership or beneficial interest in a business entity. Securities law concerns the sale or transfer of these business interests. This chapter introduces the security and the catch-all provision for “investment contracts” as securities. It explains the primary statutory and regulatory framework making up the securities law. It introduces the Securities Exchange Commission and its objectives and functions in enforcing the securities laws. It explains the process of selling or transferring securities to the public, known as issuing securities, before moving on to the subsequent sale or exchange of securities in the public market, such as trading securities on public exchanges. Lastly, it reviews the the major laws and forms of civil and criminal liability associated with violation of the securities laws.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• <u>Securities</u> • <u>Security Laws</u> • <u>Investment Contract</u> • <u>Major Federal Securities Laws</u> • <u>Regulatory Goals of Security Laws</u> • <u>Securities and Exchange Commission</u> • <u>Securities Act of 1933</u> • <u>Offer to Sell Securities</u> • <u>Regulated Parties</u> • <u>Initial Public Offering</u> • <u>Direct Public Offering</u> • <u>Disclosure Requirements</u> • <u>Disclosure Process</u> • <u>Disclosure Documents</u> - Registration Statement - Prospectus • <u>Permissible Activity of Issuer</u> - <u>Pre-Filing Period</u> - <u>Post-Filing Waiting Period</u> - Post-Effective Period • <u>Issuer Classifications</u> • <u>Emerging-Growth Companies</u>	• <u>Exempt Securities & Transactions</u> • <u>Restricted Securities</u> • Private Placement Memorandum • Section 3 Exemptions - <u>Section 3a</u> - <u>Section 3b</u> • <u>Rule 147 Safe Harbor</u> • Section 4 Exemptions - <u>Section 4a2</u> - <u>Section 4a5</u> • <u>Regulation A Exemption</u> • <u>Regulation D Exemptions</u> - <u>Rule 504</u> - <u>Rule 505</u> - <u>Rule 506b</u> - <u>Rule 506c</u> • <u>Rules 502d & 144 Safe Harbor</u> • <u>Regulation D - Disclosures</u> • <u>Form D - Filing Requirement</u> • <u>Consequences for Failing to Register</u> • <u>Crowdfunding</u>	• <u>Section 11 Liability</u> • <u>Section 12 Liability</u> • <u>Section 11 & 12 - Defenses</u> • <u>Section 17 Liability</u> • <u>'33 Act - Criminal Liability</u> • <u>Securities Exchange Act of 1934</u> • <u>'34 Act - Registration Requirements</u> • <u>Public Company Disclosures</u> • <u>Section 10(b) & Rule 10(b)(5) Liability</u> • <u>Insider Trading - Rule 10b5</u> • <u>Rule 10b5 - Damages</u> • <u>Section 14 Liability</u> • <u>Section 16 Liability</u> • <u>Section 18 Liability</u> • <u>Securities Enforcement Remedies Act</u> • <u>'34 Act - Criminal Liability</u> • <u>Blue Sky Laws</u> • <u>State-Law Regulation of Issuances</u> • <u>Registration Under State Law</u> • <u>Coordinated Registration Methods</u>
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TOPIC 14: SECURITIES LAW - QUESTIONS & ANSWERS

1. What are “securities laws”?

Securities laws are the federal and state statutes and regulations that control the sale or transfer of rights or ownership interests in a business entity (securities). Specifically, securities laws purport to protect the general public from deceptive practices in the sale or trade of securities. The major securities laws include the Securities Act of 1933 and the Securities Exchange Act of 1934. The primary method of protecting investors prescribed under these acts is thorough disclosure of relevant or material information. As we discuss in this chapter, the requirements for the disclosure of information vary based upon the nature of the sale or transfer of securities.

- **Discussion:** Why do you think the Federal Government seeks to protect the rights of private owners of a business entity? Do you believe that the disclosure of relevant or material information is the best way of achieving this goal? Why or why not?
- **Practice Question:** What are the laws applicable to the sale or trade of securities?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-securities-laws/>

2. What is a “security”?

Most people think of a security as simply stock or other ownership units of a business entity; however, the statutory definition of a security is far more extensive. The term “security” means any,

“note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral trust certificate, pre-organizational certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate or deposit, or group or index securities (including any interest therein or based on the value thereof) or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any interest commonly known as a security.”

The definition of a security is broad, but it leaves open the inclusion of any interest not identified within the definition, but that the court deems to constitute a security. There is a great deal of common law surrounding the judicial interpretation of what constitutes a security. Most notably, the term “investment contract” from the definition of a security is construed very broadly and is somewhat of catch-all for business interests that may constitute a security.

- **Discussion:** Why do you think Congress applied such a broad definition of what constitutes a security? Does the fact that common law goes much further to define a security affect your opinion about the suitability of the statutory definition?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-security/>

3. What qualifies as an “investment contract”?

The broadest category of a business interest constituting a security is an “investment contract”. Courts have developed a number of tests to determine what constitutes an investment contract. The most influential is the “*Howey* test”. The elements for determining whether a business interest constitutes an investment contract (and thereby a security) are as follows:

- an investment of money,
 - *Note:* To invest money means to provide any sort of value to the company in exchange for a beneficial interest in or ownership of the company. The investment does not have to be cash or currency.
 - *Example:* I receive an ownership interest (10% ownership) in your business activity in exchange for my contribution of a pickup truck for use in the business.
- in a common enterprise,
 - *Note:* A common enterprise is any form of concerted business activity. The enterprise does not have to be a registered business entity.
 - *Example:* A common enterprise may include a default entity form, such as a general partnership.
- with the expectation of profits, and
 - *Note:* The expectation of profits is a very broad notion. An individual can invest in the enterprise with the purpose of directly or indirectly deriving profits. This may include the objective of taking advantage of any tax benefits associated with the investment.
 - *Example:* I invest in ABC, LLC. The LLC will have losses this year and for the next couple of years. I am not actively involved in the business. As such, I will be able to offset the passive losses against the active profits I have in a separate investment. This will reduce my tax liability. Eventually, I expect ABC, LLC to produce a profit.
- derived solely from the efforts of others.
 - *Note:* Derived solely from the efforts of others means that the investor does not actively take part in the business activity. She may be able to offer limited guidance to the business managers, but she does not take part in the active affairs of the business. This provision seems to eliminate investments in games of chance that do not involve a business activity or a concerted activity with someone else.
 - *Example:* I am interested in providing money to Alice’s design services business. I may offer some guidance to Alice in how to run the business, but I do not take part in any of Alice’s business operations. It is Alice’s efforts and not my personal activity that constitute the business (such as in a sole proprietorship or general partnership).

Each element of this test requires considerable analysis. Courts have interpreted each element to add a great deal of

specificity and complexity to the individual factors.

- **Discussion:** Why do you think the definition of an investment contract has been interpreted so broadly? What would be the potential effect of a narrow interpretation?
- **Practice Question:** Ralph is an avid gambler. He loves to wager money on any type of sporting event or game of chance. He puts his money in a pool to purchase lottery tickets under the understanding that everyone will split any winnings. Is this an investment contract? Why or why not? Does it change your analysis if Ralph and the other investors depend upon Carter to manage the funds, purchase and hold the tickets, collect any winnings, and distribute those funds to any investors? Why?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-an-investment-contract-under-securities-law/>

4. What are the primary security laws?

Securities are subject to federal and state regulation. State securities laws are known as “Blue Sky laws” and are discussed at the end of this chapter. The two primary federal laws governing the trade or sale of securities are the Securities Act of 1933 ('33 Act) and the Securities Exchange Act of 1934 ('34 Act).

- **'33 Act** - The '33 Act provides the rules for the initial sale of securities to the public. This includes detailed rules for the personal disclosure to prospective purchasers and disclosure of information to the general public through registration with the Federal Government.
- **'34 Act** - The '34 Act concerns the on-going disclosure requirements once company securities are traded publicly, such as on national exchanges. These laws provide for the substantive content of the disclosure, the procedural disclosure requirements, and the repercussions (such as civil and criminal penalties) for failing to adhere to these laws.

Both the '33 and '34 Acts are administered by the Securities Exchange Commission. Along with the regulations promulgated by the SEC, they govern the sale or exchange of securities in any context.

- **Discussion:** Why do you think the securities laws treats the initial sale of securities to the public separately from the subsequent sale of issued securities on public markets? How are these types of securities different?
- **Practice Question:** What type of activity is regulated by the Securities Act of 1933? The Securities Exchange Act of 1934?
- **Resource Video:** <http://thebusinessprofessor.com/major-federal-securities-laws/>

5. What are the regulatory goals of security laws?

The regulatory goals or purpose of the securities laws include:

- preventing manipulation of the securities market;
- full disclosure of “material information” to stakeholders;
- preventing fraud; and
- leveling the playing field between insiders of a company and investors.

Each of these regulatory goals are not independent. Fairness and the prevention of deceit underline each objective.

- **Discussion:** How do you feel about these securities law objectives? Are there any additional objectives that should be achieved under the securities laws?
- **Resource Video:** <http://thebusinessprofessor.com/regulatory-goals-of-the-security-laws/>

6. What is the “Securities and Exchange Commission” (SEC)?

The Securities and Exchange Commission (SEC) is a semi-independent, administrative agency created in 1934 (as part of the '34 Act) to regulate the sale or exchange of securities. The commissioners are appointed by the President under the advisement of Congress. The SEC is divided into five main divisions regulating: Corporation Finance, Trading and Markets, Investment Management, Enforcement, and Economic and Risk Analysis. The SEC has quasi-legislative and quasi-executive powers. The SEC develops the regulations to carry out the statutory laws passed by Congress. It has the ability to issue cease and desist orders, issue fines, and bring civil actions against issuers of securities who violate the law.

- **Note:** Criminal actions for violation of securities laws are referred to the US Attorney’s Office for prosecution.
- **Discussion:** Why do you think securities law requires a dedicated administrative agency? How do you feel about an independent agency making securities regulations with the force and effect of law?
- **Practice Question:** What is the role of the Securities and Exchange Commission in the regulation of securities?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-securities-and-exchange-commission/>

BUSINESS FINANCING AND PUBLIC OFFERINGS

7. What is an “initial public offering”?

An initial public offering is the process by which a company first sells an equity interest in the company to the public at large. The primary purpose of the IPO is to generate operating capital for the company. Equity shares in a company constitute securities, so the IPO process is subject to securities law and is closely scrutinized by the SEC. The IPO process is complicated and generally involves a number of professional service providers. The process for an IPO is substantially as follows:

- *Underwriting* - “Underwriting” involves hiring an investment bank (or group of investment banks) to market and sell company securities. In some instances, smaller companies will make an offering directly to individual customers through a licensed broker. This process is known as a “direct public offering” and is often associated with low-value securities, commonly referred to as “penny stocks”. For larger companies, investment banks stand in a unique position to be able to create awareness of the issuance and sell the securities to large, institutional investors. This process is commonly known as a “road show”. In some instances the bank will purchase shares from the company and then resell them to investors in pre-arranged transactions on the open market. In this situation the bank is making a “firm commitment” as underwriter. The bank will often keep a percentage of the shares for itself as compensation for the underwriting process. In other arrangements, an underwriter may simply act as a sales agent for the issuer. The bank may guarantee a limited number of sales, but generally it does not guarantee any specific number. This is known as a “best efforts commitment”. The bank earns a commission on the number of shares sold. The underwriter assists the issuer in determining the price and number of shares to issue.
 - *Note:* The underwriter has the ability to garner interest in the securities, but no sale of securities can take place at this point. The issuer can only sell to the underwriter or to prospective purchasers identified by the underwriter once the registration process is complete.
 - *Example:* ABC Corp intends to undergo an IPO and needs assistance with arranging for the sale of its shares to the public. JP Morgan Bank contracts with ABC Corp to handle the IPO. JP Morgan will advise ABC Corp on the number and value of shares to issue. It will then seek to sell (seek commitments for the purchase of) these shares to institutional investors. JP Morgan makes a firm commitment, so it is obligated to purchase a predetermined number of shares, which it will sell to the institutional investors for a price above what it pays ABC Corp.
- *Registration* - Registration is the process of filing extensive disclosures with the SEC about the companies finances and operations and characteristics of the issuance of securities. The filings with the SEC are made public and provide information to potential investors in the market. The SEC will review the disclosures for completeness, but it does not evaluate the quality of the securities being issued. The approval of the SEC is based upon whether sufficient information is disclosed to allow a potential investor to make an informed decision. Often this is a back-and-forth process until the SEC is satisfied that all necessary information has been disclosed.
 - *Note:* Disclosure to the SEC is a very complicated process. Though expensive, businesses generally hire experienced legal firms to help with the disclosure process. Private sale of securities (discussed below) may be exempt from the registration process.
- *Solicitation of Purchasers* - After the registration process is complete, the issuer will solicit prospective purchasers and consummate the sale of securities. At this point, the investment bank will proceed with the road show and begin contacting potential purchasers. As part of this process, the issuer or underwriter must provide all offerees or prospective purchasers with a disclosure document, known as a “prospectus”. The prospectus contains much of the same information contained in the registration statement but provides a more concise presentation of material information.

The extensive registration requirements associated with an IPO can be very burdensome and expensive to the company. As such, many companies seeking to raise capital avoid the IPO process and seek equity financing from private investors. This process is known as a “private offering” and is discussed further below.

- **Discussion:** How do you feel about the extensive registration requirements and sale restrictions on securities? Are these regulations a benefit or detriment to businesses? Society? Why or why not?
- **Practice Question:** Ernest is interested in offering shares of his company, ABC Corp, for sale to the public. He believes that this will bring in the capital necessary to continue growth. Outline the securities law process that ABC Corp will need to undergo prior to selling to the public.
- **Resource Video:** <http://thebusinessprofessor.com/what-is-an-initial-public-offering/>

8. What is a “direct public offering”?

A direct public offering is the process by which a company offers its shares for sale directly to the public without employing the services of an underwriter. The underwriter has the ability to reach out to large institutional investors and guarantee the sale of a certain quantity of securities. In a direct public offering, the company will generally enlist the services of a broker to make certain the offering is carried out in accordance with the securities laws. The requirement to register securities still applies; however, the company may be able to employ an exemption from registration (discussed below). Once registration (or an exemption therefrom) is complete, the company will advertise the offering and begin selling to individuals, investment firms, etc. The direct public offering has become popular for companies seeking to crowdfund its growth. Numerous websites and services now exist to meet this demand.

- **Note:** The direct public offering is generally employed by smaller firms who cannot attract an investment bank to underwrite the public offering. It is far cheaper than an IPO, particularly if the company is able to employ an exemption from the securities registration process.

- **Discussion:** Why do you think larger companies generally go through the IPO process, rather than undertaking a direct public offering? Can you see any advantages to the IPO over the DPO or vice versa?
- **Practice Question:** How does the process of a direct public offering differ from that of an initial public offering? What are the advantages of the DPO process?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-direct-public-offering/>

THE SECURITIES ACT OF 1933

The '33 Act is a federal disclosure law covering the initial sale of securities to the public. Specifically, the '33 Act makes it illegal to use the mail or any other means of interstate communication or transportation to sell securities without disclosing certain financial information to potential investors. Most notably, the issuer must register the issuance of securities with the SEC, unless the issuer is able to conduct the issuance pursuant to a registration exemption. Regardless, the '33 Act covers all initial offers to sell securities and places detailed disclosure requirements on those issuing securities (issuers). These disclosures allow potential investors to make informed decisions about purchasing the issued securities.

- **Note:** Failure to comply with the '33 Act may lead to civil and criminal penalties. Often, however, violations of the '33 Act may lead to court ordered relief such as injunctions against the violator or equitable remedies for those

negatively affected by the issuance.

- **Resource Video:** <http://thebusinessprofessor.com/securities-act-of-1933/>

9. What is an “offer” to sell securities?

The '33 Act specifically regulates any offer to sell securities. The term “offer” is defined very broadly under the '33 Act as any attempt to solicit interest in buying shares. The definition of an offer to sell securities goes far beyond actually attempting to sell securities. As such, securities law regulates a much wider range of conduct than many people anticipate.

- **Note:** Even if the communicator includes disclaimers or provisions stating that the information is not an offer and that the recipient cannot purchase securities at this time, the communication may still be considered an offer.
- **Example:** Under this definition, direct mail or advertisement of any sort would constitute an offer. Posting information about a securities offering on a website would be considered a solicitation of offers. Further, any communication that discloses information about the decision to sell securities, depending upon the context, may be considered an offer.

- **Discussion:** Why do you think an offer to sell securities is defined so broadly? Do you think it is appropriate or overly broad? Why?
- **Practice Question:** ABC Corp is considering raising money for operations by selling bonds to the public. ABC Corp wants to gauge public interest, and posts an announcement on a popular investment website stating the ABC Corp will be selling bonds at the end of the year. Does this activity implicate the securities laws?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-an-offer-to-sell-securities/>

10. Who are the parties regulated in an offer to sell securities?

The '33 Act regulates offers to sell securities by a number of individuals, including the issuer, underwriter, controlling party, or sales representative. The “issuer” is the individual or business organization offering a security for sale to the public. “Underwriters” are individuals participating in the original distribution of securities by selling such securities for the issue or by guaranteeing their sale. A “controlling party” is one who controls or is controlled by the issuer, such as a major stockholder of a corporation. A “sales representative” is anyone who contracts with a purchaser or who is a motivating influence that causes the purchase transaction to occur.

- **Discussion:** Why do you think that the securities laws regulate the conduct of such a wide variety of sellers or securities? How does regulating the conduct of these individuals align with the objectives of the securities laws?
- **Resource Video:** <http://thebusinessprofessor.com/who-is-regulated-in-a-securities-issuance/>

11. What are the primary disclosure documents required in a offer to sell securities?

The '33 Act requires that an issuer of securities register with the SEC by filing a registration statement prior to any offer or sale of securities. Further, the issuer (or individual offering to sell securities) must provide a detailed disclosure document, known as a “prospectus”, to any potential investor prior to consummating a sale.

- *Registration Statement* - Generally, it is illegal to sell securities to the public unless those securities are registered or there is an exemption from registration. The registration statement is the primary document that the entrepreneur must file with the SEC before undertaking a securities offering. The registration statement provides extremely detailed information about the business and the intended equity offering. The SEC reviews this information and makes it available to the public. Potential investors considering investing in the venture will use this information to make an informed decision. The investor can feel confident in the veracity of the information.
 - *Note:* There are several versions of the registration statement – the applicability of each depends upon the character and status of the business. The most common and recognized registration statement is the S-1, which applies to larger corporate entity forms that intend to offer securities to the public at large. The form S-1 contains instructions and references to dozens, if not hundreds, of applicable regulations that provide detailed information that must be included in the statement. While the actual requirements for registration are sufficient to fill a textbook, we simply make reference to them in order to illustrate the extensive requirements associated with registering the sale of a covered security.
- *Prospectus* - Due to the volume of the disclosure included in the statement, it is somewhat difficult for a perspective investor to use the registration statement effectively to glean information about a particular investment opportunity. As such, the SEC requires that an issuer also prepare a “prospectus”, which is summary document containing fundamental information about the issuer, the security issuance, and the terms that apply. It provides the investor with sufficient facts (including financial information) to allow her to make an informed investment decision. At a bare minimum, it includes balance sheets and statements of operation by the investor. The issuer must provide this document to prospective investors prior to selling a security or accepting any investor funds. Like the registration statement, the information contained in the prospectus is subject to review and approval by the SEC.
 - *Note:* The prospectus delivery requirements generally do not apply to persons other than issuers (and their affiliates), underwriters or dealers. An individual purchaser of a security is generally exempt from providing this document in sales to a subsequent purchaser.

- **Discussion:** Why do you think the SEC requires both an issuer to file a registration statement and prospectus prior to offering securities for sale? Why do you think the SEC requires the issuer to provide the prospectus to perspective purchasers of securities? Do you think this method of disclosure is effective? Why or why not?
- **Practice Question:** What are the disclosure documents required under the Securities Act of 1933 and how are they used?
- **Resource Video:** <http://thebusinessprofessor.com/disclosure-documents-in-a-securities-issuance/>

12. What is an issuer allowed to do during each stage of the registration process?

A company offering its shares for sales to public for the first time (an initial public offerings) must register with the SEC or perfect an exemption from registration. If the company must register, the ability to advertise or offer to sell securities to the public follows a process that is linked to the filing of the registration statement. Generally, companies must follow the following framework and timeline:

- *Pre-filing Period* - This refers to the period leading up to making the regulatory filings required by the SEC. During this period, the issuer cannot make offers to sell or take offers to buy securities. The issuer may, however, engage underwriters about the planned issuance. The underwriters may make commitments regarding the underwriting process for the securities, but no securities are actually sold during this period.
- *Waiting Period* - This period refers to the post-SEC filing period during which an issuer can undertake limited efforts to market or sell the securities. The waiting period generally lasts for 20 days following the filing, if not extended. During this period, the SEC is charged with evaluating the registration statement and investigating the information contained therein. The SEC is looking for disclosures that may be incomplete or confusing to investors. The issuer may use this period to solicit offers to purchase securities, but no sales can take place until the registration is complete. The issuer will generally put out advertisements, known as “tombstone ads”, to garner interest in the offering. The ads generally identify the securities being offered, the broker, provide access to prospectus information, and state an offer price.
 - *Note:* Nearly all registrations filings extend beyond the standard 20-day period. This gives the SEC more time to evaluate the issuance. Companies are rightfully woeful to proceed with the sale of securities if the SEC has not properly evaluated the offering disclosures. Issuing securities with noncompliant disclosures can subject the company to civil and criminal liability.
- *Post-Effective Period* - This is the period following registration. At this point, the registration and plan for issuing securities is officially approved. Unless the SEC gives notice that the registration and plan is defective, the approval is automatic. The issuer is now free to sell securities.

As stated above, the ability of an issuer to undertake activity in promoting, offering, or selling securities varies somewhat based upon the status of the issuer.

- **Discussion:** Why do you think the securities laws prohibit the offer to sell securities to varying degrees based upon the stage of filing of the registration statement? Should there be any restrictions that remain in place following the post-effective date?
- **Practice Question:** ABC Corp is in the process of registering with the SEC to sell company shares to the public. Rachel, a large investor, approaches ABC Corp immediately following the filing of the registration statement. Rachel wants to get ahead of other investors and purchase a large quantity of shares. What are ABC Corp’s options and limitations in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/limitations-during-securities-issuance-process/>

13. How are issuers of securities classified for purposes of the registration and offering process?

The rules applicable to an issuing company during the above time periods depend upon the issuer's classification. The classifications are as follows:

- *Non-reporting Issuer* - This refers to a company that is not subject to any SEC reporting requirements at the time of the issuance. This includes non-public companies below a certain capitalization (\$75 million).
 - *Note:* Most companies seek to maintain a non-reporting status as long as possible. Many companies will maintain their private status until they reach this reporting threshold. Once the threshold is reached, the company is required to undertake the extensive reporting similar to that of a public company. At this point, the companies often decide to become public companies to open this funding channel.
- *Unseasoned Issuer* - This is a company subject to SEC public reporting requirements, but it has either not been subject to the reporting requirements for 12 consecutive months or does not meet the \$75 million public float requirement.
- *Seasoned Issuer* - A seasoned issuer is a reporting company that has greater than \$75 million in public float, but less than \$700 million and at least one year of timely reporting.
- *Well-Known Seasoned Issuer (WKSI)* – This is an issuer with worldwide stock float of \$700M or outstanding debt of \$1billion that has been issued within the past 3 years.

Each classification relates to the capitalization of the company or status as a company compelled to report to the SEC. The purpose behind classifying companies in this manner regards the ability of the company to offer for sale or solicit offers to purchase securities during the pre-filing and waiting periods.

- **Discussion:** How do you feel about classifying companies and providing different rights to offer for sale or solicit purchasers of securities based upon the capitalization and reporting history of the company? Should there be other considerations that affect the extent of regulation? Why or why not?
- **Practice Question:** What are the different classifications of issuers of securities?
- **Resource Video:** <http://thebusinessprofessor.com/classification-of-issuance-of-securities/>

14. What is an issuer allowed to do during the “Pre-Filing Period” (and the exceptions)?

During the pre-filing period, no offers to sell or offers to buy securities are permitted. There is a limited exception to this rule under SEC Rule 135, which allows for the announcement of an upcoming offer. The issuer can have discussions with underwriters or with an underwriting syndicate. This allows the company to undertake the procedural arrangements and financing of the offering. In any event, the communications or announcement of the upcoming offer cannot have the purpose or effect of “conditioning of the market”. That is, it cannot cause a market reaction for the pending IPO that is commensurate with the effect of an actual offering. This is a poorly defined standard, which does not provide a great deal of guidance to issuers. There are some other notable exceptions to the general prohibition against offers to sell during the

pre-filing period that are worthy of note.

- *Emerging Market Company Exception* - The JOBS act makes an exception and eliminates the “conditioning the market” restriction for “emerging market companies”. So, if a company meets the criteria to be an emerging market company, the announcement of the upcoming issuance faces few limitations aside from waiting to consummate the sale until the post-effective period.
- *Section 5(b) Exception* - This provision allows oral or written communication with qualified institutional buyers (QIBs) and accredited investors that are institutions, prior to filing of the registration statement. This is a limited exception that allows issuers with connections with potential purchasers who have the knowledge and sophistication that warrants a lower level of protection under the securities laws.
- *Public Company Exception* - Public filers can (must) continue their periodic disclosure (quarterly and annual reports) and Rule 168 permits forward-looking information. This means that a public company that is planning to issue more securities on the market must disclose this intended action to the market and existing shareholders. The prohibition against conditioning the market is trumped by the need for full disclosure.
- *Free-Writing Prospectus Exception* - Under Rule 163, WKSIs can use a “free-writing prospectus” during the pre-filing period, so long as it is filed with SEC prior to distribution. Per Rule 405, a free-writing prospectus is a written communication (including electronic/graphic) that constitutes an “offer to sell” that does not fall under a statutorily defined format (such as preliminary prospectus defined in section 10(b) or Rule 430 “red herring” prospectus).

There are other limited exceptions to the ability to make offers of securities at the pre-filing stage; however, these are the most commonly recognized.

- **Discussion:** What do you think is the reason for restricting the sale of securities prior to filing a registration statement? Do you think that requiring the filing of a registration statement achieves the underlying objectives? Why or why not? Why do you think the securities law allows for these exceptions?
- **Practice Question:** What are the limitations on an issuer of securities prior to filing a registration statement? What are the primary exemptions from these limitations?
- **Resource Video:** <http://thebusinessprofessor.com/securities-issuance-prefiling-period/>

15. What are the limitations on an issuer during the “Post-Filing Waiting Period”?

During the post-registration, waiting period, special rules apply to the general dissemination of information about the issuance. Generally, oral discussions or offers to buy the securities are unregulated. This allows investment banks to carry on a “road show”, which is a concerted effort by the bank to build a book of subscribers for the security issuance. Written offers to sell (or other solicitations) must be accompanied by a prospectus that meets statutory standards for disclosure. Anyone submitting a written request to purchase must receive a prospectus that has been reviewed and approved by the SEC. No actual sales can occur until the registration statement “goes effective” for any issuer.

- *Note:* One notable exception under Rules 164 and 433, seasoned issuers and WSKI can use a free-writing

prospectus, so long as it contains information on where to get the statutory prospectus. Unseasoned issuers and non-reporting issuers (IPO filers) can use free writing so long as accompanied by statutorily approved prospectus.

- **Discussion:** Why do you think the securities laws closely regulate written disseminations of information during the post-filing period? Why do you think these are treated differently than oral communications? Should there be a free-writing prospectus exception for certain issuers? Why or why not?
- **Practice Question:** ABC Corp is a well-known, seasoned issuer. It has made the registration statement with the SEC and is awaiting approval. Jamie is an investor and approaches ABC Corp (through its representative) with a written request to purchase a large block of shares. If ABC Corp chooses to respond to Jamie's inquiry with any information about the issuance, what are its obligations and limitations?
- **Resource Video:** <http://thebusinessprofessor.com/securities-issuance-post-filing-waiting-period/>

16. What is an issuer allowed to do during the “Post-Effective Period”?

During the Post-Effective Period, the issuer can begin selling securities. The issuer must still deliver a statutorily prescribed prospectus to offerees. Additional rules benefiting WKSIs exist during this stage that allow for an automatic “shelf registration”. Shelf registration is the pre-registration of securities that will not be issued until a later date. This can be useful when the business plans for multiple stages of funding over a period of time.

- **Discussion:** Why do you think the securities laws are less restrictive on communications by issuers following the post-effective period? Should there be any continued regulation (beyond the requirement to provide purchasers with a prospectus) following the post-effective date?

17. What is an “Emerging Growth Company” and why is it important?

An emerging growth company (EGC) is any company that meets the following requirements:

- the company has less than \$1 billion or more of total gross revenue in a consecutive 12-month period;
- is within 5 years of its original IPO;
- the company cannot have issued more than \$1 billion in non-convertible bonds within the last 3 years, and
- the company does not qualify as a “large accelerated filer”, meaning a public float of over \$700 million.

Status as an emerging growth company provides a number of benefits to the company with regard to security laws and regulation.

- **Confidentiality** - An EGC may make confidential submission to SEC of a preliminary prospectus prior to the public filing with SEC. This gives the SEC an opportunity to review the prospectus and maintains confidentiality

about the securities issuance.

- *Note:* Eventually this draft and all amendments must be filed public with the SEC at least 21 days prior to underwriters commencing a road show.
- *Unregulated Communications* - An EGC may have unregulated oral or written communications with qualified institutional buyers and accredited investors. This effectively allows the EGC to “test the waters” before the preliminary prospectus is filed with SEC.
 - *Note:* This is a big difference from non-EGC companies that must file the preliminary prospectus with the SEC before discussions/selling efforts could begin.
- *Audited Financial Statements* - The EGC must produce 2 years of audited financial statements with the registration statement.
 - *Note:* Non-EGC companies are required to submit 3 years of audited statements.
- *Security Analyst Reports* - Securities analysts will be permitted to freely publish research reports about companies about to issue securities.
 - *Note:* Securities analysts generally do not have access to information from non-public company. Disclosing this information to the public could be seen as conditioning the market for the issuance, which is prohibited for non-EGC companies. This benefit is so broad as to allow companies participating in underwriting process to publish an analyst report.
- *Accounting Standards* - Exemption from new or revised accounting standards.
 - *Note:* This can reduce the cost of updating disclosures of financial documents based upon new or revised accounting procedures.
- *Auditor Exemptions* - The EGC is exempt from compliance with PCAOB rules requiring mandatory rotation of external firms auditing the company. Further, the company executives are not required to produce an auditor attestation of internal controls under section 404(b) of SOX of 2002.
 - *Note:* Smaller companies generally do not have the funds or resources to rotate auditing firms or verify compliance with SOX.
- *Executive Compensation Rights* - EGC companies are exempt from many requirements to disclose executive compensation. Also, EGC companies are exempt from “say-on-pay” vote requirements placed on non-EGC companies by securities laws. Say-on-pay rights allow shareholders to vote to approve the compensation of executives of the business.

Given the benefits associated with EGC status, companies are apt to monitor their growth and plan for the effects of losing EGC status.

- **Discussion:** Why do you think Congress established the category of Emerging Growth Company and provided the above-referenced benefits? Can you think of any other factors that should be considered in categorizing a company as an EGC? Which of the state exemptions do you see as the greatest benefit to EGCs?
- **Practice Question:** What are the requirements to qualify as an emerging growth company? What advantages does this designation provide to the company?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-an-emerging-growth-company/>

18. What type of information must an issuer disclose?

Securities laws intend to protect individuals from financial loss due to a lack of understanding of the risk associated with an investment or intentional fraudulent activity by an issuer. As such, the SEC requires that anyone offering to sell securities disclose certain “material” information about the venture to prospective purchasers. The disclosure requirements vary with the type of investor and the amount and context of the security offering. Courts have held that “there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”

- *Note:* The “total mix” is inherently fact specific. It also raises questions about who is the reasonable investor.
- **Discussion:** Why do you think the law focuses on the disclosure of only material information? How do you feel about the subjective determination of what information is material?
- **Practice Question:** What standard will a court apply in determining whether an issuer of securities has complied with its duty of disclosure?
- **Resource Video:** <http://thebusinessprofessor.com/types-of-information-disclosed-in-securities-issuance/>

19. What laws govern the mechanics of disclosure of information in a securities offering?

Regulation S-K is an SEC promulgated regulation that applies to new issuances under the '33 Act and subsequent sale or transfer of securities under the '34 Act. This regulates the specific types of information that an issuer must disclose to the public. The primary disclosure statement in an IPO is the registration statement (Forms S-1 and S-3 for Securities Act (33 Act)). Publicly-traded companies are subject to Schedule 14A (requiring disclosure of proxy statements). Public companies are also subject to continued reporting by filing form 10-K, 10-Q, 8-K for '34 Act.

- *Note:* The disclosure requirements are often extensive and difficult for companies to manage.
- **Discussion:** Do you think that the extensive disclosure measures have the intended effect of protecting investors? How do you think these disclosures should be balanced against the possibility of deterring companies from going public?
- **Resource Video:** <http://thebusinessprofessor.com/rules-governing-disclosure-during-registration-process/>

EXEMPTIONS FROM '33 ACT REGISTRATION REQUIREMENT

The registration and public offering process is extremely burdensome for startup companies. Numerous statutory and rule-based exemptions to the securities registration process exist. The statutory exemptions fall under Sections 3 and 4 of the '33 Act. The rule-based exemptions are based upon statutory exemptions and are found primarily in “Regulation A” and “Regulation D” of the '33 Act. These statutory and rule-based exemptions either exempt this type of security from registration or exempt a particular type of transaction from registration.

20. What are “exempt securities” and “exempt transactions”?

Certain types of securities and certain transactions are deemed by the SEC to be exempt from registration requirements.

- *Exempt Security* - Common types of exempt securities are government securities, bank securities, high-quality debt instruments, non-profit securities, and insurance contracts. Most important for private, for-profit companies is the broad exemption under Section 4 of the '33 Act of “transactions by an issuer not involving any public offering.” This is known as a “private offering”. A private offering is generally for a lesser amount of money that is invested by a small number or closely-related investors.
 - *Note:* The exempt type of security never has to be registered, even if it is resold following the issuance.
- *Exempt Transaction* - An exempt transaction is a transaction that does not warrant full-blown registration. Exempt transactions generally involve either a limited amount of capital or sophisticated or accredited investors.
 - *Note:* A security sold in an exempt transaction may have to be registered to avoid violating the '33 Act if resold within a short period of time.

- **Discussion:** Why do you think the securities laws exempt certain securities from regulations and certain types of transactions for regulation? How is your reasoning influenced by the underlying goals of the securities regulations?
- **Practice Question:** What is an exempt transaction and an exempt security and why does this designation matter?
- **Resource Video:** <http://thebusinessprofessor.com/exempt-securities-and-exempt-transactions/>

21. What are “restricted securities”?

Restricted securities, as the name implies, are subject to restrictions on when they can be sold or transferred following their issuance. Rule 144 of the '33 Act lays out the rules for restricted securities.

- *Holder Restrictions* - Restricted securities in public companies are those held by officers, directors, or major shareholders (10% of total shares). These individuals cannot sell a number of shares greater than 1) the average weekly trading volume for the shares during the prior 4 weeks of trading, or 2) a quantity equal to 1% of total

shares outstanding.

- *Transactional Restrictions* - Securities issued pursuant to a transactional exemption are also restricted from immediate resale. Regulation D exemptions prohibit resale for 12 months following the date of the issuance. This is to make certain that an exemption is not used as a straw transaction to transfer shares to individuals who could not otherwise be investors under the applicable exemption.
- **Discussion:** Why do you think the securities laws restrict the ability of certain insiders from selling a specific quantity of their shares? Is this fair to those shareholders? Why or why not? Why do you think the securities laws limit the transfer of shares issued in an exempted transaction?
 - **Practice Question:** Robert is a large shareholder and COO of ABC Corp, a publicly traded corporation. He acquired many of his shares when he joined ABC Corp, immediately prior to the company going public. He received the shares in an exempted transaction that did not require registration of the securities. He now believes that ABC Corp has plateaued in its share price and he wants to sell a large quantity of his shares on the open market. What limitations might Robert face in selling the shares?
 - **Resource Video:** <http://thebusinessprofessor.com/what-are-restricted-securities/>

22. What is a “Section 3 exemption” from registration under the '33 Act?

Section 3(a) Exemption - Section 3(a)(11) is an “intrastate offering exemption” designed to allow businesses to seek local funding. The issuer may offer securities for sale to residents of the state in which the business primarily does business without registering the issuance or securities with the SEC.

- *Note:* Issuers of securities pursuant to the section 3(a)(11) statutory exemption must be careful that no offer is made to prospective out-of-state purchasers. Even one offer to a non-resident will destroy the exemption. Issuers can use the legal fiction of publishing information likely to go only to intrastate residents with a legend, “this is an offer only to in-state residents” to try to protect themselves.
- *Exempt Security* - Section 3(a)(11) offers an exemption for a class of securities, rather than an exemption for the particular issuance or transaction. The securities can be freely resold without worrying about registration.
- *Benefits of Section 3 Exemptions* - The exemption is attractive to issuers because it allows for:
 - an unlimited number of investors,
 - an unlimited amount of raised capital, and
 - general solicitation of investors may be allowed under the applicable state law.
- *Coming to Rest* - Purchasers cannot immediately resell the security, as that resale may involve out-of-state purchasers. If the securities have not “come to rest” then resale out of state destroys the exemption for the entire offering.

- *Note:* The issuer must encourage purchasers to avoid immediate resale in order to avoid the appearance of a sham attempt to achieve a non-intrastate offering.
- *Integration Doctrine* - The “integration doctrine” applies to Section 3 issuances. This doctrine states that any offering of securities by the issuer within the last 12 months may be integrated into the current offering. Even if the other offerings were under another exemption, they may be “integrated” into a single transaction. If the issuances are integrated, it is possible that the prior offering will cause the loss of the registration exemption for the present and former transactions.
 - *Note:* The result of a failed exemption is that any purchasers in either offering may seek to rescind the transaction.
- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-section-3a-securities-registration-exemption/>

Section 3(b) Exemption

- *Section 3(b)(1) Exemption* - Section 3(b)(1) of the '33 Act is an exemption from registration of securities. It gives the SEC authority to define the types of exempt transactions where the value of securities issued does not exceed \$5 million (“small issues” exemption).
 - *Note:* This statutory authority is the basis for an exemption under Rule 504 of Regulation D (discussed below).
- *Section 3(b)(2) Exemption* - Section 3(b)(2) allows the SEC to define a new “small issuance” class with a limit on the amount of funds raised of \$50 million. These are unrestricted securities, which can be traded freely.
 - *Note:* This statutory authority is the basis for an exemption under Regulation A+ (discussed below).
- **Discussion:** Why do you think the securities laws allow an exemption from registration of securities sold strictly to residents of the state in which the issuer primarily does business? Why do you think the law exempted the security, rather than the transaction? Do the benefits of an intrastate offering make it compelling for issuers despite the geographical limitations?
- **Practice Question:** ABC Corp decides to sell shares to instate investors to raise \$2.5 million in operating capital. ABC works diligently to make certain to offer the securities to only instate residents. What are the benefits of an intrastate offering? What is the risk to ABC Corp of purchasers immediately reselling the issued securities? This is ABC Corp’s third issuance of securities pursuant to an exemption? What information do you need to know to determine if the current issuance will cause a problem for ABC Corp?
- **Resource Video:** <http://thebusinessprofessor.com/securities-registration-exemption-section-3b/>

23. What is “Rule 147” and how does it relate to a Section 3 exemption?

Rule 147 of the '33 Act is a safe harbor for section 3(a)(11). It lays out the strict requirements that the issuer must meet to remain within the confines of the statutory exemption. To qualify for the intrastate offering exemption under SEC Rule 147:

- the issuer (company) must be incorporated in the state where the offering is made;
- at least 80% of the issuer's revenues must come from business within that state;
- at least 80% of the issuer's assets must be located in that state; and
- at least 80% of the proceeds of the offering must be used in that state.

As the name of the exemption implies, the issuer and all purchasers of the security must be primary residents of the state in which the securities are sold. As previously stated, a single offer or sale to an out-of-state individual destroys the exemption. Under the broad definition of an offer under the '33 Act, any inadvertent contact with an out-of-state investor regarding the intended offering could be considered an offer to sell the securities. Lastly, a purchaser cannot resell the security to an out-of-state purchaser within 9 months of the issuance.

- *Note:* Ultimately, the issuer bears the burden of verifying the residency of each offeree or potential investor.

- **Discussion:** Why do you think the securities regulations allow for a rule-based exemption (regulation) that is a safeguard against violating the section 3(a)(11) statutory exemption? Do you agree that a purchase who meets the above-referenced characteristics should be considered an in-state purchaser? Why or why not?
- **Practice Question:** ABC Corp plans on an instate issuance of securities. They are worried about violating the section 3(a)(11) statutory exemption and losing the exemption. What options are available to ABC Corps to make certain they do not violate the statutory exemption?
- **Resource Video:** <http://thebusinessprofessor.com/rule-147-and-section-3-exemption/>

24. What is a “Section 4” exemption from registration under the '33 Act?

Section 4 provides for two statutory exemptions from registration of securities by an issuer. The exemptions available under Section 4 of the '33 Act provide for transactional exemptions for the securities, rather than a blanket exemption for the security itself.

Private Offering Exemption - Section 4(a)(2) - Section 4(a)(2) provides that, “the provisions of section 5 shall not apply to transactions by an issuer not involving any public offering.” The SEC has deemed certain transactions to constitute “private offerings” and fall outside of the scope of a public offering. That is, the securities are not being sold in a public offering and, therefore, are exempt from the registration and reporting requirements of Section 5.

- *Note:* Rule 506, discussed in a separate lesson, is a “safe harbor” for the Section 4(a)(2) exemption. That is, if you follow the requirements of Rule 506, but fail to perfect the exemption, you may still qualify for an exemption under Section 4(a)(2). The requirements for exemption under Rule 506 are less stringent than those under Section

4(a)(2). For example, Rule 506 allows for purchase by non-sophisticated investors through an agent (purchaser representative). The main advantage of having this safe harbor provision is that, in the event the issuer fails to meet the requirements, it may still attempt to claim the exemption under Section 4(a)(2) or another exemption.

The characteristics of a section 4(a)(2) offering are as follows:

- *Exempt Transactions* - Section 4 provides for a long list of exempt transactions that include:
 - transactions falling under Section 4(2) and Reg. D and Rule 144A;
 - securities issued as compensation – Rule 701;
 - cross-border rights and exchanges for business combinations: Rule 800-802; and
 - foreign issuances: Reg. S (Rules 901-905).
- *Benefits of Section 4(a)(2)* - Section 4(a)(2) allows for the following benefits:
 - there is no geographical limitations on the issuance within the United States,
 - an unlimited number of offerees and investors, and
 - there is no limit upon the amount of money raised in the issuance.
- *Limitations of Section 4(a)(2)* - The following limitations apply to a section 4(a)(2) exemption:
 - *Disclosure* - Prospective purchasers must receive the pre-sale, statutory disclosures in the form of a private placement memorandum.
 - *Sophistication Requirement* - The issuer may offer or sell securities only to investors who are sophisticated and are not in need of the public protections afforded under the SEC's regulations. Courts have interpreted this standard to mean that an investor must have the financial ability to bear the risk of loss in the investment or extensive business experience and open access to necessary information.
 - *Note:* There is no bright-line test for sophistication and financial ability to bear risk under the statute. If the potential investor does not meet the standard of “sophistication”, the exemption could be lost. If so, any investor who purchased securities within twelve months of the unauthorized offer will have an action to rescind the purchase of the security.
 - *Integration* - This offering may be integrated with prior offerings within the past 12 months.
 - *General Solicitation* - The offering cannot involve the general solicitation of purchasers. This concept is discussed further below.
 - *Restricted Securities* - These are “restricted securities”. They cannot be resold unless:

- they are held for 6 months (reporting company) or 12 months (not a reporting company), or
- they are registered prior to resale, or
- the seller perfects another transactional exemption.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-section-4-securities-exemption/>

Statutory Exemption for Accredited Investors - Section 4(a)(5) -Section 4(a)(5) of the '33 Act provides a statutory exemption for securities sold in accordance with its provisions.

- *Note:* The notable difference between Section 4(a)(5) and Regulation D exemptions is that Regulation D also allows for sales to non-accredited investors. Section 4(a)(5) is rarely used as a stand-alone exemption. The reason is because this statutory exemption generally fits within the rule-based exemptions of regulation D (Rules 505 and 506, for example), but does not contain many of the benefits.

The following limitations apply to a Section 4(a)(5) issuance:

- *Disclosure* - The issuer must provide a prospectus to purchases that complies with '33 Act disclosure provisions;
- *Accredited Investors* - The issuer can only offer and sell securities to accredited investors;
- *General Solicitation* - The issuer cannot undertake any advertising or other forms of general solicitation of purchasers;
- *Dollar Value* - The maximum offering amount cannot exceed \$5,000,000;
- *Notice* - The issuer must provide notice of sale to the SEC;
- *Restricted Securities* - Securities sold under section 4(a)(5) constitute "restricted securities" under Rule 144(a)(3) and cannot be resold in the future without registration or perfection of a separate exemption; and
- *State Registration* - Securities exempted under section 4(a)(5), like some other statutory exemptions, do not fall within the meaning of a federally covered security. The result is that federal law does not preempt state laws regulating the securities.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-section-4a5-securities-registration-exemption/>

- **Discussion:** Why do you think the securities laws allow for a statutory exemption from registration of private offerings that meet the requirements of section 4(a)(2)? What about 4(a)(5)? Can you see how the restrictions on

section 4(a)(5) make it a rarely-used exemption?

- **Practice Question:** ABC Corp is your employer and is considering a private issuance of securities. As a consultant for ABC Corp, you want to make certain that they understand the limitations and restrictions that apply to an issuance under Section 4. If asked, can you explain the limitations that apply to section 4(a)(2) and 4(a)(5)?

25. What is a “Regulation A” exemption?

Regulation A is a “conditional small issues” exemption from registration available for issuances that meet certain characteristics. Like Section 3(11), Regulation A provides for an exemption of the actual securities issued under the exemption. As such, the securities are not restricted from later sale.

- *Note:* The exemption is available for the issuer but is not available for broker-dealers offering the security for sale.

General Limitations - The following general limitations apply to all Regulation A exemptions:

- *Private, Non-Reporting Company* - The issuer cannot have stock registered with the SEC under Section 12 (i.e., cannot have stock that is traded on a public exchange) or be a reporting company under Section 15(d) of Securities Exchange Act of 1934 ('34 Act).
- *US Company* - The company must be a US or Canadian-based company.
- *Operating Company* - It cannot be an investment company, shell company, or involve fractional interests in oil or gas rights.

Types of Regulation A Exemption - Regulation A is actually divided into two classes of issuances, as follows:

- *Tier 1 Issuance:* The maximum amount of the issuance is \$5 million in a 12-month period. There is no limit on the number of amount of securities purchased by any investors.
- *Tier 2 Issuance:* The maximum amount of the issuance is \$50 million in a 12-month period. An investor may only purchase a number of securities valued at 10% of her annual income or 10% of her net worth, whichever is less.

Regulation A Disclosures

Regulation A is a middle ground between complying with the full registration and disclosure requirements of Section 5. The issuance requires review by the SEC prior to sale of the securities. The issuer must file an offering statement containing both non-financial and financial disclosures about the company and the issuance. This document has several components, including offering circular and financial statements. The issuer's CEO, CFO, and majority board members, and any selling shareholder must sign the offering statement certifying the information contained therein. This certification subjects these individuals to liability for any material omissions or misstatements. While this exemption does entail a filing requirement, the filing is far less demanding than those completing the entire registration process.

- *Note:* The issuer cannot solicit investors, make any binding commitments for sale, or sell any securities before the request for issuance and exemption is reviewed and approved by the SEC. There is, however, an exception that allows the issuer to “test the waters”.

Regulation A and General Solicitation

Regulation A allows the issuer of securities to “test the waters” for interested investors. That is, the issuer can use a written document or a radio or television broadcast to seek feedback from interested investors. The purpose of this provision is to allow the issuer to determine, prior to preparing the detailed offering disclosure documents, whether or not there is sufficient interest from investors to proceed with the issuance. The key limitations are that the test-the-waters communication must be filed with the SEC on the date of use.

- *Note:* Failing to file the “test-the waters” communication does not automatically forfeit the exemption, but it can prejudice future issuances under this provision.

Regulation A and State Regulations

Regulation A securities are not exempt from state regulation. This means that, even though the federal exemption applies, states may require that the issued securities be registered in the state and, in some states, undergo a merit review. Perhaps most importantly, many states do not allow general solicitation of investors unless the securities being sold are registered. This would strictly limit the open solicitation of purchasers in person or through television, radio, or Internet. So, even though Regulation A allows for testing the waters, the state may require state registration prior to doing so.

- *Note:* A prohibition against general solicitation requires that an issuer approach regular business contacts or professional brokers to generate interest in the issuance.

- **Discussion:** Why do you think Regulation A offers an exemption that accompanies a registration requirement? Given the extent of the disclosure requirements, do you think Regulation A is more or less attractive to issuers than full registration? Why?
- **Practice Question:** ABC Corp decides to issue securities in an effort to raise \$45 million in financing. What are some of the restrictions that ABC Corp must understand when considering Regulation A?
- **Resource Video:** <http://thebusinessprofessor.com/regulation-a-exemption/>

26. What are “Regulation D exemptions”?

Regulation D is the most commonly used set of exemptions for private placement. It consists of Rules 501-508 of the '33 Act. In addition to several statutory exemptions from registration, the SEC adopted Regulation D to provide "safe harbors" for issuers of securities. These exemptions are referred to as safe harbors because compliance with these rules will provide for an exemption from the standard disclosure requirements. Unlike the statutory exemptions, such as Section 4(a)(2) or Section 4(a)(5), failure to achieve or perfect an exemption is not completely detrimental to the validity of the securities offering. Rather, if the validity of the issuance under a Regulation D rule is challenged, the issuer can then attempt to assert a statutory exemption for the issuance. As such, Regulation D provides a safe harbor for pursuing an exemption and leaves open other possibilities for seeking exemption if somehow the offering runs afoul of the Regulation D exemptions.

- *Note:* The statutory authority for exemptions under Regulation D are found in Sections 3 and 4. Pursuant to this

authority, the SEC used its quasi-legislative authority as an administrative agency to pass these exemption rules.

Regulation D, Rule-Based Exemptions

Regulation D, rules 501, 502 and 503 provide definitions and conditions for the applicable exemptions. Rules 504, 505 and 506, are the substantive exemptions. Rules 507 and 508 lay out the consequences for failing to comply with the requirements of an individual exemption. Taken together, these rules provide for the most commonly employed exemptions to securities registration requirements.

- *Note:* Each of the rule-based exemptions are discussed in detail below. It is important, however, to remember that the general provisions of Rules 501- 503 apply to each exemption.

Limitations of Regulation D

- *Issuer Protections* - A notable limitation of Regulation D safe harbor provisions is that they only provide exemptions for the issuers of the securities during the original issuance of the security. The rules do not exempt individuals who later sell those same securities to third parties.
 - *Note:* This restriction is quite important, as some securities sold to equity investors are “restricted” and limit the investor’s ability to resell. The importance of this limitation will become apparent as we review the available exemptions.
- *General Solicitation* - Another important limitation is the restriction on the ability to make offers to sell securities to individuals. Many Regulation D exemptions prohibit issuers from soliciting investors to purchase the securities.
 - *Note:* The ability to solicit investors by making offers to sell securities is dependent upon the assumed knowledge and personal wealth of the investor.
- *Accredited & Sophisticated Investors* - Some exemptions limit the ability to sell securities to a certain number of “accredited investors” or “sophisticated investors”. Accredited investors are individuals with a net worth (not counting their primary residence) of more than \$1 million or an annual income of more than \$200,000 or institutions (such as banks and insurance companies). A sophisticated investor is an individual who has sufficient knowledge or experience to assess the risks of an offering themselves.
 - *Note:* A sophisticated investor may also be an accredited investor and *vice versa*. However, it is possible that one may not qualify as the other.

- **Discussion:** Why do you think the SEC decided to offer rule-based exemptions as safe harbors for the statutory exemptions? Do you think that offering additional protections to issuers against challenges by purchasers is a good thing? Why or why not?
- **Practice Questions:** What are the primary rules under regulation D? What are the rule-based exemptions from registration of securities and how do these rules relate to the statutory authorizations?
- **Resource Video:** <http://thebusinessprofessor.com/regulation-d-securities-exemption/>

27. What is a Rule 504 “small offerings exemption”?

Rule 504 is a transactional exemption from registration under Regulation D for small securities offerings. The statutory authority for the rule is pursuant to Section 3(b) of the '33 Act. The general requirements and limitations on the exemption are as follows:

- *Issuer Protections* - The exemption is available to the original issuer. The exemption is available to any company that is not a “reporting company”, “investment company”, or a “blank check company” under the Securities Exchange Act.
- *Dollar Limits* - Rule 504 allows an issuer an exemption for small offerings of shares with an aggregate annual value of up to \$1 million. The issuer may not split a single offering between Rule 504 and some other exemption. Any other offerings during the previous twelve-month period, even if under another exemption, will be integrated into the Rule 504 offering.
- *Number of Purchasers* - The issuer can make sales to an unlimited number of persons. It does not matter whether the purchasers are sophisticated or accredited investors.
- *Restricted Securities* - Securities are restricted. Affiliates and non-affiliates of an issuer who wish to resell securities must look elsewhere for a transactional exemption.
- *General Solicitation* - Rule 504 prohibits the issuer or anyone on the issuer’s behalf to “offer or sell the securities by any form of general solicitation or general advertising”. Rule 504 does allow for general solicitation in the following circumstances:
 - the offering is registered in the state where securities are sold, or
 - the state permits general solicitation and sales are only made to accredited investors in that state, or
 - *Note:* In these situations, the securities issued pursuant to either of these provisions are not restricted.
 - the state of issuance does not require registration, but the securities are registered in another state.
 - *Note:* This is a situation where the state allows the issuer to piggyback on the registration of securities in another state. The issuer must generally file an informational notice to the issuing state regarding the registration in another state.
- *Private Placement Memorandum* - To qualify for this exception, the state law must require “the public filing and delivery to investors of a substantive disclosure document before sale.” The disclosure document must disclose all material information to investors.
- *State Regulation* - A Rule 504 exemption does not preempt state regulations of securities under such an issuance. States may still regulate the issuance.

- **Discussion:** What do you think is the SEC's purpose in allowing for the Rule 504 exemption? Who do you think this exemption best serves? What do you think is the greatest limitation on this exemption? Why do you think the SEC allows for exceptions to the rule against general solicitation?
- **Practice Question:** ABC Corp is a relatively new company that is growing quickly. ABC needs about \$1 million in investment capital reach its growth goals for the next 18 months. In a brief letter, can you summarize the benefits and drawbacks of seeking an exemption from securities registration under Rule 504?
- **Resource Video:** <http://thebusinessprofessor.com/rule-504-securities-exemption/>

28. What is a Rule 505 “small offerings” exemption?

Rule 505 of Regulation D provides a transactional exemption from registration of a securities issuance.

- **Issuer Protections** - The exemption is generally available to all types of issuers (individuals, non-corporate businesses, corporations, as well as those reporting under the '34 Act) but it is not available for investment companies or for issuers that are subject to any statutory disqualification provisions, such as companies formally sanctioned by the SEC for untrue statements or omissions in securities offerings.
 - **Dollar Limits** - This exemption allows an issuer to raise up to \$5 million within a 12-month period.
 - **Purchaser Requirements** - The exemption allows for sale to an unlimited number of accredited investors and up to 35 non-accredited investors.
 - *Note:* Exceeding the number of non-accredited investors can forfeit the exemption.
 - **Restricted Securities** - The securities exempted in the issuance are restricted from resale.
 - **General Solicitation** - General solicitation of purchasers is prohibited in the same manner as under a Rule 504 exemption.
 - **Private Placement Memorandum** - The issuer does not have to make specified disclosures to accredited investors, but it must make extensive disclosures to non-accredited investors. This is normally done through the private placement memorandum, a disclosure document similar in nature to the prospectus. Notably, the disclosures must include certified financial statements.
 - **State Regulation** - Rule 505 does not provide an exemption from registration of securities under state law. This is similar to a Rule 504 offering.
-
- **Discussion:** The primary differences between a Rule 504 and 505 exemption is the dollar value of the issuance and classification of purchasers of securities. Why do you think Rule 505 separates classes of purchasers of securities into accredited and unaccredited investors?

- **Practice Question:** ABC Corp is an established company that is steadily growing. ABC needs about \$5 million in investment capital reach its growth goals for the next 18 months. In a brief letter, can you summarize the benefits and drawbacks of seeking an exemption from securities registration under Rule 505?
- **Resource Video:** <http://thebusinessprofessor.com/rule-505-securities-exemption/>

29. What is a “Rule 506” exemption?

Rule 506 of Regulation D allows for two exemptions of securities issuances. The statutory authority for a Rule 506 is pursuant to Section 4(a)(2) of the '33 Act. Rule 506 exemptions are the most commonly employed exemptions to securities registration.

Rule 506(b) Safe Harbor Exemption

- **Issuer Protection** - Rule 506 protections available for issuers are similar those of Rule 505. The notable exception is that the limitations for reporting companies under the '34 Act, or the so-called “bad boy” disqualifications do not apply to this exemption.
- **Dollar Limits** - This exemption allows for an unlimited dollar value for issuances.
- **Purchaser Requirements** - An issuer may sell its securities to an unlimited number of accredited investors and up to 35 non-accredited investors.
- **Restricted Securities** - This is a transactional exemption. As such, this exemption applies only to issuers and does not cover later sales by investors.
- **General Solicitation** - Rule 506(b) does not allow for general solicitation, which means that the issuer cannot use general advertising methods to reach potential customers. Of note, this general rule applies only to actual sales of securities, rather than to both offers and actual sales.
 - **Note:** The issuer must also use reasonable care to assure that the purchasers of the securities are not statutorily considered to be underwriters of the securities, as this can cause general solicitation issuers.
- **Private Placement Memorandum** - Rule 506(b) information disclosures are divided between accredited and non-accredited investors. There is no information disclosure requirement for the accredited investors, but the non-accredited investors must receive extensive disclosures. These disclosures are similar to those required under other Regulation D exemptions. The issuer must provide a private placement memorandum containing the necessary disclosures. Also, all non-accredited investors must meet a sophistication requirement. More specifically, they must have the knowledge or resources necessary to evaluate the merits of the investment.
 - **Note:** As with a Section 4(a)(2) exemption, the issuer must ascertain that offers only happen to individuals who meet qualification requirements to be purchasers. These non-accredited investors must either have sufficient sophistication to evaluate the merits and risk of the prospective investment or be represented by a sophisticated agent.

- *State Regulation* - Section 18 of the '33 Act exempts Rule 506 securities from registration requirements or a merits review under state law. As such, states cannot place additional registration requirements on the security issuance.

- **Resource Video:** <http://thebusinessprofessor.com/rule-506b-securities-exemption/>

Rule 506(c) - Exemption Pursuant to JOBS Act of 2013

The JumpStart our Businesses Act of 2013 (JOBS Act) made extensive changes to the securities registration exemption regime. As a result, it allowed the SEC to develop Rule 506(c) exemption with the following characteristics:

- *Issuer Protections* - Rule 506(c) applies to issuers to the same extent as Rule 506(b).
- *Dollar Limits* - The exemption allows an issuer to raise an unlimited amount of funds.
- *Purchaser Requirements* - The most daunting requirement of Rule 506(c) offerings is the requirement that the issuer verify that each purchaser of securities is accredited. An issuer who fails to exercise reasonable care in making this determination risks losing the exemption. The standard for judging an issuer's reasonable efforts to make this determination is uncertain. The SEC identified four primary methods of verifying that an individual is an accredited investor, including:
 - *Annual Income* - The issuer may examine proof of the purchaser's income, such as IRS filings from the last two tax years.
 - *Note:* This may require a certification by the issuer that they expect to sustain the previous years' earnings.
 - *Net Worth* - The issuer may examine bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessment, or appraisal reports, and consumer reports from a national agency, or obtain a written representation that purchaser has disclosed all liabilities.
 - *Professional Certification* - The issuer may receive a written representation from a registered broker-dealer or investment advisor, licensed attorney, or CPA that such person has taken reasonable steps to verify that the purchaser is an accredited investor as of the last three months.
 - *Written Verification* - If the prospective purchaser is a previously verified accredited purchaser, a written verification that such person is still accredited.
- *Restricted Securities* - The shares received by the investor under the exemption are "restricted".
- *General Solicitation* - The rule allows for general solicitation in an issuance where all purchasers are accredited investors and the issuer takes reasonable care to determine that each investor is accredited.

- *Private Placement Memorandum* - Before consummating a sale, the issuer must provide the purchaser with adequate disclosures under Regulation D.
- *State Regulation* - Rule 506(c) are covered securities that are exempt from state regulation.

- **Resource Video:** <http://thebusinessprofessor.com/rule-506c-securities-exemption/>

- **Discussion:** Why do you think Congress felt the need to provides for a specific exemption to accredited investors that also allows for general solicitation? Do you feel that the ability to generally solicit purchasers of securities undermines the purpose of public disclosure? Why or why not?
- **Practice Question:** ABC Corp is a wildly successful startup company that is growing by 300% per year. ABC needs about \$100 million in investment capital reach its growth goals for the next 18 months. In a brief letter, can you summarize the benefits and drawbacks of seeking an exemption from securities registration under Rule 506? Specifically focus on the differences between rules 506(b) & 506(c).

30. What is a “Rule 502(d)” and “Rule 144 Safe Harbor”?

Rule 502(d) requires that issuers of securities pursuant to an exemption under Regulation D take the following three steps to make certain the shares are not resold during the restricted period:

- reasonable inquiry to determine if each purchaser is buying the security for himself or for someone else,
- written disclosure to each purchaser that the securities are restricted, and
- a legend on the securities noting the resale restriction.

The SEC promulgated Rule 144, which allows a “safe harbor” for purchasers to resell their shares after one or two years, depending on how much public information about the issuer is available. In any case, the issuer must make certain that the shares are not being purchased with the intent of immediate resale. This safe harbor rule provides additional comfort to a purchaser of the security. As such, it adds liquidity to the security by making it easier to later sell and trade in the market.

- **Discussion:** What do you think is the underlying purpose or rationale for Rule 502(d) and Rule 144? Do you think these rules are adequate to achieve their objectives? Why or why not?
- **Practice Question:** ABC Corp issues securities pursuant to Rule 505 registration exemption. Kerry is a purchaser of securities. He realizes that the shares are restricted for a substantial period. What should ABC Corp and Kerry do to make certain that later reselling the shares does not potentially violate the Rule 505 offering?
- **Resource Video:** <http://thebusinessprofessor.com/restricted-securities-and-rule-144/>

31. What are the general information disclosure requirements for companies seeking an exemption from registration?

The perfection of an exemption does not completely relieve an issuer's disclosure requirements. The disclosure document that is generally used by businesses perfecting a registration exemption is the "private placement memorandum" (PPM). The issuer must disclose to potential investors at the time of the offer or prior to the business accepting any offer of investment funds. The PPM is very similar to the prospectus and is similarly demanding in its disclosure requirement. The PPM requirement requires extensive work and effort to prepare, but it is far less burdensome to the business than registering the issuance.

Types of Disclosure

Securities law breaks down the disclosure requirements for issuers of securities based upon the type of investor or purchaser of the securities. The relevant disclosure provision governing issuances is Rule 502(b)(2). It requires that issuers provide both financial and non-financial information. The company is required to provide the equivalent information as is required under SEC Form 1-A. It is important to note that the information disclosure or delivery requirements set forth in Rule 502(b) are only applicable to offerings under certain exemptions. Offerings to accredited investors do not require furnishing information.

- *Example:* Offerings under Rules 505 and 506 have to provide extensive information to non-accredited investors, while offerings under Rule 504 do not.
- *Note:* The issuer must always comply with state and federal anti-fraud laws, such as section 11(a), 12(a) and (b), and 10(b) under the '33 Act. Information that is factually untrue or misleading in any form runs the risk of violating one of these provisions. Generally, if the issuer is not a company that routinely provides reports to the SEC under Sections 13 or 15(d) of the Securities Exchange Act of 1934, it must furnish the following information to the purchaser of the securities.

Non-Financial Information

Non-financial information required by Rule 502(b) includes: the management team; the industry; the type and characteristics of the securities offered; any third-party facilitators in the offering process; and the risks involved in the type of security being offered. More precisely, the required information is listed in Part 1 of the registration statement that the business would be required to use, absent the applicable exemption. This information is deemed necessary to allow the investor to make an informed decision about whether to undertake the investment.

- *Note:* There is some flexibility in this disclosure requirement, as the introductory language in Rule 502(b)(2)(i) requires the issuer to furnish the specified information "to the extent material to an understanding of the issuer, its business, and the securities being offered."

Financial Information

Financial information about the business must be disclosed *via* the financial statements of the business. The extent of disclosure, which can be extremely detailed, depends on the size of the offering. The greater the dollar value the more extensive the disclosure requirements. The amount of required financial information varies between issuances below \$2 million, between \$2 million and \$7.5 million, and above \$7.5 million. Generally, the variation is the amount of financial data of the company and whether that information must be audited and certified by the company executives. The

information requirement serves to provide the investor with information that may not be available because the business is not required to register the information with the SEC.

- **Discussion:** Why do you think the information disclosure requirements vary between accredited and non-accredited investors? Why do you think the rules separate the requirements for financial and non-financial disclosures? Why do you think the amount of issuance matters with regards to the amount of information required to be disclosed to investors?
- **Practice Question:** ABC Corp is attempting to sell securities pursuant to an exemption under Rule 506(c). ABC Corp wonders what actions it should take to remain within the confines of Rule 506(c). Can you explain the types of disclosures that ABC Corp must make?
- **Resource Video:** <http://thebusinessprofessor.com/disclosure-requirements-of-regulation-d/>

32. What is the requirement to file “Form D”?

To claim an exemption from registering a securities issuance, the issuer must provide notice to the SEC of the issuance and claimed exemption. The entrepreneur provides notice by filing Form D with the SEC. Form D is currently filed in electronic format and must be filed within 15 days of the first sale of securities in the offering. The Form D is generally available through the SEC website (EDGAR). Form D makes basic disclosure about the issuance. This information includes the amount or value of the issuance and the names of company officers and directors.

- **Note:** The SEC disclosure requirement is less stringent than it sounds, as failure to file the Form D prior to the issuance will not hinder the ability of the issuer to claim an exemption. The negative side of failing to file is that, in the event of a challenge to the sale of securities, the SEC may stop the sale and deny the future use of exemptions due to the failure to file. Failure to file a Form D may also make it difficult for the issuer to comply with state securities laws.

- **Discussion:** Why do you think the SEC requires notification of a claimed exemption from registering a securities issuance? Based upon your conclusions, why do you think the failure to file Form D has very little negative repercussions?
- **Resource Video:** <http://thebusinessprofessor.com/regulation-d-form-d-filing-requirement/>

33. What is the effect of failing to register an offering under Section 5 and failing to perfect an exemption to the registration requirement?

Violating Section 5 of the '33 Act by failing to register an issuance or failing to carry out an issuance in accordance with an applicable exemption can subject the issuer to liability to purchasers of the securities. Specifically, Section 12(a)(1) allows any purchaser to bring a lawsuit to rescind the purchase of the securities (along with interest on the purchase funds) or, if the securities have been sold, to receive the damages suffered from the purchase. Rescinding the purchase transaction is often referred to as “buying a put,” because the purchaser will have the right to force the seller to repurchase the security. The SEC may also have a civil cause of action against the issuer who sells securities in violation of Section 5.

The result of failing to comply with failing to comply with a relevant exemption can be detrimental to an issuer. Rule 508 provides some relief from these effects if an anticipated exemption under Rules 504 - 506 fail because of an insignificant reason. That is, the issuer may be able to defend an action for rescission by demonstrating the following:

- the issuer's deviation from the exemption requirement was insignificant with regard to the overall offering;
- the requirements were not specifically imposed to protect this type of purchaser's interest; and
- the issuer honestly (in good faith) attempted to comply with the exemption requirements.

An issuer who successfully demonstrates these elements may be relieved from liability to plaintiff investors or the SEC.

- **Discussion:** How do you feel about the repercussions on an issuer for failure to comply with registration requirements or perfect an exemption? Is this provision overly advantageous to the purchaser or securities? Why or why not?
- **Practice Question:** ABC Corp sells securities to a small group of investors in several states. ABC did not seek legal counsel and is unaware that its sale of securities is subject to regulation under the securities law?
- **Resource Video:** <http://thebusinessprofessor.com/result-of-failure-to-comply-with-securities-registration/>

34. What is “crowdfunding” and how is it affected by securities registration laws?

The edition of Section 4(a)(6) to the '33 Act introduced equity crowdfunding as a viable option for seeking investors in a new business. Crowdfunding is a sort of mini-public offering that allows the general public to purchase securities directly from an issuer through authorized, private exchanges. Section 4(a)(6) provides for a Section 5 registration exemption for issuances conducted in accordance with specific crowdfunding methods. To qualify for the exemption under Section 4(a)(6), crowdfunding transactions by an issuer (including all entities controlled by or under common control with the issuer) must meet specified requirements, including the following:

- the amount raised must not exceed \$1 million in a 12-month period (this amount is to be adjusted for inflation at least every five years);
- individual investments in a 12-month period are limited to:
 - the greater of \$2,000 or 5 percent of annual income or net worth of an individual, if the annual income or net worth of the investor is less than \$100,000;
 - 10 percent of annual income or net worth (not to exceed an amount sold of \$100,000), if annual income or net worth of the investor is \$100,000 or more (these amounts are to be adjusted for inflation at least every five years); and
 - transactions must be conducted through an intermediary that either is registered as a broker or is

registered as a new type of entity called a “funding portal.”

Many entrepreneurs see the availability of crowdfunding as an important financing option for smaller companies that otherwise lack the resources to seek a public offering or to comply with statutory or rule-based exemptions. Section 4(a)(6) places the burden of compliance on the crowdfunding broker or portal. To become registered as a crowdfunding broker or funding portal, the entity must comply with the following:

- implement procedures to protect purchasers of securities against fraud;
- refrain from providing investment advice or soliciting purchasers;
- provide disclosures substantially similar to those required in a registration or disclosure document;
- allow for questions and feedback on securities being issued;
- file an offering statement with the SEC disclosing the terms and details of all issuances (which is also available to investors); and
- make annual filings with the SEC and make those filings available to the public on the crowdfunding site or portal.

The qualified broker or portal must also make certain that all investors meet the accreditation standards laid out by Section 4(a)(6). It cannot employ intermediaries to sell securities on behalf of the broker or portal. It must make certain the securities are understood to be restricted and, with limited exception, cannot be sold within a 12-month period of purchase.

- **Discussion:** Why do you think Congress decided to provide a statutory method for allowing crowdfunding that is exempt from Section 5 registration requirements? Do you think the limitations on investor and the requirements of brokers or portals are sufficient to protect investors? Why or why not?
- **Practice Question:** ABC, LLC is a new company that is growing quickly. It believes that crowdfunding may be the best method for generating much-needed capital. Eric is an investor interested in investing in a startup fund. What are the securities law requirements for ABC to undertake crowdfunding? What are the limitations on Eric as an investor?
- **Resource Video:** <http://thebusinessprofessor.com/crowdfunding-and-securities-laws/>

LIABILITY UNDER THE SECURITIES EXCHANGE ACT OF 1933

The 1933 Act provides for both criminal and civil liability for individuals who violate its provisions in the issuance of securities. Civil liability generally arises when a purchaser of securities sues the issuer (or its agent) for failure to comply with the registration or applicable exemption requirements under the '33 Act. This often includes (unintentionally) failing to make or making incomplete or erroneous disclosures of material information to purchasers of securities. Criminal liability generally arises when an issuer (or its agent) willfully violates the securities laws in a manner that defrauds or deceives a purchaser of securities. Remedies for civil and criminal violation range from the ability to recuperate the amount paid for the securities to fines and imprisonment.

35. What is civil liability under “Section 11” of the ’33 Act?

Sections 11(a) and (b) of the ’33 Act provide for strict liability (tort liability) for issuers who make material misstatements or omissions in the issuance of securities. This provision primarily applies to omissions and errors in disclosure pursuant to a public offerings. For example, an error in a private placement memorandum or registration statement could give rise to Section 11 liability.

Requirements for Liability

To be liable for a Section 11 violation, the issuer must make a material misstatement or omission of information in the transaction. An individual may be liable if the final registration statement contains any:

- untrue statement of material fact;
- omits material facts required by a statute or government regulation; or
- omits information that makes the stated information materially misleading.

The plaintiff does not have to demonstrate or prove any reliance on the statement. It is sufficient to demonstrate that the information was erroneous or misleading. The limitation is that the purchaser must not know that the information is erroneous or misleading at the time of purchase. Lastly, the securities the plaintiff purchased must be traceable to the registration statement or disclosure document at issue. This requirement is easy to meet in an IPO, but it may be difficult in subsequent purchases of shares issued in private offerings.

Who is Potentially Liable?

The issuer is potentially liable under Section 11. Further, Section 15 makes any person or entity that controls an issuer potentially liable. This provision provides for joint and several liability for the controlling person or entity under agency principles. Liability extends to those who endorse or sign their names (“signer”) to assert the veracity of the information. This generally leads to potential liability for corporate directors, underwriters, and others who take part in the preparation of the registration statement or prospectus. Any “signer” has a due diligence defense, though an insider CEO and CFO will have hard time asserting this defense. The due diligence defense regards the amount of effort and care the signer exercised in verifying the erroneous or omitted information. Section 11(e) provides for rescission of the transaction (along with interest) or damages suffered (losses sustained) from the later sale of the securities.

- **Discussion:** What do you think about Section 11 liability for omissions or errors in disclosure? Do you think these provisions adequately make officers accountable for public disclosures? Why or why not?
- **Practice Question:** ABC Corp is going through the registration process. It files the S-1 containing all relevant financial and non-financial information. It also translates this information into a prospectus that it distributes to potential purchasers. What is ABC Corp’s potential liability if some of the revenue calculations are erroneous in the accompanying financial statements?
- **Resource Video:** <http://thebusinessprofessor.com/civil-liability-under-section-11-of-the-1933-act/>

36. What is civil liability under “Section 12” of the ’33 Act?

Section 12 of the ’33 Act provides for civil liability for issuers of securities in two situations.

- *Section 12(a)(1)* - This provision provides a civil cause of action for purchasers of securities against issuers who sell securities without registering the securities or perfecting an exemption. Within the applicable statute of limitations, the purchaser must show that she purchased the shares from the issuer.
 - *Note:* This includes a situation where an issuer attempts to perfect one or more registration exemptions that fail.
- *Section 12(a)(2)* - This provision provides a cause of action for purchasers against issuers who makes a material misstatement or omission in a prospectus or other communication made as part of the sale of securities to the purchaser. The purchaser must not know that the information is incorrect at the time of purchase.
 - *Note:* Liability under Section 12(a)(2) is in addition to liability under Section 11.

As a remedy for violation under either subsection, the purchaser may rescind the purchase and receive interest on the money invested and any damages incurred by the investment. Generally, these causes of action are only available to purchasers in the original issuance of the securities. Individuals who purchase the securities in a subsequent sale cannot bring these actions. The issuer is potentially liable under Section 12, which makes anyone controlling the issuer potentially liable. The SEC may also bring a civil action against the issuer.

- **Discussion:** Why do you think that failure to register or perfect an exemption may lead to civil liability for an issuer? Should a purchaser who is not negatively affected by a failure to register or a misstatement of material information be able to force the company to repurchase the securities? Why or why not?
- **Practice Question:** ABC, LLC issues securities pursuant to a Rule 506(b) exemption. Unfortunately, some of the investors did not meet the accredited investor or sophistication requirements. No other registration exemptions apply to the offering. What does this potentially means for ABC?
- **Resource Video:** <http://thebusinessprofessor.com/civil-liability-under-section-12-of-the-1933-act/>

37. What defenses exist for issuers with potential liability under Sections 11 and 12 of the 33’ Act?

An issuer subject to claims by purchasers of securities under Sections 11 and 12 of the 33’ Act has several available defenses that may relieve her of civil liability. These defenses are as follows:

- **Materiality Defense** - The defendant may argue that the false or misleading information is not material and thus should not have had an impact on the purchaser’s decision-making process. Materiality is the kind of information that an average prudent investor would want to have so that she can make an intelligent, informed decision whether or not to buy the security.

- *Example:* ABC Corp fails to adequately identify the nature of certain operational assets held. While this disclosure is technically incorrect, the disclosure is not one that is likely to be the basis of a decision to purchase shares in the company.
- *Statute of Limitations* - The statute of limitation to bring an action against an issuer is one year. The statutory period does not start to run until the time of discovery of the actionable conduct or the conduct would have been made with reasonable diligence. In no case can a plaintiff bring an action more than 3 years after the security is properly sold to the public.
 - *Example:* ABC Corp issued securities pursuant to Rule 504. Eric, a purchaser of shares during the issuance, decides to challenge the issuance under Section 12 in order to force the company to repurchase his shares. His challenge is based upon violation of the general solicitation rules. The company may be able to defend against the action if the issuance took place more than 12 months ago and Eric was aware of the solicitation practices at the time.
- *Due Diligence* - An issuer may defend against liability under Sections 11 or 12 if she conducted adequate due diligence and such effort failed to uncover the misleading or omitted material information. With information included in a registration statement, the due diligence defense applies differently to portions of the registration statement that includes “expertised” information versus “non-expertised” information. Basically, the issuer is personally responsible for conducting a reasonable investigation of any information that is not reviewed or certified by a qualified expert. The issuer has a due diligence defense when relying on experts to identify and provide information in the disclosure statement. Courts have interpreted this defense to offer a sliding scale for determining the requirement of personal due diligence versus the ability to rely upon experts. In summary, a successful defense must show that a reasonable investigation of the financial statement of the issuer and controlling persons was conducted. Further, the expert must prove that there was no reason to believe any of the information in the registration statement or prospectus was false or misleading. In effect, this defense requires proof that a party was not guilty of fraud or negligence.
 - *Example:* ABC Corp discloses material in its registration statement. Some of the financial material is incorrectly recorded and thereby inaccurate. The issuance is now the subject of a Section 11 and 12 action by shareholders. The CEO signed the financial projections as being correct, but she depended largely upon the certification of the large outside-accounting firm hired to audit and certify the corporate books. This may be a defense to the shareholder action based upon the CEO’s justifiable reliance upon the auditor’s certification.
- *Negative Causation Defense* - Negative causation is a defense claiming that something other than the material misstatement or omission in a disclosure statement caused the damages (i.e., the value of the equity to fall).
 - *Note:* This is a difficult thing to prove. The party asserting the defense will often use professional experts to perform event studies to determine what actually caused the drop in price of the purchased security.
- - *Example:* ABC Corp issued securities last year. The disclosure of information in the registration statement was inaccurate in certain aspects at the time of issuance. Mary, a purchaser of securities, is angry because the shares have dramatically dropped in value. ABC Corp may be able to defend an action by Mary by showing that the drop in value was due to new governmental regulations of the business activity. Further, ABC would have to show that the inaccurate reporting of information did not materially contribute to the

drop in value.

- **Discussion:** Why do you think the SEC and courts allows for the above-referenced defenses? Do you think a 12-month statute of limitations is fair to issuer and purchaser? Why or why not?
- **Practice Question:** ABC Corp is subject to a Section 11 and 12 action for a material misstatement of information in the company's registration statement. Several purchasers of securities in the initial public offering are angry that the value of the shares have declined. What are four major defenses that ABC Corp may be able to assert in response to the civil action?
- **Resource Video:** <http://thebusinessprofessor.com/defenses-in-section-11-and-12-securities-actions/>

38. What is liability under “Section 17” of the '33 Act?

Section 17 of the '33 Act is an anti-fraud provision applicable to the initial sale or issuance of securities. It makes it illegal to “employ any device, scheme, or artifice to defraud ... obtain money or property ... engage in any transaction, practice, or course of business which operates or would operated as a fraud or deceit upon the purchaser.” It is primarily a government enforcement provision and courts generally do not allow a private cause of action by purchasers against the issuer under this provision.

- **Note:** Section 17 is very similar in nature to Rule 10(b)(5) of the Securities Exchange Act of 1934, which is a common fraud prevention provision. The primary difference is Section 17 does not require the government to demonstrate a specific mental intent of the issuer to defraud purchasers of securities.

- **Discussion:** Why do you think Congress provided specifically for a government civil action based upon fraudulent practices? Do you think the statute is sufficiently broad to cover all types of fraudulent conduct in the issuance of securities? Why or why not?
- **Practice Question:** ABC Corp is issuing securities to finance its growth. The directors purposely generate false information to include in the financial disclosures provided to investors. These disclosures are instrumental in the investor's decision to invest in ABC Corp. What is the potential for director liability under Section 17 of the '33 Act?
- **Resource Video:** <http://thebusinessprofessor.com/liability-under-section-17-of-the-1933-act/>

39. What is the potential criminal liability for violations of '33 Act?

Section 24 of the '33 Act allows the Department of Justice (DOJ) to bring a criminal action against anyone who knowingly and willfully violates the '33 Act. This normally only arises in situations where an issuer commits fraud in the sale of securities. The SEC cannot bring a criminal action itself, but it regularly works in hand with the DOJ to substantiate claims of securities fraud.

- **Note:** Conviction under this provision allows for up to a \$10,000 fine and up to 5 years in prison.

- **Discussion:** How do you feel about this consumer fraud statute? Why do you think the DOJ, rather than the SEC, is charged with pursuing criminal charges in securities actions under Section 24?
- **Resource Video:** <http://thebusinessprofessor.com/criminal-liability-under-1933-act/>

THE SECURITIES EXCHANGE ACT OF 1934

Securities Exchange Act of 1934 ('34 Act) regulates transfers of securities after the initial sale. Basically, it picks up where the '33 Act leaves off. More specifically, it deals with regulation of securities exchanges, brokers, and dealers in securities. It also created the Securities and Exchange Commission. The '34 Act makes it illegal to sell a security on a national exchange unless a registration is effective for the security. Registration under the '34 Act requires filing prescribed forms in a timely manner with the applicable stock exchange and the SEC. The registered issuer must then file periodic reports as well as report significant developments that would affect the value of the security. The '34 Act contains several provisions allowing for civil liability of individuals trading securities. The most notable of these provisions are discussed below.

- **Note:** Most securities law violations under the '34 Act may be enforced civilly (bring a lawsuit) either by private plaintiffs or the SEC. The Private Securities Litigation Reform Act of 1995 (PLSRA) states that only the SEC can pursue claims against third parties not directly responsible for the securities law violation. The Department of Justice is primarily charged with bringing criminal actions for violation of securities laws.

- **Resource Video:** <http://thebusinessprofessor.com/securities-exchange-act-of-1934/>

40. When must a company register with the Securities Exchange Commission pursuant to the '34 Act?

A company issuing securities must either register or perfect and exemption from registration. There are, however, other situations that subject a company to SEC public reporting requirements. The company becomes known as a “reporting company”. A company is generally required to register with the SEC if it meets any of the following characteristics:

- it completes a public offering pursuant to the '33 Act;
- securities of the company are traded on a national exchange (such as the NYSE or CME); or
- it has 2,000 or more total shareholders (or 500 or more unaccredited shareholders) of unrestricted securities and a total asset value of more than \$10 million.

The 2,000 (or 500 unaccredited) shareholder rule does not apply to shareholders who acquired shares through sanctioned crowdfunding or pursuant to employee compensation plans. Notably, if an issuer later drops below the shareholder limitation numbers, it may apply to the SEC to be exempted from the '34 Act reporting requirements.

- **Discussion:** Why do you think the SEC requires a company to register in the above-referenced scenarios? Do you

think the size of the company (number of shareholders or value of assets) should determine whether reporting is required? Why or why not?

- **Practice Question:** ABC Corp is a private company that has been steadily growing over the past several years. They have gone through several private offerings and have a large number of accredited and unaccredited investors. They also have substantial land holdings as well as equipment. Under what conditions might ABC Corp be forced to registered with the SEC and become a reporting company?
- **Resource Video:** <http://thebusinessprofessor.com/requirement-to-register-securities-under-1934-act/>

41. What disclosures are required of registered companies under the '34 Act?

A reporting company must make routine disclosures to the public by filing reports with the SEC. The information required to be disclosed is substantially as follows:

- *Reporting Company Initial Statement* - Similar to the registration statement required under the '33 Act, a company initially registering as a reporting company under the '34 Act must make an initial disclosure of information. This information primarily concerns the operations, equity structure, and securities issued by the company.
- *Annual Reporting* - Reporting companies are required to make detailed annual reports to the SEC, which are also provided to security holders. The disclosure takes place on Form 10-K and it contains all relevant operational data, an explanation of company performance, audited financial statement, and detailed information about corporate officers and directors.
- *Quarterly Reports* - The reporting company must file and disclose to shareholders a quarterly report on Form 10-Q. The quarterly report contains similar information to that contained in the annual report, but it only covers the most recent quarter of the fiscal year. Also, the financial statement included in the quarterly report is not audited.
- *Special Reports* - The reporting company must disclose to the SEC and shareholders *via* Form 8-K any major operational, structural, financial, or ownership changes in the company within a reasonable time of the occurrence. Major occurrences include: new security issuances, changes in corporate control (officer and directors), mergers, acquisitions, changes in auditor, etc.

The information disclosed in each of the above reports must be certified as accurate by corporate executives (including the company's CEO and CFO). These individuals must also attest to the operable status of controls over internal affairs and finances. This includes attesting that the company has in place an audit committee to examine the efficiency of internal controls.

- **Discussion:** Why do you think the SEC requires such extensive, recurring disclosures for reporting companies? Do you think these reporting requirements serve the intended purpose?
- **Practice Question:** What are the reporting requirements of companies that registered pursuant to The Securities Exchange Act of 1934?
- **Resource Video:** <http://thebusinessprofessor.com/reporting-and-disclosure-requirements-under-1934-act/>

LIABILITY UNDER THE SECURITIES EXCHANGE ACT OF 1934

42. What is liability under “Section 10(b)” and “Rule 10(b)(5)” of the 1934 Act?

Section 10(b) prohibits fraud in connection with the purchase and sale of any security. This provision applies whether or not the security is registered under the '34 Act. The SEC adopted Rule 10(b)(5) to implement section 10(b). Together, these anti-fraud provisions are the basis for most litigation under the '34 Act. These provisions make it unlawful to use most communication methods (such as the mail, internet, or wire) or any national securities exchange to defraud any person in connection with the purchase or sale of any security. Any party directly connected to the sale of securities is potentially liable; though there may be limits on the liability of certain professionals, such as auditors, bankers, accountants, etc. Rule 10(b)(5) allows for a cause of action by the SEC as well as private actions. Generally, Rule 10(b)(5) prohibits the following conduct in connection with the sale of a security:

- using any device, scheme, or other artifice to defraud purchasers;
 - *Example:* A device or scheme includes any sales or investment program, whether done in person or *via* distant communication, to defraud participants.
- making any untrue statement or failing to disclose any material fact that make the statement misleading; or
 - *Example:* This includes making false statements or failing to disclose relevant information in the process of selling or transferring a security.
- employing any practice that would deceive or defraud.
 - *Note:* This is a very broad, catch-all provision.

These prohibitions give rise to a potential cause of action for plaintiffs under Rule 10(b)(5), the elements of which are as follows:

- *Deceit* - A plaintiff must demonstrate deceit through the misrepresentation or omission of information. This must be done either intentionally or recklessly. Simple negligence is not enough to establish liability.
- *Material Information* - The information must be material to the purchaser of the security. That is, the information must be important to a potential investor in making the decision of whether or not to purchase the security. What is material information is interpreted very broadly and based on the individual situation of the company.
- *Purchase of Sale of a Security* - The information must directly related to the purchase or sale of a security. An individual who does not purchase or sell a security based upon the deceitful information cannot bring an action under this provision.
- *Reliance on the Information* - The actual purchaser must rely on the misrepresented information. Reliance is assumed if material information is omitted or broadly stated to the whole market.
- *Cause Damages* - The plaintiff must suffer some actual damages resulting from or caused by the omission or misrepresentation. This normally comes in the form of a diminution in the value of the shares purchased.

In summary, to recover under Rule 10(b)(5), a plaintiff, whether the SEC or a private plaintiff, must show that an individual trading in securities had an intent to deceive the purchaser. Intent to deceive may be inferred from a partial or untimely disclosure of important information.

- **Discussion:** How do you feel about the extensive liability or breadth of potential actions available under Section 10(b) or Rule 10(b)(5)? Do you think these provisions are overly broad? Why or why not?
- **Practice Question:** Bernie is the head of a new investment firm. His firm solicits money from investors and invests that money in short-term, high-risk securities. Bernie has been suffering substantial losses, but has been able to continue to pay investor returns from the funds invested by new investors. In order to attract new investors, he is falsifying much of the information on his investment returns. The DOJ gets word of his practices and begins an investigation. In the meantime, shareholders bring a civil action under Rule 10(b)(5) to recover their losses from Bernie. What elements will they have to demonstrate in Bernie's conduct to find him liable?
- **Resource Video:** <http://thebusinessprofessor.com/liability-under-section-10-and-rule-10b5/>

43. What is “insider trading” under Rule 10(b)(5)?

Insider trading is the sale or purchase of securities by individuals privy to non-public, material information of a firm based upon her special relationship with the firm. Generally, anyone who has material, non-public information must either disclose that information prior to trading the securities or abstain from trading in the effected or related security. Normally, insiders include officers, directors, and professionals in fiduciary relationships with the firm. The negative aspect of insider trading is that it provides individuals an advantage over others in the sale or purchase of securities and undermines the integrity of the market and the confidence of those investing in securities. Section 10 of the '34 Act has been broadly interpreted to prohibit the practice of trading securities based on material, non-public information received as an insider or from an insider of a company.

- **Note:** Trading securities on non-public information is most commonly addressed in 10(b)(5) actions. The SEC is charged with bringing civil actions under Rule 10(b)(5), while the Department of Justice is charged with bringing criminal actions against violators.

Elements of a 10(b)(5) Action

The insider or an individual receiving information from an insider is liable for trading securities based on the information. A “tippee” is a person who learns of nonpublic information from an insider. Upon receipt, this person is considered to be a legal, temporary insider. As a temporary insider, the tpee is subject to the prohibitions of Section 10(b) prohibiting the insider from trading securities based upon the inside information. The elements of a 10(b)(5) action are the same for criminal and civil actions and are as follows:

- **Information** - The insider must have material, non-public information.
 - **Note:** This type of information is generally the result of detailed knowledge of business performance or long-term plans that will affect the corporation's value in the market if it were publicly known.

- *Example:* I am a director on the board of ABC Corp. I receive a report that demonstrates that the corporation's cost of production is going to drop dramatically in the near future due to a drop in materials cost. This information is not public and it will certainly increase corporate profits.
- *Fiduciary Duty* - A core element of a 10(b)(5) action is the breach of a fiduciary duty. Insiders and third parties may have a fiduciary with regard to the material, non-public information.
 - *Insiders* - Corporate insiders have a fiduciary duty to the company.
 - *Example:* Corporate insiders who have a fiduciary duty include: board members, major shareholders, employees, and so-called temporary insiders, such as lawyers and investment bankers who are doing deals for the company.
 - *Third Parties* - A fiduciary duty exists for third parties in a personal relationship with an insider if:
 - the third party receives information and promises to keep the information secret;
 - the insider has a reasonable expectation that the recipient will not tell; or
 - the recipient has obtained the information from her spouse, parent, child or sibling.
- *Trading and/or Misappropriation* - Either the insider or third party may breach a fiduciary duty by trading on (i.e., using the information to make stock trades) or misappropriating the information.
 - *Insiders (Tippers)* - The insider breaches a fiduciary duty by trading on the information. Further, an insider misappropriates and breaches his fiduciary duty by transmitting information if:
 - he knows the information was confidential, and
 - he expected some personal gain.
 - *Third Parties (Tippees)* - Third parties misappropriate information obtained through a professional or personal relationship from an insider. Therefore, a third party violates a fiduciary duty to the rightful owner of the information by trading on the information if she knows:
 - the information is confidential,
 - that it was transmitted in breach of a fiduciary duty, and
 - the insider expected a personal gain from transmitting the information.

The idea of holding a third-party, recipient of material, non-public information liable for trading on that information is based on theory that the information is misappropriated from the rightful owners (shareholders). The third party has no duty to reveal the nonpublic information to the public, since she was not in a fiduciary position with respect to company.

Trading on that information, however, is effectively breaching a duty owed to those shareholders to either disclose that information or refrain from trading. In summary, anyone who has material, non-public information must either disclose the information prior to trading the securities or abstain from trading in the effected or related security.

- **Discussion:** How do you feel about holding a tippee of insider information liable under Section 10(b)? Is it fair to consider a tippee to be a temporary insider? Why or why not? Do you think the knowledge requirement for third parties is fair? Why or why not?
- **Practice Question:** Arnold is a director of ABC Corp. He is specifically involved in a committee that evaluates potential mergers and acquisitions. He becomes aware that a group of managers are considering a manager buyout that would allow the managers to purchase all corporate shares and make the company private (i.e., no longer publicly traded). This would ease the regulatory burdens of reporting to the SEC. Also, the buy-out will drive up the price of shares temporarily. What Arnold face liability if he purchased a large block of ABC shares based upon this knowledge? What if he provided this information to his brother-in-law who subsequently purchased a large block of shares?
- **Resource Video:** <http://thebusinessprofessor.com/liability-for-insider-trading-under-rule-10b5/>

44. What damages are available to a plaintiff under Section 10(b) and Rule 10(b)(5)?

While both the SEC and a private plaintiff may enforce the antifraud provisions of Section 10 and Rule 10(b)(5), only purchasers or sellers of securities may bring a private action for damages under Rule 10(b)(5). A private plaintiff in a suit under 10(b)(5) may recover for the actual damages suffered as a result of purchasing the security. As part of the action, a buyer must allege specific damages due to the seller's fraud. The measure of damages is generally the difference between what is paid over the value of the security received. The measure of a defrauded seller's damages is the difference between the fair value of all that the seller received and the fair value of what he or she would have received had there been no fraud. In an SEC action under 10(b)(5), the civil penalty for gaining illegal profits with nonpublic information is three times the profits gained. The statute of limitation is 5 years from the wrongful transaction.

- **Note:** A purchaser may also be entitled to receive consequential damages from the purchase of securities. Consequential damages include lost dividends, brokerage fees, and taxes. The court may also order payment of interest on funds. Punitive damages for the conduct are not available.

- **Discussion:** Why do you think the law allows for different calculations of damages for injured shareholders versus damages in actions by the SEC?
- **Practice Question:** ABC Corp issues securities last year. The shares sold for \$10 each. The S-1 that they filed contained some materially incorrect information supplied by the CEO. Since that time, the shares have dropped to \$5 each on the public market, which reflects the real value of the shares at the time of issuance. Amy is a shareholder who purchased 100,000 shares. She and the SEC are bringing an action against ABC under Rule 10(b)(5). What are the potential damages against ABC?
- **Resource Video:** <http://thebusinessprofessor.com/damages-available-in-rule-10b5-action/>

45. What is “insider trading” under Section 14 of the 1934 Act?

Rule 10(b)(5) is not the only securities law to target trading of securities by individuals with inside information. Rule 14(e)(3) is an insider trading provision that applies specifically to corporate buyouts or takeovers. This provision prohibits anyone from trading on insider information if the trader knows that the information was obtained from either party to the proposed buyout. The information is effectively misappropriated from the companies. No fiduciary duty is required as in 10(b)(5) actions.

- **Discussion:** Why do you think the securities laws provide for a special cause of action for insider trading based upon information obtained about a corporate takeover or buyout?
- **Practice Question:** ABC Corp is in the midst of dealing with a proposed corporate buyout of ABC Corp by 123 Corp. Earl is a news reporter who learns from a low-level employee at ABC Corp that there are likely merger-acquisition talks happening. Earl seizes the opportunity to purchase a large block of ABC Corp and 123 Corp stock. The merger is likely to push up the share price of both entities. Is Earl potentially liable under the securities laws?
- **Resource Video:** <http://thebusinessprofessor.com/insider-trading-under-section-14-of-the-1934-act/>

46. What is liability under “Section 16” of the 1934 Act?

Section 16 of the '34 Act governs the sale or transfer of securities by “insiders” of the corporation. An insider is an officer, director, or large shareholder (holding 10% or more of outstanding securities). Insiders must generally register with the SEC and indicate their ownership interest at the time of filing the registration statement or within 2 days of becoming an insider (i.e., acquiring a large ownership of shares). Section 16 prohibits insiders from making “short-swing” profits by trading their shares within 6 months of the registration or acquiring the shares. There is an assumption that insiders have material, non-public information during this period. As such, any trades during this period are *per se* illegal. Any profits derived from the sale are forfeited to the corporation.

- **Note:** The SEC does not enforce the short-swing profit rule; rather, this rule is enforced through civil action by the company or shareholders.
- **Discussion:** Why do you think the securities laws absolutely prohibit insiders from earning short-swing profits from trading the business securities? Do you think that allowing for private civil actions for such profits is an effective manner of policing this practice? Why or why not?
- **Practice Question:** McKenzie is the Chief Operating Officer of ABC Corp. She recently acquired a large block of stock as part of her executive compensation. There is a rumor in the market that 123 Corp is interested in partnering with ABC Corp for an international joint venture. The speculation has pushed up the stock price. McKenzie is considering selling most of the stock she recently acquired, which will yield a handsome profit for her. Does she face potential civil liability for this action?

- **Resource Video:** <http://thebusinessprofessor.com/insider-trading-under-section-16-of-1934-act/>

47. What is liability under “Section 18” of the 1934 Act?

Section 18 of the '34 imposes liability on any person “who shall make or cause to be made any false and misleading statement of material fact in any application, report, or document filed under the act”. Section 18 is based upon a theory of fraud. Unlike under rule 10(b)(5), however, Section 18 applies only to the documents required to be filed under the '34 Act. This includes annual, quarterly, and special reports. A plaintiff must prove that:

- the defendant knowingly made a false statement,
- the plaintiff relied on the false or misleading statement, and
- the plaintiff suffered damages as a result of that reliance.

Unlike the sections 11 and 12 of the 1933 Act, the defendant’s good faith in making the written statement is a defense. Further, unlike sections 11 and 12, the Section 18 plaintiff must prove reliance by the plaintiff shareholder on that information.

- *Note:* The statute of limitations for bringing a Section 18 action was extended under Sarbanes-Oxley Act to 5 years from the wrongful act, and within 2 years of discovery.

- **Discussion:** Why do you think that Section 18 provides a specific cause of action for material misstatements in a public disclosure document? How do you feel about the availability of a good faith defense? What about the requirement that the plaintiff prove reliance on the statement?
- **Practice Question:** ABC Corp issues a Form 10-K annual report containing numerous material errors in the financial information. The errors drastically misstate the asset holdings of the company. If a group of shareholders learn of the misstatement and decide to bring a lawsuit, what must the shareholders show to hold ABC Corp liable under Section 18?
- **Resource Video:** <http://thebusinessprofessor.com/liability-under-section-18-of-1934-act/>

48. What is liability pursuant to the “Securities Enforcement Remedies Act”?

The Securities Enforcement Remedies Act provides for additional civil liability for defendants found to have violated the securities laws. A judge may impose fines of up to \$500,000 per institution and \$100,000 per individual. This can also lead to a court prohibiting an individual from serving as an officer or director of a corporation.

- **Discussion:** Why do you think congress decided to augment the level of civil fine or penalty associated with securities law violations?
- **Practice Question:** <http://thebusinessprofessor.com/securities-enforcement-remedies-act/>

49. What is criminal liability under the 1934 Act?

The '34 Act provides for criminal sanctions for willful violations of its statutes or corresponding regulations. More specifically, it imposes liability for false, material misstatement in applications, reports, documents, and registration statements. Individuals face up to a 25-year sentence and business entities face fines of up to \$25 million. Many professionals (accountants) have been found guilty for failure to disclose information. The common defense for this criminal charge is a lack of intent to deceive or defraud.

- *Note:* Most criminal prosecutions occur under Section 10(b) or Rule 10(b)(5).
- **Discussion:** How do you feel about the possibility of criminal liability for violation of the securities laws? Should these penalties be reserved for intentional deceit? Why or why not?
- **Practice Question:** <http://thebusinessprofessor.com/criminal-liability-securities-exchange-act-of-1934/>

BLUE-SKY LAWS

“Blue-sky laws” are state laws regulating the sale of securities within that state. These laws are so named from early laws passed in Kansas and in the Midwest to protect investors from undertaking investments that had no more substance than the blue sky. Issuers of securities must comply with these state laws as well as the previously discussed federal regulations. Blue-sky laws may allow for both civil and criminal penalties against violators. The requirements of state blue-sky laws will differ among the states, but they are all based closely on the Uniform Securities Act, promulgated in 1956.

50. Are all issuers of securities required to comply with state blue sky laws?

Generally, no. In 1996, Congress passed the National Securities Markets Improvement Act (NSMIA) with the purpose of simplifying the registration process for issuers of securities. The NSMIA preempted any state regulation of certain “covered securities”. Covered securities include:

- those traded on a national exchange (such as the NYSE or CME);
- securities of registered investment companies, and
- offers of securities exempt from Federal registration under Regulation D, Rule 506.

NSMIA effectively limited the ability of states to regulate many security offerings. In addition to these preempted offerings, states also recognize any number of exemptions for certain issuances of securities:

- isolated transactions involving the issuance of securities;
- offers or sales to a limited number of offerees or purchasers within a stated time period;

- issuances qualifying as private offerings under Rule 504; and
- issuances to a predefined, but limited, number of purchasers.

Another optional model law is known as the Uniform Limited Offering Exemption. This provision excuses certain securities offerings, such as offerings issued pursuant to Regulation D, Rule 505.

- **Discussion:** Why do you think federal securities law sought to exempt certain securities issuances from state regulation? Why do you think that some states choose to either adopt or not adopt the Uniform Limited Offering Exemption?
- **Practice Question:** Under what circumstances does federal law limit the ability of states to regulate the issuance of securities?
- **Resource Video:** <http://thebusinessprofessor.com/securities-issuances-regulated-by-state-law/>

51. What are the registration requirements under state law?

Registration pursuant to federal law focuses on disclosure of information to offerees and purchasers. States adopt this approach, but also may impose a test to make certain the security being issued meets certain quality standards. This is known as a “merit review”. The merit review examines certain qualities, such as the financial stability of the company making the issuance. Other examinations may focus on the terms or rights associated with the issued security. With this in mind, states generally employ one of three registration methods for issuers of securities:

- **Registration by Qualification** - Some states require issuers to undergo a full-blown registration, complete with a merit review. Issuers registering with the SEC must file duplicate documents with the state’s administrative agency regulating securities. Unless a state official objects, the state registration becomes effective automatically when the federal registration statement is deemed effective.
- **Registration by Notification** - Some states permit issuers with an established track record to simply file a notice before offering their securities. This allows issuers to offer securities for sale automatically after a stated time period expires unless the state administrative agency takes action to prevent the offering.
- **Registration by Coordination** - Some states permit issuers that have registered with the SEC to file copies of the federal registration statement (and perhaps some additional documents) with the state. This process requires a more detailed disclosure by the issuer. A security cannot be offered for sale until the administrative agency grants the issuer a license or certificate to sell securities.

- *Note:* Alternatives forms of coordinated registration exist and are discussed below.

- **Discussion:** Why do you think states employ the additional layer of registration beyond the federal requirements? How do you feel about state merit reviews? Should the Federal Government employ a merit review for issuances? Why or why not?
- **Practice Question:** ABC Corp is issuing securities for sale in a number of states. ABC plans on seeking a federal

exemption from registration under Rule 505. ABC is curious about the different registration requirements that it could face in different states. Can you describe the three major types of state-level registration?

- **Resource Video:** <http://thebusinessprofessor.com/registration-requirements-under-state-law/>

52. What types of coordinated registration are available under state laws?

There are two primary options for registration by coordination that ease the process of complying with state securities requirements.

- *Coordinated Review-Equity* - This type of review is designed for use during an IPO that is seeking registration (not seeking a statutory or rule-based exemption from registration). It is generally not allowed for limited registrations under Regulation A. Under this program, the issuer files to register its securities in Pennsylvania. Pennsylvania Securities Commission (PSC) acts as an administrator and collects the required disclosure documents. The PSC will also choose another state that requires a merits review and solicit this state to review the offering. The issuer may then register this disclosure and merit review in any other state in which it seeks to sell securities. One state takes the lead on all disclosure concerns, while another assumes responsibility for any merit issues.
 - *Note:* This process is advantageous, as it allows the issuer to only deal with two states in the disclosure and review process. The alternative is to undergo disclosure and review requirements in every state of issuance.
 - *Example:* ABC Corp is undertaking an IPO. As part of the IPO process, ABC will be forced to register its securities in each state in which it is directly offering securities for sale. ABC seeks to undertake the coordinated review-equity process to circumvent the need to comply with the disclosure and review requirements of every state.
- *Coordinated Review-Small Company Offering Registration* - Most states permit the use of CR-SCOR for offerings under Rule 504 or Reg A, Tier 1. Under this program, registration only requires a simplified disclosure form. The issuer would be able to submit this form in lieu of going through the standard state disclosure or merit review requirements. Also, the SCOR system separates the US into five filing regions. Rather than filing a SCOR disclosure in each state where securities will be sold, the issuer can file in a region to cover all the states in that region.
 - *Note:* The issuer would have to file a disclosure in each region in which an issuance state is located.
 - *Example:* ABC Corp is undertaking a small offering issuance. It is seeking an exemption from federal registration under Rule 504. ABC will primarily offer securities for sale in Delaware, District of Columbia, Maryland, New Jersey, Pennsylvania, Virginia and West Virginia. All of these states are part of the Mid-Atlantic SCOR regions. As such, ABC may file the SCOR disclosure documents with each state rather than going through the state-mandated disclosure and review processes.
- **Discussion:** How do you feel about the coordinated-review programs available for IPOs and small offerings? What do you think is the state purpose behind allowing for these exemptions? Do you think these systems are

effective in accomplishing those objectives? Why or why not?

- ***Practice Question:*** ABC Corp is considering issuing securities pursuant to rule 504. It needs to raise approximately \$1 million in funds to grow operations. ABC is concerned with having to comply with state disclosure and review requirements? What options may be available for ABC? Please describe any procedures necessary in this process.
- ***Resource Video:*** <http://thebusinessprofessor.com/coordinated-registration-under-state-securities-law/>

TOPIC 15: EMPLOYMENT LAWS

Overview

Employment laws concern the federal and state statutes governing the practices of employers and the rights of employees. Labor laws, a subset of employment laws, concern the ability of employees to organize and collective bargain for employment rights and benefits. This chapter identifies the primary employment and labor laws protecting employee interests and putting affirmative obligations upon employers. It gives a cursory explanation of the laws, explains the laws objectives, and identifies specific employee rights and employer obligations affected by the law.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• <u>Employee & Independent Contractor</u> • <u>At-Will Employment</u> • Internal Revenue Code • <u>Fair Labor Standards Act</u> • <u>Family Medical Leave Act</u> • <u>Worker Readjustment and Retraining Act</u> • <u>Employee Retirement Income Security Act</u>	• <u>Worker's Compensation Act</u> • <u>Occupational Safety and Health Act</u> • <u>Consolidated Omnibus Budget Reconciliation Act</u> • <u>Health Insurance Portability and Accountability Act</u> • <u>Affordable Care Act</u> • <u>Immigration Reform and Control Act</u> • <u>Privacy Laws</u>	• Labor Laws • <u>Norris-LaGuardia Act</u> • <u>National Labor Relations Act</u> • <u>Taft-Hartley Act</u> • <u>Labor Management Reporting & Disclosure Act</u>

TOPIC 15: EMPLOYMENT LAWS - QUESTIONS & ANSWERS

1. What is an “employee”?

An employee is a stakeholder and representative agent of a firm. She may also be an owner of the firm, but her role as employee is generally separate from that of owner. For purposes of employment law, it is important to distinguish an employee from an independent contractor. Most of the employment laws apply to the relationship between employer and employee, and specifically exclude the independent contractor relationship. In a dispute concerning whether an individual is an employee or an independent contractor, administrative agencies and courts generally employ some version of the following tests:

- *Control Test* - The control test applies numerous factors regarding the extent of an employer’s control over the employee or independent contractor. This test seek to measure the extent to which the agent is an extension of and answerable to the employer. An employee is engaged by a business to perform services under the guidance and supervision of the employer. These tasks are generally part of the core operations of the business. The employer will control the place, hours, and method of work. The employee generally works exclusively for the employer. An independent contractor, on the other hand, is an individual hired as an outside professional to perform services to a business. The employer maintains far less control over the independent contractor, who generally controls her own time and manner of performing services. Frequently, the independent contractor may have other clients and may employ her own employees.
 - *Note:* The control test is most notably employed by the Internal Revenue Service to determine employee status. Factors the IRS employs in making this determination include the employer’s behavioral and financial controls over the agent. Further, it looks at the nature of the employer-agent relationship, such as the nature of the work agreement between the parties.
- *Economic Realities Test* - This tests seeks to determine the economic situation under which the individual performs services for the employer. It focuses on whether an agent is taking advantage of an employer’s opportunity or whether an individual has their own business and is performing a necessary service to the employer. Factors examined in this determination include:
 - Does the agent have her own equipment and employees?
 - How much control over the agent does the employer exercise?
 - To what extent is the agent exposed to the opportunity for profit or loss?
 - Is the relationship temporary or permanent in nature?
 - How integrated in the employer’s business is the agent’s activity?
 - How much independent thought, decision making, and initiative is charged to the agent?
 - How independent is the agent’s business organization?
 - *Note:* This test is primarily used by the Department of Labor to determine employee status.
- *Example:* A business may hire a marketer, accountant, attorney, etc., to perform work for the business. These individual are not employees. They have their own businesses.

- **Discussion:** Do you think the status of an independent contractor or employee should matter for purposes of employment laws? Why or why not?
- **Practice Question:** ABC Corp is considering hiring someone to perform auditing functions for the corporation. What do you need to know to determine whether ABC should hire an outside firm as an independent contractor or an internal employee to carry out the duties?
- **Resource Video:** <http://thebusinessprofessor.com/how-to-determine-employee-status/>

2. What are the legal obligations regarding the terms of employment between an employer and employee?

The terms of an employment relationship will either be determined by the employment agreement between employer and employee or pursuant to the legal duties established under state law. All states in the US, except Montana, recognize the “at-will” employment doctrine. This doctrine allows for an employer to discharge or fire an employee for any non-discriminatory or retaliatory reason without cause or justification. Further an employee may resign from or quit her employment at any time without legal liability. This doctrine seeks to promote free movement of employment. Each state, however, recognizes limited exceptions to the principle of at-will employment. That is, these states either pass statutes or have common laws protecting the employee from discharge in certain situations:

- **Public Policy Exception** – Most states in the United States prohibit an employer from firing an employee if the reason for the action violates some readily accepted public policy. This prevents an employer from terminating an employee for exercising a legal right or failing to perform a legal act for the employer.
 - **Example:** Firing an employee for performing some public duty (showing up to jury duty), for exposing illegal conduct (such as reporting violation of some law to the employer or government agency), or exercising her rights as a US or state citizen (such as voting) are all against public policy.
- **Implied Contract Exception (Good Cause Exception)** - Some states see the employer employee relationship as a contract that cannot be undone without specified or “good cause”. The terms of the contractual relationship consist of any representations or assurances made by the employer prior to or during the term of employment.
 - **Example:** If an employer provides an employee handbook to a new employee, the provisions in the handbook may be considered part of the contractual relationship. Often, these handbooks will outline a procedure for performance review, discipline, and discharge of the employee. An employer who fails to live up to these obligations prior to discharging an employee could be liable.
- **Good-Faith and Fair-Dealing Exception** - Some states impose upon the employer a duty to exercise good faith and fair dealing with regard to all employees. This doctrine, to varying degrees, means that an employer must treat an employee fairly in the decision to fire her. This generally means that an employee violates these duties by firing an employee without due cause of justification.

As stated above, these doctrines exist to varying degrees in all states. A pure, at-will state will not recognize or recognize these principles to a lesser extent.

- **Discussion:** How do you feel about the at-will employment doctrine? Is it fair to employees and employers? Why or why not? Why do you think states vary as to the at-will employment exceptions they recognize? Can you think of any other exceptions to the at-will doctrine you believe should exist?
- **Practice Question:** Heather is a consultant and joins AVG, a local consulting firm in Chicago. She does not sign an employment contract and is considered an at-will employee. After working for the company for two years, she is transferred to work under a new boss. The new boss does not like that Heather's involvement in a local social club and decides to fire Heather. What do you need to know about state law and Heather's employment relationship to determine if she has a cause of action against AVG for wrongful termination?
- **Resource Video:** <http://thebusinessprofessor.com/at-will-employment-state-employment-laws/>

EMPLOYMENT LAWS

3. What are the major employment laws?

There are many federal and state employment laws. Federal laws controlling a particular type of employer conduct set minimum standards for conduct. States may pass laws that place additional requirements on employers, so long as these laws do not conflict with or hinder the execution of federal laws. That is, if not in conflict, the state laws may be more restrictive upon employer practices than similar federal statutes. The major federal laws controlling the employer-employee relationship are as follows:

- Internal Revenue Code
- Fair Labor Standards Act
- Family Medical Leave Act
- Worker Readjustment and Retraining Act
- Uniformed Services Employment and Reemployment Rights Act
- Employee Retirement Income Security Act
- Worker's Compensation Act
- Occupational Safety and Health Act
- Consolidated Omnibus Budget Reconciliation Act
- Health Insurance Portability and Accountability Act
- Affordable Care Act
- Immigration Reform and Control Act
- State Laws

The Department of Labor may also require employers that meet certain criteria to prominently display information about employment laws and employee rights.

- *Note:* Laws prohibiting discrimination in the workplace are discussed in detail in a separate topic section.

4. What tax and other compensation withholding requirements do the state and federal governments place on employers with regard to employees?

Employers are obligated to comply with statutes and IRS regulations regarding the withholding of:

- *Income Taxes* - Employers have an obligation to withhold income taxes from employee compensation based upon an employee's election. The employer then submits the withheld funds to the IRS and state taxing authority on behalf of the employee each month.
 - *Note:* The employee elects an amount to be withheld on IRS form W-4. This is done by indicating the number of employee claimed dependents and indicating any desire for additional withholdings.
 - *Payroll Taxes* - Employers are required to withhold Medicare and Social Security taxes from the employee's salary pursuant to the Federal Income Contributions Act (FICA). The employer combines these withheld funds the employer's FICA tax obligations for the employee and submits the funds to the IRS each month.
 - *Note:* Self-employed individuals must withhold self-employment taxes, which consist of the employer's contribution and employee's FICA tax responsibilities.
 - *Federal Unemployment Tax Act (FUTA) & State Unemployment Tax Act (SUTA)* - Employers are required by state and federal law to pay for unemployment insurance to cover events in which an employee loses her employment for any covered reason. FUTA is common to all employers across the United States. SUTA varies among the states. Some states allow an employer to be self-insured; while other states require employers to pay into a private or state-funded insurance plan or policy.
 - *Note:* FUTA and SUTA taxes do not apply to self-employed individuals.
 - *Worker's Compensation* - Worker's Compensation is a state law regime that requires employers to maintain insurance that provides wage and benefit replacement in the event an employee is injured in the scope of her employment. Federal worker's compensation laws, primarily the Federal Employee Compensation Act, provide the same protections to federal, non-military employees. Workers compensation covers lost wages, medical expenses, disability payments, and costs associated with rehabilitation and retraining.
 - *Note:* Application of worker's compensation laws varies from state to state based upon the number of employees. Also, states may offer state-provided plans or allow for private worker's compensation plans.
- **Discussion:** Why do you think state and federal governments have the obligation to withhold taxes from employee compensation? Do you agree with this system? Why or why not? What are the advantages and disadvantages of this type of system?
 - **Practice Question:** Isabelle starts a business and hires her first employee. What are her obligations under state and federal law with regard to withholding from her employee's compensation.
 - **Resource Video:** <http://thebusinessprofessor.com/employer-withholding-requirements/>

5. What is the "Fair Labor Standards Act"?

Overview

The Fair Labor Standards Act (FLSA) is a law administered by the Wage and Hour Division of the Department of Labor. The FLSA places limitations and requirements on the rate and method of pay for public and private employees who are covered by the law. Specifically, it lays out the national minimum wage, age limitations, and over-time pay requirements for employees. Currently the federal minimum wage is \$7.25 per hour, with a higher rate of 1 and ½ times an employee's hourly wage for each hour worked beyond 40 hours in a given work week. The minimum wage law does not apply to certain classes of employees or certain types of jobs. Further, there are other exemptions based on ancillary benefits and privileges provided to the employee, such as meals, insurance, retirement benefits, etc. The FLSA generally prohibits minors under the age of 14 years from working for compensation outside of a family business or agriculture. It further limits the number of hours that an adolescent between the ages of 14 and 16 can work in a given workweek. It may also proscribe employing minors below the age of 18 years in certain positions (such as dangerous positions or positions charged with handling controlled substances or alcohol).

- *Note:* The FLSA applies to hourly employees. Salaried employees may, in some instances, work a number of hours for a rate of pay that violates minimum FLSA requirements. The rate of salaried pay for employees who are managers or supervisors that exempts these employees from overtime pay is \$47,476.

Enforcement

The FLSA primarily provides for civil causes of action by employees or the Department of Labor against employers who violate the provisions. The FLSA also provides for an optional complaint system whereby the Department of Labor will review the complaint and determine whether to seek action or redress. Plaintiffs may file an FLSA lawsuit against an employer in federal or state court in the jurisdiction in which the employer is organized or carries on business. Any suit must commence within 2 years from the date of the claimed violation of the law. A plaintiff may seek damages in the form of any lost or back pay associated with the violation. Further, the court may assess a penalty in the amount of any actual damages, plus court costs and reasonable attorney's fees.

- **Discussion:** Why do you think the Federal Government seeks to establish standards for employee work hours and compensation? Should the Federal Government (or state governments) regulate this area? Why or why not?
- **Practice Question:** Mark runs a small business with his business partner, Frank. His daughter, Amy, wants to make some extra money and asks her father for a part-time job. What information do you need to know about this situation to determine if Mark could face liability under the FLSA if he employs Amy?
- **Resource Video:** <http://thebusinessprofessor.com/fair-labor-standards-act/>

6. What is the “Family Medical Leave Act”?

Overview

The Family Medical Leave Act (FMLA) was passed to provide covered employees (both male and female) with time away from work in the event of medical necessity. Specifically, covered employees can take up to 12 weeks of unpaid leave from work during any 12-month period in any of the following situations:

- *Health Conditions* - The covered employee is unable to work due to a serious health condition;

- *Family Members* - An immediate family member of the employee has a serious health condition that requires the employee's care;
 - *Note:* An immediate family member of a covered employee includes a spouse, minor child, or individual over whom the employee has legal guardianship (such incapacitated individuals).
- *Birth* - Upon the birth of a newborn child of the employee;
- *Adoption/Guardianship* - Upon acquiring physical guardianship of child pursuant to adoption or foster care; or
- *Military Injury* - A family member is injured pursuant as part of military activity or medical necessity arises pursuant to notice of a family member's pending deployment.

The employer cannot take any negative actions against the employee for taking the unpaid leave and must allow the employee to return to her same job at the end of the period. The employee does not have to take the entire time off. Further, the period is independent of any paid time off or vacation time accrued and taken by the employee.

Covered Employees and Employers

When determining whether the FMLA applies to an employer or covers a particular employee, there are two separate tests. First, the FMLA applies to employers employing:

- *50 + Employees* - The employer must employ 50 or more part or part-time or full-time employees,
- *Daily Employees* - The 50 or more employees only includes those who work each working day (whatever days of the week that may be),
- *20 + Weeks of Employment* - The 50 + employees must work for 20 or more weeks during the current or preceding calendar year.

If any of the above elements are missing, the FMLA does not apply to the employer. Second, the FMLA provides benefits to employees who meet the following conditions:

- *12-Month Period* - The employee must have worked for the employer for at least 12 months;
 - *Note:* The 12-month period does not have to be consecutive. That is an employee can work for a time, stop, and then restart. The question is whether the employee has worked for a total period of 12-months.
- *1250 + Hours* - The employee must have worked at least 1250 hours during the proceeding 12 months; and
 - *Note:* Look back 12 months and see if the employee has a combined 1250 hours.
- *50 + Employees* - The employee must work at a location where at least 50 employees work.
 - *Note:* This requirement excludes employees in satellite offices for larger companies.

If all of these elements are present, an employee of a covered employer is eligible for FMLA benefits. The onus is on employers to notify eligible employees of their eligibility for such leave and to document any request for leave by the employee. The employer may require a medical certification that a qualifying event has occurred prior to granting the leave.

- **Discussion:** How do you feel about each of the requirements for an employer to be regulated by the FMLA? How do you feel about the requirements for an employee to be covered? Why do you think the law allows for these employer and employee exemptions? Do you agree with these limitations? Why or why not?
- **Practice Question:** Sandra works for ABC Corp. She recently learned that she is pregnant. She knows that she will want to take some time away from work after having her baby to build the mother-child bond. She has 5 weeks of paid leave and 1 week of sick leave available. What do we need to know to determine how much time Sandra could possibly take off from work?
- **Resource Video:** <http://thebusinessprofessor.com/family-medical-leave-act-fmla/>

7. What is the “Worker Adjustment and Retraining Act”?

Overview

The Worker Adjustment and Retraining Act (WARN Act) was passed to protect employee rights and interests in the event of large-scale layoffs as a result of operational closures by businesses (such as plant closure). The law provides that covered employers must provide adequate notice (a minimum of 60 days) to employees in the event of such a pending layoff. The WARN Act is applicable to employers with 100 or more part-time and full-time employees. A part-time employee is one who works a minimum 20 hours per week. If the WARN Act applies to an employer, all employees, including hourly and part-time employees, must be given notice.

Employee Protections

The provisions of the WARN Act are made to protect individuals who will suffer a loss of employment as a result of the layoff or operational closure. Loss of employment for purposes of the WARN Act includes:

- termination of employment,
- layoff exceeding 6 months, or
- a reduction in employee’s work time of more than 50% in each month for 6 months.

The broader definition of loss of employment prevents employers from skirting the rules through structural shifts that have the same effect as immediate termination. Any of the following situations qualify as mass layoff events triggering WARN Act notice provisions:

- **Plant Closing** – This includes closing an employment site resulting in loss of 50 employees within a 30-day period. This applies also if there are more than one plant location closings for the business that combine to equal the number.

- *Mass Layoff* – This is when 500 or more employees lose their job within a 30-day period, or when more than 50 employees lose their job and it comprises 33% of the employer's total workforce. Employees that work less than half time do not count toward the 50-employee requirement.

Failure to comply with the provisions of the WARN Act allows for a cause of action by affected employees. The limitations on what constitutes a mass layoff prevents the WARN Act from applying to routine firings and operational downsizing across a business.

Enforcement

There is no governmental agency cause of action, investigation, or other enforcement of the WARN Act provisions. Employees protected by the WARN Act must bring a civil action for violation of the statute. Under the law, these employees are entitled to pay for 60 days from receipt of notice. If notice is not given 60 days prior to the operational closure, the employee receives pay past the date of closure (or layoff) until reaching the 60-day requirement. Further, failure to notify local government in accordance with the provisions of the WARN Act may lead to court-ordered fines up to \$500 per day for each day of violation (along with court costs and attorney's fees).

- *Note:* The employer may generally avoid penalties if the entire amount owed to employees is paid within 3 weeks of the closing.

Exceptions from WARN Act Provisions

A few limited exceptions to the notice provisions of the WARN Act exist that allow an employer to give less than 60 days notice to protected employees. The primary exceptions are as follows:

- *Strikes* - An employee may execute a mass layoff and rehiring to replace employees who are striking, so long as such actions do not violate other labor laws.
- *Refinancing* - Exception to notice may be applicable if an entire business is failing and giving the required notice could disqualify or cause the business to not be able to secure financing to continue operations.
- *Force Majeure* - If a natural disaster disrupts the business's operations leading to a mass layoff.

These exceptions provide for fairness to the employer in the event of happenings that are beyond its control and the equities justify limiting the notice provided to protected employees.

- **Discussion:** Why do you think the government requires notice of a pending mass layoff or plant closing? Do you agree with the objectives of this law? How do you feel about the exemptions from notice?
- **Practice Question:** ABC Corp is considering a consolidation of manufacturing sites to cut costs. It currently has 5 manufacturing facilities. ABC is considering closing the two smallest facilities and ramping up production in the three larger facilities. The downside of this plan is that lots of employees will be let go. What do you need to know about each facility to determine whether the WARN Act requires 60-days notice of the pending foreclosure?
- **Resource Video:** <http://thebusinessprofessor.com/worker-adjustment-and-retraining-act/>

8. What is the “Occupational Safety and Health Act”?

Overview

The Occupational Safety and Health Act (OSHA) was passed to regulate safety conditions for employees in the work places of private employers with 20 or more employees. The Occupational Safety and Health Administration is the federal agency charged with overseeing OSHA compliance. The agency develops rules and regulations concerning workplace safety, inspects business premises, fields and investigates complaints of hazardous conditions, and may take administrative and judicial actions for failure to comply.

- *Note:* Certain types of industries are exempt from regulation under OSHA due to regulation under other federal statutes. OSHA also allows for state programs that regulate industries pursuant to OSHA guidelines, which may also cover state or public employees. The state guidelines may be stricter and place additional requirements on the business beyond the OSHA guidelines.

Employer Requirements

The primary employer requirements under OSHA are as follows:

- *Safe Work Environment* - Employers must "furnish to each of his employees employment and a place of employment which are free from recognized hazards that are causing or are likely to cause death or serious physical harm to his employees."
- *Notification* - Employers must inform employees of certain potential dangers of the workplace to which they are exposed.
- *Right to Complain* - Employees may report or file a complaint with OSHA regarding any non-compliance with OSHA provisions.
- *Retaliation* - Employers cannot retaliate against employees for exercising their rights or protections under OSHA.

Enforcement

Employees may file an OSHA complaint against the employer. Complaints alleging an imminent danger in the workplace are likely to result in an OSHA inspection. If there are issues of retaliation for filing an OSHA complaint, employees must file a retaliation complaint within 30 days of the violation. In the event of any OSHA violations, the OSHA inspector may refer the matter to the Department of Labor to investigate and potentially file suit against the employer. Employees cannot bring an action directly against the employer under OSHA.

- **Discussion:** Why do you think the Federal Government passed health and safety regulations for private company workers? Do you think these regulations are necessary? Why or why not? Do you believe the employee protections are sufficient? Why or why not? Should an employee be able to bring a private OSHA compliance action? Why or why not?

- **Practice Question:** ABC Corp manufactures steel. The manufacturing facility contains smelters that are very hot to the touch and large machines with moving parts. What are the potential OSHA compliance issues ABC Corp may encounter?
- **Resource Video:** <http://thebusinessprofessor.com/occupational-safety-and-health-act/>

9. What is the “Employee Retirement Income Security Act”?

Overview

The Employee Retirement Income Security Act (ERISA) was passed to protect employees’ rights with regard to pension, retirement, and other benefit plans offered or provided by employers. Portions of the plan are administered by the Department of Labor, the Internal Revenue Service, and the Employee Benefits Security Administration. Important provision of ERISA include:

- *Disclosure and Reporting* - Title I establishes disclosure and reporting requirements for sponsors of pension and benefit plans.
- *Fiduciary Standards* - The Act establishes fiduciary standards for administrators of pension and benefit plans.
- *Insurance Benefits* - Title IV requires certain employers to pay premiums to the Pension Benefit Guaranty Corporation, which is an insurance fund to secure certain retirement benefit plans.

Importantly, ERISA does not require employers to offer any particular benefits or pension plan; rather, it applies the above rules to employers who voluntarily provide such plans to employees.

Types of Pension Plans

There are two basic categories of pension plan covered under ERISA.

- *Defined Benefit Plan* - A defined benefit plan provides recurring payments to an employee upon retirement. The amount of payment is calculated using a formula based upon the years of service and the employee’s salary during a specified period prior to retirement. The payments generally continue for the remainder of the employee’s life.
- *Defined Contribution Plan* - A defined contribution plan allows an employee to make contributions to a retirement account. The employer generally matches a portion of these contributions. The fund is invested to allow growth (often on a tax-free basis) until the time of retirement. The employee may then withdraw any amount of the funds at any time. Early withdrawal of retirement funds generally results in a penalty to the employee. The funds are taxed at the employee’s marginal tax rate at the time of withdrawal.

Employee Protections & Employer Requirements

The three primary protections afforded employees with defined benefit plans are as follows:

- *Funding* - An employer must adequately fund defined-benefit plans. Employers typically employ the services of actuaries to calculate the required amount of funding to meet future projected pension payment demands.

- *Vesting* - A pension plan must vest ownership in the employee within a specified time. That is, the employee becomes entitled to receive benefits under the pension plan after a specified period. The percentage or rate of benefit entitlement is calculated as a percentage of full benefits based on the period or length of employment.
- *Guarantee* - Employees pay premiums to the Pension Benefit Guaranty Corporation to insure the defined benefit plan against loss.

- **Discussion:** Why do you think the government heavily regulates retirement accounts or plans and the companies that sponsor them? What are some arguments against this form of regulation? Do you believe these provisions are sufficient to achieve the government objectives? Why or why not?
- **Practice Question:** ABC Corp decides to offer a retirement plan for its employees. The plan provisions will apply equally to everyone in the company. Can you write a short memo explaining the difference between a defined benefit and defined contribution pension plan? Also, can you explain the primary requirements that the employer must ascertain to protect employee interests in the plan?
- **Resource Video:** <http://thebusinessprofessor.com/employee-retirement-income-security-act-erisa/>

10. What is the Consolidated Omnibus Budget Reconciliation Act?

Consolidated Omnibus Budget Reconciliation Act (COBRA) was passed to protect employees from the loss of healthcare coverage in certain situations. Specifically, it allows an employee or an employee's dependent who is a beneficiary under an employee's healthcare plan to maintain health coverage when a qualifying event causes a loss of coverage. COBRA applies to employers with 20 or more employees.

- *Note:* Some states have passed "mini-COBRA" statutes to help an employee maintain coverage when the federal law does not apply.

Qualifying Events - A qualifying event is defined as:

- Death of a covered employee;
- Voluntary or involuntary termination, layoff, strike, reduction of hours, etc.;
- Divorce from a defendant beneficiary; or
- Dependent minor reaches an age of non-coverage under the employee's plan.

Situations where an employee remains employed but voluntarily cancels healthcare coverage or when an employee loses coverage for not paying are not qualifying events.

Period of Employee Protection - COBRA allows the employee to purchase continuation coverage for the following periods:

- Up to 18 months under no extenuating circumstances,
- 29 months if a person is disabled, and
- 36 months in case of divorce or widow(er).

The continued coverage can be equal to the terminated plan or any form of lesser coverage. COBRA, however, does not allow for an increase in coverage.

- **Discussion:** Why do you think the Federal Government is interested in protecting employee health coverage? How do you feel about additional state regulations in this area? Do you think the list of “qualifying events” is sufficiently broad to achieve these objectives? Why or why not? Is the time period for benefit protection sufficient? Why or why not?
- **Practice Question:** Marco works for ABC Corp., a large employer in New York state. Marco pays for health coverage for himself and his wife, Julie, under a plan that is sponsored by ABC Corp. After several years of marriage, Marco and Julie decide to divorce. After the divorce, Julie will no longer be an eligible beneficiary on Marco’s health plan. What benefits does COBRA offer to Julie?
- **Resource Video:** <http://thebusinessprofessor.com/consolidated-omnibus-budget-reconciliation-act-cobra/>

11. What is the “Health Insurance Portability and Accountability Act”?

The Health Insurance Portability and Accountability Act (HIPAA) is the primary law governing the protection of health information by employers and healthcare providers. Notably, it prevents providers of health insurance or group health plans from discriminating against individuals who transfer from one insurance plan or provider to another. If an employee leaves or is discharged from employment, HIPAA allows that employee to enter into a subsequent health plan with a new employer without having any elements of her prior coverage denied for preexisting conditions. The employee, however, must maintain coverage during the period of transition. This is often done by purchasing interim insurance under COBRA. If an employee leaves an employer without continuing insurance from another provider, the new insurer can only exclude pre-existing conditions arising during the previous 12 months (18 months if the employee is a late enrollee). HIPAA also protects the new employees from extensive hikes in premiums. In such a situation, the insurer cannot charge more for adding an individual to the plan because of health status, medical condition or history, genetic information, or disability. The insurer can, however, charge more for the entire plan – which is paid for by the employer or group of insured employees.

- **Note:** The Affordable Care Act in 2014 (ACA) makes numerous changes to the rules regarding insurance and pre-existing conditions. For example, ACA requires all US citizens to purchase insurance either privately or through their employers. Failure to do so results in a fine or tax penalty. As part of this mandate, an insurer cannot deny an individual coverage for pre-existing conditions. These rules provide employees with protection beyond that provided by HIPAA.

- **Discussion:** Why do you think the Federal Government seeks to regulate health insurers in the provision of health benefits under employee health plans? How do you feel about the extent and nature of protections afforded under

HIPAA and COBRA collectively?

- **Practice Question:** Ervin is an employee at ABC Corp, which sponsors his individual health plan. Ervin decides to leave ABC Corp and go to work for 123 Corp. Ervin is a diabetic and has suffered numerous ailments related to his medical condition. What do you need to know about Ervin's move from ABC Corp to 123 Corp to determine whether Ervin could be prejudiced by the move?
- **Resource Video:** <http://thebusinessprofessor.com/health-insurance-portability-and-accountability-act-hipaa/>

12. What are “Worker’s Compensation” laws?

Worker’s Compensation laws are either state or federal statutes designed to protect employees and their families from the risks of accidental injury, death, or disease resulting from their employment. It is a form of insurance for the employee that is paid for by the employer. Specifically, if an employee suffers an accidental injury in the course of performance of her work obligations, the administering worker’s compensation board or commission will pay the employee a pre-determined percentage of her wages during the period of temporary disability. The governing commission also administers claims and makes determinations as to the validity of claims for injuries allegedly suffered in the course of employment.

Worker’s compensation laws protect employers as well as employees. It assures that an employee will be compensated in the event of a work-related injury. This protects the employee from the consequences of working for an insolvent employer that may not be able to continue paying the employee or that may go out of business in the event the employee sues the employer. Worker’s compensation payments are generally the exclusive remedy available to the injured employee. That is, the employee cannot sue the employer unless the conduct of the employer that injured the employee was intentional.

- **Note:** The Federal Employee’s Compensation Act (FECA) establishes a worker’s compensation scheme for federal employees. The FECA program is administered by the Office of Workers’ Compensation Programs (OWCP). All states have statutes establishing similar plans and state-run commissions or boards to administer the program. Some states allow employers to self-insure for worker’s compensation claims, while other states require employers to make recurring payment to a state-funded, worker’s compensation plan. The premiums paid by employers are the funds used to compensate injured employees making worker’s compensation claims.
- **Discussion:** How do you feel about federal and state regulation of injuries employees suffer while on the job? Are these regulations justified? Why or why not? Who enjoys a greater benefit, employees or employers? Why?
- **Practice Question:** Martha is an employee of ABC Corp. She is walking down the stairs in the corporate office, trips, and breaks her ankle. Because of the nature of her work requires standing and walking, she is unable to work for several weeks. What benefits do worker’s compensation laws provide to her and her employer? What are the disadvantages to Martha?
- **Resource Video:** <http://thebusinessprofessor.com/workers-compensation-laws/>

13. What are the “employee verification laws”?

The primary employment law concerning employee verification is the Immigration Reform and Control Act of 1986 (IRCA). The IRCA requires that all employers complete and retain Form I-9 Employment Eligibility Verification forms for each individual they hire in the US. These forms seek to verify that individuals are legally permitted to hold employment within the United States based upon their citizenship or immigration status. Generally, an employee must be a citizen, lawful permanent resident, or holder of a work visa to qualify to hold employment. The employer is required to examine the employment eligibility and examine the documents an employee presents to determine whether the document(s) reasonably appear to be genuine. The employer must retain these forms and information for 3 years after the date of hire or for one year after employment is terminated, whichever is later.

- *Note:* The new, federal E-verify program makes the I-9 employee verification process easier. An employer can enter an employee's pertinent information and receive verification of employment eligibility.
- **Discussion:** How do you feel about these federal regulations require verification of employment eligibility? Who or what is the government attempting to deter with this regulation? Do you believe these regulations are effective? Why or why not?
- **Practice Question:** Gary is from Russia and recently moved to the United States to attend school. After graduating, he wants to remain in the United States and find employment. He approaches ABC Corp about a posted job. What procedure will ABC Corp undertake in verifying that Gary may legally work in the country?
- **Resource Video:** <http://thebusinessprofessor.com/employment-verification-laws/>

14. What “worker privacy laws” apply to the workplace?

Two primary federal acts provide for rights of privacy of employees with regard to their personal communications.

- *Electronic Communication Privacy Act (ECPA)* - The ECPA prohibits the recording or monitoring of employee's private conversations without the employee's knowledge. That is, an employee has an expectation of privacy with regard to her personal communications in the workplace. As such, an employer cannot infringe upon an employee's privacy by monitoring those communications. There are, however, several glaring exceptions to this rule.
 - *Business Equipment* - An employee has no right to privacy when employing the employer's equipment to communicate.
 - *Example:* An employer can monitor employee communications, such as emails, chat logs, search history, etc., if done on a business computer, phone, copier, etc.
 - *Security* - An employer may undertake reasonable monitoring of employee conversations if done for purposes of security or operational quality. The best manner to comply with this law is to disclose to employees any monitoring of communications.
 - *Example* - An employer may have surveillance cameras in the workplace, but the ability to record audio is limited.

- *Employee Polygraph Protection Act (EPPA)* - The EPPA prohibits private employers from using a polygraph while screening job applicants. That is, an employee or prospective employee cannot be compelled to submit to a polygraph as a condition of employment. There are certain exceptions for current employees who may be the subject of inquiry or personnel in sensitive industries.
 - *Example:* In some instances, private security firms and firms that manufacture or sell controlled substances may subject employees or applicants to polygraph examination based upon the sensitive nature of the position.
- *Drug Testing* - Some states place limits on the ability of an employer to conduct drug tests of employees. These laws generally do not apply to job applicants.

- **Discussion:** How do you feel about the federal or state governments regulating the ability of private businesses to infringe upon the privacy of workers? Are these provisions too restrictive or not protective enough of employees? Why? Do you believe that these laws accomplish the underlying objectives?
- **Practice Question:** Erin is applying to work as a government contractor for Halliburton oil consulting. This position will require her to embed in US military units to negotiate oil contracts in war-torn, Middle-Eastern countries. Does Halliburton have the ability to require Erin to submit to a polygraph during the application process or once she is an employee?
- **Resource Video:** <http://thebusinessprofessor.com/workplace-privacy-laws/>

LABOR RELATIONS AND LAWS

15. What are “labor laws”?

Labor laws control the relationship between employers and employees with regard to such things as benefits, obligations, and bargaining rights. Labor law is generally grouped together with all employment laws, but it is frequently used to refer to the group of laws affecting collective bargaining rights of and unionization by employees. Numerous federal and state laws govern labor relations. There are also specific laws designated to govern the collective bargaining and unionization rights of public sector employees of the federal and state governments.

- **Discussion:** Why do you think state and federal governments are concerned with the rights of employees to organize and collectively bargain with employers? What are the arguments for and against regulating this sort of activity?
- **Practice Question:** What is the difference between employment laws and labor laws?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-labor-laws-2/>

16. What are the major federal labor laws?

- *Norris-LaGuardia Act* - This law prevents courts from issuing injunctions (stop orders) to individuals or groups of striking employees.
- *National Labor Relations Act* (or *Wagner Act*) - This law takes affirmative steps to allow unionization of employees.
- *Taft-Hartley Act* - This law regulates a wide range of employer-employee conduct and is administered by the National Labor Relations Board.
- *Labor Management Reporting and Disclosure Act* - This law took steps to protect the rights of union members with regard to union actions.

As stated above, states frequently pass laws that govern labor relations between employers and employees. These laws cannot conflict with federal law, but they may regulate labor relations in a way that is more restrictive than federal law.

- **Discussion:** What do you notice about the evolution of labor laws from the simply descriptions above? Why do you think the legal approach to labor relations has taken this course?

17. What is the “Norris-LaGuardia Act”?

The Norris-LaGuardia Act of 1932 was the earliest federal law broadly protecting the rights of employees to organize and bargain collectively. Section 2 states the Act’s purpose is to protect the individual worker’s right to organize. More specifically, the Act prohibits certain practices by federal courts with regard to collective bargaining rights. Early in the development of labor-relations law, courts would issue injunctions (orders to stop doing an activity) against individuals and collective groups of employees that prohibited certain collective bargaining practices, such as picketing or striking. Individuals or groups who engaged in these practices could be arrested and fined for contempt of a court order. In response to this judicial activity, Section 4 of the Act limited the ability of a federal court from enjoining the following activity:

- striking or discontinuing work in protest;
- unionizing, organizing, or becoming a members of a group dedicated to collective labor relations;
- receiving or issuing unemployment benefits or pay as part of a strike;
- offering legal assistance to those involved in a labor dispute (including court representation);
- picketing or other public displays support or dissension for labor practices (except as where such publicity executes fraud on the public); and
- assembling privately or publicly (when done peacefully).

Section 7 of the Act outlined the specific procedures that a federal court must follow when issuing an injunction (or a temporary restraining order) prohibiting any of the above labor practices. Basically, the court may issue a temporary

restraining order for a limited number of days. The court must then hold a hearing during which each party (labor and employer) can present evidence as to why the conduct at issue should be allowed or enjoined. This procedure is in line with the rules of civil procedure governing temporary restraining orders in federal and state courts. The limits placed on the ability of employers to request such injunctions in federal court had the effect of limiting the ability of employers to thwart collective bargaining practices through the court.

- *Note:* Employers can, however, still bring actions seeking injunctions in state courts. Also, federal common law allows the employer to seek injunctions in federal courts if a collective bargaining agreement between employers and the organized labor allows for a grievance procedure through arbitration.
- **Discussion:** Do you think the Federal Government was justified in regulating the practice of granting injunctions against collective bargaining practices? Why or why not? Do the regulations go far enough in protecting employees? Why or why not? Does the ability of state courts to hear an injunction request thwart the intent behind the federal law? Should a contract arbitration clause in a collective bargaining agreement between employer and union or organized labor affect the ability of a court to hear an injunction against the above-referenced activities? Why or why not?
- **Practice Question:** Donna is an employee of ABC Corp and president of the employee union. The union is in a dispute with ABC Corp and has decided to stage a picket and protest. What right does ABC have to seek an legal order (injunction) against the planned picket and demonstration?
- **Resource Video:** <http://thebusinessprofessor.com/labor-union-laws-norris-laguardia-act/>

18. What is the “National Labor Relations Act”?

The National Labor Relations Act of 1935 (NLRA), also known as the Wagner Act, was passed in 1935 to strengthen the protections afforded private-sector employees to organize or bargain collectively. The fundamental premise behind the Norris-LaGuardia Act was to allow employers and labor organizations to work out their disputes through negotiation and existing legal channels. The NLRA adopted the principle that organized labor groups could not successfully protect its interest in conflicts with employers without additional government protections. The major provisions of the NLRA protecting labor are as follows:

- *Section 7:* “Employees shall have the right to self-organization, to form, join or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection.” Under this provision, an employee is allowed to undertake a boycott if:
 - there is a labor dispute between employees and employer that is made public, and
 - the boycott does not disparage the employer’s product or service.
- *Section 8(a):* Provides numerous limitations on an employer’s ability to thwart collective bargaining or worker organization efforts. The relevant subsections are as follows:
 - Subsection (1) prohibits a number of practices by employers designed to interfere with employees

exercising their Section 7 rights.

- Subsection (2) prohibits companies from forming unions among themselves.
- Subsection (3) prohibits an employer from discriminating against employees for taking part in Section 7 protected activity.
- Subsection (5) prohibits an employer from refusing to recognize and negotiate through an organized group's duly appointed representative.

The provisions of the NLRA are administered by the National Labor Relations Board (NLRB). Employees alleging that their rights under the NLRA are violated by their employer may file an action with the NLRB within 6 months of the violation. Unions may file complaints pursuant to section 8(a)(5). The complaint must explain the alleged discriminatory conduct and how it violates rights protected by the NLRA. If the NLRB believes there is a violation, it will issue a complaint against the employer. The matter will then go before an administrative law judge for resolution.

- **Discussion:** What do you think the Federal Government was attempting to accomplish in passing the NLRA? Why do you think the NLRA vested regulatory authority to oversee the Act in the NLRB? What do you think is the significance of the specific employer activity prohibited under the NLRA?
- **Practice Question:** ABC Corp is a large corporation with lots of employees. In recent months, there has been lots of rumors that a significant number of employees are disgruntled with work condition and are considering forming a union. ABC wants to fight the unionization of the employees for a number of reasons. ABC asks your advice on what conduct is prohibited in attempting to dissuade unionization. Can you explain to ABC the prohibited practices?
- **Resource Video:** <http://thebusinessprofessor.com/national-labor-relations-act-of-1935/>

19. What is the “Taft-Hartley Act”?

The Taft-Hartley Act of 1947 is a group of amendments to the NLRA. Since the passage of these amendments, the NLRA is commonly known as the Labor Management Relations Act (LMRA). Though the name is modified, the provisions of the NLRA make up the core of the LMRA, which is still administered by the NLRB. The major additions of the Taft-Hartley Act include:

- *Right to Work Laws* - Perhaps most notable addition of the Taft Hartley Act was Section 14(b). This provision allows states to pass laws prohibiting mandatory membership in a union or mandatory union dues for an employee. These state laws are known as “right-to-work” laws. These statutes are a huge detriment to unions, which depend on employee dues. Approximately 25 states have passed these types of laws.
- *Unfair Discharge* - The Taft-Hartley Act added Section 8(b) to prohibit additional unfair labor practices by employers and employees. Section 8(b)(2) prohibited union employees from causing an employee to be fired for any union-related reason.
- *Employer Protections* - Many of the provisions of the Taft-Hartley Act offer protections to employers, as well as

employees. Notably, Section 8(b)(7) prohibits employees of one company from picketing on behalf of the employees of another company (known as a “secondary boycott”). Another example is Section 301, which recognizes a collective bargaining agreement as a valid contract. Also, employers may sue a unionized group for failure to comply with the terms of a previously executed agreement. So, if an agreement contains provisions prescribing a procedure for dealing with disputes (such as an arbitration clause) or strikes in violation of a no-strike clause, the employer may seek an injunction against the strike and recover any monetary damages suffered as a result.

- **Discussion:** Do you notice a different tone and purpose behind the Taft-Hartley amendments in comparison to the objectives of the NLRA? Why do you think the Federal Government took these steps to curtail the protections granted organized labor in existing law?
- **Practice Question:** State A is concerned that union activity is likely to cause large corporations that resent union activity to locate in other states. State A passes a “right-to-work” law that prohibits unions from mandating all corporate employees pay union dues. ABC Corp is located in State A and has an active union. ABC is concerned that the union is unduly pressuring employees to join the union, pay union dues, and are threatening negative actions if the employee fails to comply. What are the ABC and employee rights in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/labor-management-relations-act-taft-hartley-act/>

20. What is the “Labor Management Reporting and Disclosure Act”?

The Labor Management Reporting and Disclosure Act of 1959 (LMRDA), also known as the Landrum-Griffin Act, was passed to provide greater protections to individual union members. The prominent provisions of the LMRDA are as follows:

- *Section 101(a)(1)* - This provision allows union members the right to vote for union representatives, to nominate candidates, and to take part in union meetings. These rights are "subject to reasonable rules and regulations in such organization's constitution and bylaws." Depending upon what the union constitution provides for member rights, general members must have equal rights. If, however, the constitution withholds specific authority to a group or board of individuals, the Act does not grant this right or authority to all members.
- *Section 101(a)(2)* - This provision protects the right of each member to meet with or assemble with any other or all members of the union. It also protects freedom of expression (including criticism or dissension) with regard to union activity.
- *Section 101(a)(3)* - This provision protects union members from being subject to raises in union dues without first going through established procedures.
- *Section 101(a)(4)* - This provision protects union members from retribution or discharge for bringing suit against the union or any of its members. The member must generally follow any internal or administrative procedures in place to resolve union disputes prior to filing suit.
- *Section 101(a)(5)* - This provision provides due process rights for union members in disciplinary actions. Except for instances of non-payment of dues, members cannot be subject to disciplinary action by the union without being given notice of the charged misconduct, a reasonable time to prepare for the proceeding, and a formal

hearing before the union's board or adjudicative body.

- *Title IV* - Title IV of the Act places requirements on union elections. Similar to corporate board procedures, it allows candidates for election the right to inspect certain documents, to obtain membership lists, and the right to campaign or advertise equally in union newsletters. Failure to follow these rules can cause the DOL to invalidate an election.
- *Title V* - Title V of the Act places fiduciary standards upon union officers. Particularly, officers must avoid self-interested transactions at the expense of the union and report any dealings (such as financial expenditures) to the members.

The LMRA allows union members to bring an action in federal court for any violations of these provisions. This is subject to any requirements in the constitution to first pursue administrative remedies for disputes.

- **Discussion:** What do you think was the Federal Government's purpose in passing greater protections for individual union members as against the union organization? Do you think these provisions are warranted or effective? Can you think of any other protections that union members should be afforded as part of their union membership?
- **Practice Question:** William is an employee of ABC Corp and a member of the worker's union. He has been very outspoken against the union's stance on new hiring salaries. William believes that the salary system should be more tiered in favor of experienced employees as apposed to affording new employees such extensive benefits. Is William protected if the union (or its members) takes any negative actions against him for his position?
- **Resource Video:** <http://thebusinessprofessor.com/labor-management-reporting-and-disclosure-act/>

TOPIC 16: EMPLOYMENT DISCRIMINATION

Overview

Employment discrimination is a specific area of employment law. Numerous federal or state statutes provide for “protected classes” of individuals based upon innate characteristics. Employment discrimination law protects employees who fit into these classes from discrimination by their employer based upon these characteristics. This chapter defines the purpose of employment discrimination law and the role of the federal and state governments in its enforcement. It then identifies the major federal employment discrimination laws and the agencies charged with their administration. All of these laws establish rights for covered employees and place affirmative obligations upon covered employers.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

- [Employment Discrimination](#)
 - [Role of State Law](#)
 - [The Civil Rights Act of 1964](#)
 - [Title VII](#)
 - [Enforcement Actions](#)
 - EEOC
 - [Disparate Treatment](#)
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 - [Sexual Orientation & Gender Identification Discrimination](#)
 - [Civil Rights Act of 1866 \(1981 Act\)](#)
 - [The Age Discrimination in Employment Act \(ADEA\)](#)
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 - [Genetic Information Nondiscrimination Act \(GINA\)](#)
 - [Uniformed Services Employment and Redeployment Act \(USERRA\)](#)
 - [The Health Insurance Portability Accountability Act of 1996](#)
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 - Title VII Actions
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 - [Sexual Harassment](#)
 - [Hostile Work Environment](#)
 - [Equal Pay Act](#)
 - [Pregnancy Discrimination Act](#)
 - [Affirmative Action](#)
-

TOPIC 16: EMPLOYMENT DISCRIMINATION - QUESTIONS & ANSWERS

1. What is “employment discrimination”?

Employment discrimination is a specific area of employment law that is based upon fundamental rights granted or protections afforded under the US Constitution. Employment discrimination laws prohibit certain types of discrimination by employers against employees or prospective employees based upon their protected characteristics. Various federal and state laws prohibit employer discrimination based upon race, ethnicity, sex, religion, national origin, age, physical disability, and sexual orientation. These are known as “protected classes” of individuals. Discrimination generally includes demonstrating biases in actions or decision making in the context of hiring, firing, compensation, benefits, promotion, job details or scheduling, etc. These laws also prohibit retaliation against employees for reporting or bearing witness to any of these forms of discrimination. While the due process clauses of the 5th and 14th Amendments to the US Constitution prohibit these practices by the federal and state governments, numerous federal statutes prohibit this conduct by private employers based upon authority under the Commerce Clause. Lastly, states often pass laws that afford greater protections to employees than those afforded under federal law. This chapter focuses on the major federal statutes protecting employee rights.

- *Note:* Discrimination may result from creating conditions that are oppressive and cause an employee to leave employment. This is known “constructive discharge”.
- *Example:* Employer biases may include failing to hire someone because of her race. Less obvious examples include allowing or failing to prevent sexual harassment or the development of a hostile work environment as form of sex-based discrimination.

- **Discussion:** How do you feel about state and federal government efforts to prevent employer discrimination? What do you think are the government objectives behind these laws? Can you think of any arguments against such regulation? Should these laws be balanced against an employer’s rights with regard to carrying on its business practices?
- **Practice Question:** What major actions by an employer implicate employment discrimination laws? What reasons or justifications for an employer action are potentially prohibited by employment discrimination laws/
- **Resource Video:** <http://thebusinessprofessor.com/what-is-employment-discrimination/>

2. What are the major employment discrimination laws?

The major federal laws and regulations prohibiting employment discrimination were passed as part of several major federal acts and the subsequent amendments thereto. The primary federal acts addressing employment discrimination are as follows:

- *The Civil Rights Act of 1964 (Title VII)* - Title VII is the most developed body of employment discrimination law. This Act, along with its numerous amendments, prohibits specific types of employer discrimination based on race, sex (including pregnancy and childbirth), color, religion, and national origin. The Act, as amended in 1993,

provides for damages for those discriminated against under the Civil Rights Act of 1964, as well as the Americans with Disabilities Act and the Rehabilitation Act.

- *Civil Rights Act of 1866 (1981 Act)* - The 1981 Act was passed to prohibit discriminatory practices against individuals based upon race. The Act is commonly known as the 1981 Act, as it is found at Section 1981 of title 42 of the US Code of Statutes. The 1981 Act, as amended in 1991, provides the elements for a claim of intentional discriminatory treatment (disparate treatment) and discriminatory policies with a discriminatory impact (disparate impact). The 1981 Act also outlines the remedies available for discriminatory actions.
 - *The Age Discrimination in Employment Act (ADEA)* - The ADEA provides protection for employees over the age of 40 years from discriminatory practices by the employer based upon age. The discriminatory practices prohibited by the ADEA are similar to those prohibited by Title VII.
 - *Americans with Disabilities Act (ADA)* - The ADA prohibits discriminatory practices by employers against employees based upon an employee's mental or physical handicap. The ADA requires employers to take measures to accommodate the disabilities of certain prospective or current employees.
 - *The Rehabilitation Act* - The Rehabilitation Act is another federal law attempting to protect the rights of individuals suffering from physical and mental handicaps. The Act applies only to the Federal Government, federal contractors, and employers receiving federal financial assistance.
 - *Genetic Information Nondiscrimination Act (GINA)* - The GINA prohibits employers from discriminating against employees based upon information about genetic tests of the individual, past family members, requests for genetic service, etc.
 - *Uniformed Services Employment and Redeployment Act (USERRA)* - The USERRA prohibits employers from discriminating against employees who are also members of the military service. Specifically, it protects employees who are members of the military reserve, state national guard, or national disaster medical system are called to temporary periods of active service from suffering any negative employment consequences.
- **Discussion:** After reading the short description of the above-listed, federal statutes, what do you think about the Federal Government's effort to protect specific classes of individuals? Based upon these laws, do you see in gaps in protection or forms of discrimination that are not prohibited? Should these types of discrimination be prohibited?
 - **Practice Question:** Can you identify the major federal employment discrimination laws and the type of conduct that they prohibit?
 - **Resource Videos:** <http://thebusinessprofessor.com/major-employment-discrimination-law/>

CIVIL RIGHTS ACT OF 1964

The Civil Rights Act of 1964 is the most comprehensive statute dedicated to protecting the civil rights of individuals. For purposes of this chapter, Title VII of the Civil Rights Act (Title VII) is wholly dedicated to eliminating discriminatory employment practices. The Act has been amended numerous times since 1964 to provide additional protections.

- **Resource Video:** <http://thebusinessprofessor.com/overview-of-title-vii/>

3. What are the protections against employment discrimination provided by the “Title VII” of the Civil Rights Act of 1964?

Overview

Title VII makes it unlawful for an employer to “fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin”. The terms of Title VII have been interpreted very broadly to include any number of adverse actions against the employee based upon race, color, religion, sex, or national origin. This includes retaliation against an employee for making a claim of discrimination or an employee bearing witness to acts of discrimination against another employee.

- *Note:* States pass civil rights statutes similar in nature to Title VII. These statutes are generally more protective of employees or provide additional prohibitions on employer practices.

Applicability - Bona Fide Occupational Qualifications

The provisions of Title VII apply to employers with 15 or more employees, labor unions, and certain other employers. The prohibitions of Title VII are limited to circumstances where an employee does not have a reasonable and justifiable reason for discriminating against an employee or prospective employee. A good faith reason for discriminating against an employee based upon a protected class is known as a “*bona fide* occupational qualification” (BFOQ). If a specific job or position has a BFOQ that has the effect of discriminating on the basis of religion, sex, or national origination, such discrimination is not illegal. The key aspect of a BFOQ is that the qualification(s) must be reasonably necessary to the normal business operations of the business and the performance of the duties of that position.

- *Note:* No BFOQ exists for intentional discrimination based upon race or color.

- **Discussion:** What was happening in 1964 that gave rise to passage of the Civil Rights Act? What do you think are the underlying objectives of Title VII? Do you think Title VII is effective in accomplishing these objectives? Are there any unintended consequences? Why do you think Title VII specifically protects individuals with these characteristics? How do you feel about the exemption of discriminatory practices if a *bone fide* occupation qualification exists? In your opinion, how necessary should the qualification be to the job for a discriminatory practice to be legal?
- **Practice Question:** Carrie owns a small business in South Carolina. She does not like to work with men and is resolute about only hiring female employees. What do you need to know to determine whether this practice is legal? *Hint:* Think about Carrie’s business, state law, and the types of job.
- **Resource Video:** <http://thebusinessprofessor.com/employment-discrimination-under-title-vii-of-the-civil-rights-act/>

4. How are employment discrimination actions under the Title VII enforced?

The Civil Rights Act of 1964 established the Equal Employment Opportunity Commission (EEOC). The EEOC is charged with interpreting and enforcing the provisions of Title VII and numerous other employment laws (including the ADA, ADEA, Equal Payment Act, and sections of the Rehabilitation Act). The EEOC's enforcement procedures are as follows:

- *Filing a Charge* - An employee alleging a violation of Title VII must file a complaint with the EEOC within 180 days of the alleged discriminatory conduct.
 - *Note:* If the employee elects to file a state-law action with the relevant state agency, the state filing may toll the statute of limitations for filing the federal discrimination action.
- *Review by Investigator* - The EEOC will notify the employer of the complaint and assign an investigator to the case to determine whether there is a reasonable belief that discrimination occurred. The alleged offender will provide a response, known as a "position statement", to the EEOC. Based upon the initial inquiry and response by the employer, the EEOC may proceed with the investigation or summarily dismiss the complaint for failing to make any showing of discriminatory conduct.
 - *Note:* The EEOC determination on this point is based largely on evidence presented by the employee and the documentation provided by the employer. Documentation supporting the employer's action may include any manager's report, counseling statements, or affidavits of witnesses to the action taken.
- *Negotiation & Mediation* - Parties (the employer and employee) are generally free to negotiate a settlement of the claim prior to disposition by the EEOC. However, a settlement between the parties does not prohibit the EEOC from continuing an inquiry or initiating an investigation of an alleged violation. In some cases, the EEOC will offer assistance with the mediation process.
 - *Note:* The EEOC will generally only continue an inquiry following a settlement when the employer practices are particularly egregious or likely to be repeated.
- *Investigation* - The EEOC investigator will collect extensive information about the situation from the employer and employee, conduct interviews, etc. This investigation will drive the EEOC's determination in disposing of the complaint.
 - *Note:* Employers are not legally compelled to comply with investigation demands; however, failure to comply with the investigation process can result in negative administrative finding against that party.
- *Determination* - Once the investigation concludes, the EEOC will make a determination of the merits of the complaint. The options for determination are as follows:
 - *Dismissal and Notice of Rights* - If the EEOC does not find reasonable cause to believe that there was discrimination, it will issue a "Dismissal and Notice of Rights" letter. This notice tells the employee the conclusions of the investigation and that the EEOC will take no action on the matter. The notice does, however, inform the employee that she can file an action against the employer in federal court within 90 days.

- *Note:* The dismissal and notice of rights generally indicates that there is little merit to the complaint. Employees who proceed to file a legal action often see the complaint summarily dismissed.
- *Letter of Determination* - If the EEOC does find reasonable cause to believe that there was discrimination, the EEOC issues a “Letter of Determination”. This letter informs employer and employee of the EEOC’s findings and invites the parties to undergo a form of mediation to resolve the issue. This mediation process is known as a “conciliation”. The conciliation is not binding on the parties, and either party may reject the results of a conciliation.
 - *Note:* Most businesses, rather than risk a civil trial on the allegations, are willing to take part in the conciliation process.
- *Notice of Right to Sue* - If conciliation is ineffective, the EEOC has authority to bring an action against the employer for the discriminatory conduct. In determining whether to sue on behalf of the employee, the EEOC will consider: the seriousness of the violation, the type of legal issues in the case, the wider impact the lawsuit could have on the agency's efforts to combat workplace discrimination, and the resources available to litigate the case effectively. If the EEOC does not sue, the employee will receive a “Notice of Right to Sue” and may file an action in federal court within 90 days of the determination.
 - *Note:* If a party cannot afford an attorney, the EEOC may appoint an attorney to represent the employee.

Per the 1991 Amendments to Title VII, an employee may recover compensatory damages suffered as a result of the discriminatory conduct. If the conduct is intentional, the employee may recover punitive damages of up to \$300,000 per individual subject to discrimination.

- **Discussion:** How do you feel about the EEOC enforcement process? Do you think that this process offers sufficient protections to employees? Why or why not? Can you think of any modifications to this process that may offer greater protections? Do you think individuals should be able to sue an employer directly without first exhausting the EEOC administrative process?
- **Practice Question:** Derek applies for a position at ABC Corp. He believes that the manager who interviewed him was biased against him because of his religion. If Derek decides to bring a legal action against ABC Corp for legal discrimination, what is the process that he must follow to do so?
- **Resource Video:** <http://thebusinessprofessor.com/enforcing-title-vii-actions-through-eeoc/>

5. What must a plaintiff demonstrate to the court to win a lawsuit under Title VII?

To make an actionable claim under Title VII, the effected employee must demonstrate that the employer is covered by Title VII and that actions taken (or inaction) by the employer likely had a discriminatory effect or result. As previously discussed, Title VII prohibits discrimination based on race, color, religion, sex or national origin. Courts interpreting these

provisions include pregnancy, childbirth or related medical conditions under the aegis of sex discrimination. The employee must then demonstrate discrimination with regard to hiring, discharging, compensating, or concerning the terms, conditions, and privileges of employment. Employer discrimination is broken down into the following three primary categories:

- *Disparate Treatment* - This involves direct discriminatory treatment of an employee by the employer (or the employer's representative). The plaintiff must convince the court that the employer intentionally discriminated against the plaintiff. The plaintiff may demonstrate intent by showing that discrimination is a "substantial or motivating factor" for the employer's action or decision. If the employee can make this showing, the employer will be liable even if other factors (such as customer preference in interacting with individuals of a specific race, gender, religion, etc.) also contributed to or motivated the conduct or decision.
 - *Note:* Remember, the defendant may still be able to show that discriminating against one protected class of individual in favor of another was done based upon a *bona fide* occupational qualification. No BFOQ exists for race-based discrimination.
- **Discussion:** What do you think constitutes discriminatory intent with regard to an employment decision? Can you think of a situation where an employer action or decision may be influenced by the protected characteristics of an employee or applicant but does not constitute discrimination? What level of consideration of a protected characteristic constitutes a substantial motivating factor?
- **Practice Question:** Juan is an employee of ABC Corp. He believes that his current manager treats him unfairly because of his Hispanic heritage. When a position comes open in his company for promotion, Juan applies for the position. Juan's manager hires another Caucasian employee with less seniority and fewer credentials for the position. He believes that he was discriminated against by not being selected. If Juan decides to bring a discrimination action against ABC Corp, what will he have to show in order to prevail?
- **Resource Video:** <http://thebusinessprofessor.com/disparate-treatment/>
- *Disparate Impact* - Disparate impact is a form of discrimination that involves a policy or practice that is not primarily motivated by a discriminatory purpose but has a discriminatory impact on a protected class of individual. Restated, unlike discriminatory treatment actions, the employee does not have to demonstrate an intent to discriminate. Rather, the plaintiff must prove that the employer's practices or policies had a discriminatory effect on her due to her race, gender, religion, etc. The effect on the employee must be "substantial" and related to an identifiable disadvantage or a loss of opportunity. Employers can defend such a claim by proving that the alleged discriminatory policies are job-related and based upon a business necessity. That is, the employer must show that there was a *bona fide* occupational qualification to overcome the employer's successful demonstration of a business necessity, the plaintiff must then show that other policies would serve the employer's intended purpose without having a discriminatory effect or impact.
 - *Note:* To prove a discriminatory impact case, the employee most generally provide extensive data and demonstrate statistically that the policy had an impact on anyone belonging to the employee's protected class.

- **Discussion:** How do you feel about the possibility of facing liability for a policy that did not have a discriminatory intent? How much of an impact on protected classes of employees must a policy have to be considered substantial and thereby actionable? If an employer demonstrates that a valid business necessity for discrimination exists, should the policy be actionable if it was not the least discriminatory method available? Why or why not?
- **Practice Question:** Pete is an employee of ABC Corp. He is Jewish and frequently attends religious service on Saturdays. While the company does not mandate participation, he believes that the company policy of incentivizing employees to participate in work events on Saturdays has a discriminatory impact on Jews. If Pete wishes to bring a discrimination action against ABC Corp, what must he show in order to demonstrate disparate impact?
- **Resource Video:** <http://thebusinessprofessor.com/disparate-impact/> ; <http://thebusinessprofessor.com/disparate-impact-discrimination-examples/>

- **Retaliation** - Title VII protects employees who report or bear witness to discriminatory conduct. More specifically, employers cannot retaliate by taking disciplinary action against employees for making discrimination charges, making a statement to the EEOC or administrative agency, or giving testimony in a discrimination case. Pursuant to this prohibition, employers have an affirmative duty to create an atmosphere in which a complainant and others with relevant information about alleged discrimination feel comfortable coming forward with the complaint or information.
- **Note:** For conduct to be actionable, the employer's adverse action against the employee must be motivated by the employee's complaint or cooperation therewith. The employer may still take adverse actions against the employee for unrelated conduct.

- **Discussion:** Why do you think Congress included anti-retaliation provisions in Title VII? Do you believe that these provisions are effective in preventing employer retaliation? Why or why not?
- **Practice Question:** Mary is an employee at ABC Corp. Her colleague, Angela files a sexual harassment complaint with the EEOC against her boss, Tom. On multiple occasions, Mary witnessed Tom making inappropriate sexual advances toward Angela. Mary is worried about providing a statement to the EEOC investigator. Should Mary be worried?
- **Resource Video:** <http://thebusinessprofessor.com/retaliation-under-title-vii/>

6. What is discrimination on the basis of race or color under Title VII?

Discrimination on the basis of race or color may be intentional or as a result of policies with a disparate impact. Failing to hire, firing, or compensating individuals differently based upon race are obvious examples of intentional discriminatory treatment. Below are some less-obvious examples of discriminatory treatment with regard to employment benefits and

characteristics:

- *Discriminatory Language* - Using or permitting employees to use racial insults in the workplace. This is similar to creating a hostile work environment for sex-based discrimination.
- *Race-Based Scheduling* - Scheduling individuals, giving individuals personal preference in work shifts, or maintaining all-black or all-white crews for no reason are examples of discrimination in employment characteristics.
- *Accommodations* - Providing better offices, workspace, housing, etc., for one race above another is discriminatory.
- *Incentives* - Providing greater compensation, employment benefits, performance or routine bonuses based upon race is discriminatory.
- *Private Affirmative Action Programs* - Private employers (not federal contractors) voluntarily adopt affirmative action programs. This often gives rise to reverse discrimination when minorities or women with lower qualifications or less seniority than white men are given preference in employment or training. To combat this issue, the EEOC issues guidelines for employers who set up affirmative action plans.
 - *Note:* Affirmative action is a federal program that applies to the Federal Government and federally contracting employers. This program puts requirements that the workforce demographic roughly represent the immediate population. There are no quotas for hiring and there is no mandate to hire any single individual. The 1991 Civil Rights Act amendments prohibit the setting of quotas in employment.

Employer conduct constituting discrimination based upon the impact upon the employee may be far less obvious than intentional forms of discrimination. Examples of discriminatory impact based upon employer policies potentially include:

- *Personnel Tests* - Using personnel tests that have no substantial relation to qualifications or duties of the job may have the effect of screening out minorities.
- *Marital Status* - Denying employment to unwed mothers may have a discriminatory impact when minorities have a statistically higher rate of single-parent births.
- *Credit Scores* - Refusing to hire individuals because of their poor credit rating may be discriminatory when minorities are disproportionately affected by poor or no credit history.
- *Nepotism* - Giving priority in hiring to relatives of present employees may be discriminatory when minorities are underrepresented in the workforce.
- *Grooming Requirements* - Some races may have different grooming practices as a result of medical conditions or physiological characteristics. If minorities are unduly affected by these standards, the policy could result in unequal and discriminatory employment conditions.
 - *Example:* African-American men often suffer from razor bumps when shaving too closely. An employer's hiring policy of no facial hair may be discriminatory

Recall that there is no *bona fide* occupational qualification for intentional discrimination based upon race. There is, however, a business necessity defense for discriminatory impact claims.

- **Discussion:** Do you agree that the above-referenced employer actions and policies result in intentional or discrimination against employees based upon race? Why or why not? Are these laws adequate, over broad, or should they go farther to protect minority rights? What are the arguments for and against such protections?
- **Practice Question:** Winston is a single father. His dream is to join the state police force. The police force has a policy against hiring single parents. The objective of the policy is to protect family members in the event an officer falls in the line of duty. Across the United States, a significantly higher percentage of African-Americans are single parents. If Winston is denied employment based solely upon this policy, does he potentially have a cause of action against the police force?
- **Resource Video:** <http://thebusinessprofessor.com/race-discrimination-under-title-vii/>

7. What is discrimination on the basis of national origin under Title VII?

National origin discrimination is any form of intentional conduct or policy that favors one or more national origins over others. National origin includes the origin or birthplace of the employee or the employee's ancestors. Examples discriminatory treatment would be failing hire, firing, creating less favorable conditions, or compensating individual differently based upon their national origin. An example of a policy with a potential disparate impact includes mandating communication in a given language or prohibitions of cultural practices without a good faith business necessity.

- **Discussion:** How do you feel about the Title VII protections afforded employees against national origin discrimination? Are these prohibitions adequate, over broad, or should they go farther to protect minorities? Can you think of any examples of conduct or policies that should be prohibited based upon national origin discrimination?
- **Practice Question:** Olga and Roman are employees of ABC Corp. They work in the loading warehouse. Olga and Roman are both from the Ukraine and speak Russian as their first languages. Their manager does not like not knowing what they are saying, so he institutes a rule prohibiting employees from speaking any language other than English while at work. Roman ignores the rule and is subsequently fired. Does Roman have a cause of action against ABC Corp?
- **Resource Video:** <http://thebusinessprofessor.com/national-origin-discrimination-under-title-vii/>

8. What is discrimination on the basis of religion under Title VII?

Religious discrimination is intentional conduct or policies that treat or affect individuals differently based upon their religious beliefs or affiliations. This includes any of the intentional discrimination, such as failing to hire, firing, or allowing different benefits. An employer's policy may have a discriminatory impact if it unduly affects certain employees' ability to observe or practice their religion in the workplace. Employers must generally make "reasonable

accommodations” for the religious needs or practices of their employees. The limitation on accommodating religious beliefs or practices is when it results in an “undue hardship” on the employer. Undue hardships generally result from a material disruption in job performance or business operations.

- *Note:* A well-founded exception to the religious accommodation rule is that religious organizations may discriminate in their employment practices on the basis of religion. This is a form of business necessity. For example, a church may refuse to hire a non-Christian based upon the difference in religious belief. This exception exists to accommodate the business purpose of religious organizations.
 - *Example:* May’s religion requires her to wear a headdress. Her employer bans the wearing of any headwear during the workday. Unless the employer has a valid business necessity for limiting headdresses, the policy may violate May’s religious rights under Title VII. The court would examine whether allowing an exception for May would be an undue burden on the employer.
- **Discussion:** How do you feel about the protection of religious belief in the employment environment? What do you think about the standards for protection of employee religious needs or practices? Are you comfortable with a “reasonable accommodation” requirement? Why or why not? At what point do you believe a reasonable accommodation amounts to an undue hardship?
 - **Practice Question:** Mohammad is an employee of ABC Corp and a practicing Muslim. His religious beliefs require that he take 15-minute breaks three times throughout the work day to pray. Mohammad is a retail sales employee. His prayer sessions require that he ask permission to leave the sales floor. What do you need to know to determine whether ABC Corp can limit Mohammad’s practices?
 - **Resource Video:** <http://thebusinessprofessor.com/religious-discrimination-under-title-vii/>

9. What is discrimination on the basis of sex under Title VII?

Discriminatory Treatment

Discrimination based upon sex is slightly more complicated than discrimination based upon other protected classes. Understandably, Title VII prohibits intentional discrimination by an employer, such as hiring, firing, differentiating benefits of work conditions, based upon sex. In the absence of a valid business necessity for the discrimination, an employee will face liability for such actions.

- *Note:* Two important types of discriminatory treatment arises from the employer-employee agency relationship. Employees may act (or fail to act) in a manner that results in discrimination against other employees based upon sex. “Sexual harassment” and “hostile work environment” are two forms of discrimination in which the employer is held liable for the conduct of its employees. These two types of intentional sexual harassment are discussed in a section.

Other less obvious examples of intentional discrimination under Title VII include:

- *Job Classifications* - Employers cannot advertise or classify a job listing for only males or females.

- *Seniority Lists* - Employers cannot keep separate male and female seniority or promotion lists.
- *Parenthood* - Employers cannot discriminate based upon an employee's pregnancy or intention to have children.

Discriminatory Impact

Employers may also adhere to policies that have a discriminatory impact upon employees based upon sex. Like intentional discrimination, these policies are prohibited in the absence of a business necessity or *bona fide* occupational qualification. In the context of sex-based discrimination, a *bona fide* occupational qualification means a "reasonable cause to believe or a factual basis for believing that all of substantially all women would be unable to perform safely and efficiently the duties of the job involved." Examples of policies that may have a disparate impact based upon sex include the following:

- *Height and Weight Requirements* - Height and weight requirements often discriminate against women, who are statistically smaller than men. When these requirements have the effect of screening out applicants of a particular sex, it may be discriminatory. The employer must demonstrate that such requirements are validly related to the ability to perform the work in question (a business necessity).
 - *Appearance Requirements* - Appearance requirements may discriminate against individuals based upon sex, race, religion, etc. Appearance requirements, such as short hair, may negatively impact women who traditionally wear longer hair.
- **Discussion:** How do you feel about the protections against sex-based discrimination afforded employees under Title VII? Can you think of examples of conduct that could constitute intentional discrimination? What about employer policies that demonstrate a discriminatory impact based on sex? Should these provisions be more or less protective?
 - **Practice Question:** ABC Corp is a private security agency. It supplies security officers for events and securing business locations. As such, ABC generally hires men who are very large and intimidating. Evelyn is a 5-foot, 3-inch female. She applies for an open position at ABC Corp. ABC refuses to hire Evelyn because of her size. Does Evelyn have a cause of action for sex-based discrimination against ABC Corp?
 - **Resource Video:** <http://thebusinessprofessor.com/sex-discrimination-under-title-vii-2/>

10. What is "sexual harassment" and "hostile work environment"?

Two types of intentional discriminatory conduct based upon the actions or inactions of the employer (or its agents) are "sexual harassment" and "hostile work environment".

- *Note:* These types of conduct is that they are not subject to a *bona fide* occupational qualification.
- *Sexual harassment* - Sexual harassment involves conduct by an employer (or its agents) that directs unwelcome sexual advances, requests for sexual favors, or other verbal or physical harassment that is sexual in nature toward an employee. Sexual harassment is most commonly committed by a manager or a superior of the employee being

sexually harassed. An employer will be liable for failing to make reasonable efforts to prevent such activity.

- *Note:* Conducting employee training and instituting workplace policies prohibiting such behavior will not necessarily protect the employer.
 - *Example:* An example of sexual harassment is when a manager or supervisor offers favorable action (such as promotion, raise in pay, time off, etc.) in exchange for sexual favors from the employee. This type of conduct is commonly known as “quid pro quo”. Another situation constituting sexual harassment would be threatening or insinuating unfavorable action against an employee for failure to take part in sexual relations. The key element is that the employee feels compelled to undertake sexual activity with the superior.
 - *Hostile Work Environment* - Hostile work environment is a form of sex-based discrimination resulting from sexually explicit or harassing communications or actions by employees that is offensive to other employees. To be actionable under Title VII, the conduct must be “so severe or pervasive as to alter the conditions of the victim’s employment” and thereby create an abusive work environment. The employer will be liable if she commits, promotes, or fails to take actions to prevent such behavior. As such, the employer will only be liable if it is aware of alleged conduct and fails to take prompt and reasonable steps to correct it. The employee must inform the employer of the conduct or the employer must otherwise be aware of the conduct. The employee cannot unreasonably fail to take advantage of any preventive or corrective opportunities provided by the employer, unless she reasonably believes that reporting the conduct would cause negative consequences. In such a situation, the employer can be liable for failing to provide a reasonable means of reporting the conduct without the employee suffering retribution. An employer charged with creating or failing to respond to a hostile work environment may defend itself by showing that it did not know (and it was not reasonable to expect them to know) of the problem. Further, an employer can protect itself by exercising reasonable care to prevent and correct promptly any sexually harassing behavior.
 - *Note:* Sexually offensive comments might include allowing (or failing to eliminate) sexually-oriented language, images, expressions, etc., in the workplace.
 - *Example:* Each morning when Ann arrives to the office, Bob whistles at her and tells her that she looks good. Ann originally thought Bob was just being nice, but she has grown increasingly uncomfortable with his comments and actions. She informs her manager of Bob’s conduct, but the manager does nothing. If the conduct becomes severe or pervasive to the point it interrupts Ann’s ability to do her job, it could constitute a hostile work environment.
- **Discussion:** How do you feel about the protections afforded employees against sexual harassment? What about hostile work environment? Do you agree with the defenses available to the employer? Why or why not? In a hostile work environment action, what type of conduct should be considered severe and pervasive?
 - **Practice Questions:** Jean is a new employee at ABC Corp. She is very offended when she sees a calendar depicting images of naked women on a calendar in a colleague’s office. She raises the complaint to her manager, Bob. Bob explains that the calendar was a gag gift and is only displayed as a joke. Jean is not satisfied with the explanation and quits her job. She later files a complaint against ABC Corp under Title VII for sex-based discrimination. What will she have to demonstrate to prevail in the action?

- **Resource Video:** <http://thebusinessprofessor.com/sex-discrimination-under-title-vii/>

Equal Pay Act of 1963

The Equal Pay Act of 1963 (Equal Pay Act) was an amendment to the Fair Labor Standards Act and a pre-cursor to the Civil Rights Act. The Equal Pay Act works in conjunction with the Civil Rights Act to prohibit sex-based discrimination in employment compensation. Covered employers cannot compensate employees differently based upon sex. More specifically, the Act requires equal pay if workers perform equal work in jobs requiring "equal skill, effort, and responsibility . . . performed under similar working conditions...". Title VII was necessary for complete protection against sex discrimination, as the Equal Pay Act did not address other forms of discrimination based upon sex. The Equal Pay Act relies heavily upon statistical analysis of disparities in pay, benefits, and promotion across the organization.

- **Note:** The employee must file an EEOC charge within 180 or 300 days (depending on whether there is a collateral filing in her state) or lose her claim. The Lilly Ledbetter Act of 2009 makes the 180-day period for filing a claim begin to run on the date that the last discriminatory payment is received.
- **Discussion:** How do you feel about the requirement for equal compensation across sexes for similar jobs? When do two different jobs entail "equal skill, effort, and responsibility [and] . . . performed under similar working conditions." Should there be an affirmative duty on employers to make certain pay is commensurate? Should an employee's attempt or willingness to negotiate for a given salary be considered?
- **Practice Question:** Mary has been working at her firm for 10 years. There are five employees in her department that do her same job. The other four employees are male. She recently learned that she is paid approximately 10% lower than all of her colleagues. If Mary decides to sue her employer for sex-based discrimination, what information would she have to show to support a cause of action?
- **Resource Video:** <http://thebusinessprofessor.com/equal-pay-act-of-1963/>

11. What are the protections under Title VII against discrimination based upon pregnancy?

Title VII protects women against discrimination based upon pregnancy or intent to become pregnant. The Pregnancy Discrimination Act of 1978 amended title VII to provide the following specific protections:

- **Pregnancy** - An employer cannot discriminate against women employees who become pregnant or give birth. This may include intentional discrimination or policies that have the effect of discriminating
 - **Example:** Intentional discrimination may include failing to hire, firing, or denying benefits based upon her pregnancy. A discriminatory policy might include mandatory reassignment of pregnant employees to low-stress jobs.
- **Insurance Plans** - Employers sponsoring or offering health or disability plans must include coverage for pregnancy, childbirth, and related medical conditions in the same manner as other health conditions. Further, plans

that cover female employees must also cover employees' spouses.

- *Note:* This is a considerable difference between privately-purchased health plans and employer-based plans.
- *Maternity Leave* - Employers are limited in their ability to force employees to take maternity leave from work. For example, employers cannot force pregnant women to stop working until after birth. Lastly, the employer cannot mandate a specific leave of absence for pregnancy or birth.
- *Note:* The Family Medical Leave Act may provide for rights to unpaid leave during and following birth.

- **Discussion:** How do you feel about the protections afforded women in the event of pregnancy? Do you think these protections are effective? Why or why not? Can you think of any arguments against any of the protections? Should an employer's intent in passing a policy affecting maternity leave be considered when determining discrimination? Why or why not?
- **Practice Question:** April is an employee of ABC Corp. She becomes pregnant and is scheduled to give birth in two weeks. Her manager, Eric, approaches her about maternity leave. He strongly encourages her to go ahead and take leave and states, "you should take leave because, if you do not, I am going to assign you to a desk and not give you anything to do". Eric is trying to be a helpful boss, but April is offended by his statement. Does April have a cause of action against ABC Corp?
- **Resource Video:** <http://thebusinessprofessor.com/pregnancy-discrimination-under-title-vii/>

OTHER STATUTES AND EMPLOYMENT CONSIDERATION

The Civil Rights Act of 1964 is the most commonly exercised anti-discrimination statute, but there are several other federal laws that provide important protections against discrimination.

12. What is the "Civil Rights Act of 1866"?

The Civil Rights Act of 1866, commonly known as the 1866 Act, was passed at the end of the Civil War in an effort to protect minorities against race-based discrimination. The pertinent provisions of the Act reads, "All persons shall have the same right to make and enforce contracts as enjoyed by white citizens." While the 1866 Act also protects against race-based discrimination, it provides additional protections beyond those of Title VII. It specifically protects against discrimination in hiring, retaliatory firing, and creation of a hostile work environment. It originally allowed for the recovery of damages for intentional discrimination. The Act was amended in 1991 to allow a plaintiff to recover for policies or practices with a discriminatory impact. Unlike Title VII, the 1866 Act allows a plaintiff to bring an action in federal court without filing a complaint through the EEOC. It also allows plaintiffs to recover compensatory and punitive damages in the event of intentional discrimination.

- **Discussion:** Why do you think Congress passed a separate Act (beyond Title VII) to combat race-based discrimination? Do you believe the objectives of the 1866 Act are the same as those under Title VII? Why or why

not?

- **Practice Question:** Walt is an African-American man applying for a position at a local restaurant. At the interview he noticed that the entire wait staff is Caucasian, while the entire kitchen staff is African-American. During the interview, the restaurant manager indicates that he believes Walt would be a better fit as a kitchen manager. Walt kindly refuses the kitchen manager position and reasserts that he wishes to be considered for the waiter position. The restaurant eventually hires a Caucasian female to fill the waiter position. Does Walt potentially have a cause of action against the restaurant? If so, what are his legal options and procedure for bringing the action?
- **Resource Video:** <http://thebusinessprofessor.com/civil-rights-act-of-1866-1981-action/>

13. What is the “Age Discrimination in Employment Act”?

The Age Discrimination in Employment Act of 1967 (ADEA) was passed to address discrimination in employment based upon age. The Civil Rights Act of 1964 and the Equal Employment Opportunity Act do not protect against discrimination based on age, which makes the ADEA the primary law providing this protection. The ADEA prohibits employers with 20 or more employees from discriminating against employees who are 40 years of age and older. The Act protects against disparate treatment and policies that have a disparate impact on covered employees. Unlike under Title VII, there must be some form of discriminatory intent behind discriminatory impact cases. An employer may defend an ADEA claim by demonstrating that the discriminatory action or policy was motivated by a reasonable factor other than age. The employer does not have to show a business necessity, and it does not matter if there is a less discriminatory policy or manner of achieving the employer’s objective. Plaintiffs may achieve reinstatement in their positions and recover damages for violation of the act. A willful violation may give rise to double the actual damages (including lost wages and any losses resulting from the discrimination). Lastly, the ADEA allows for an action against employers who retaliate against employees for exercising their rights under the ADEA.

- **Note:** The ADEA has numerous requirements for benefits, pension, and retirement plans that expand upon the protections of the Employee Retirement Income Security Act.
- **Example:** Discrimination may include disparate treatment, such as failing to hire, discharging, or changing benefits. An example of discriminatory impact includes the practice of establishing mandatory retirement dates for employees. A notable exception to this rule is that high-level executives with qualified retirement plans can be forced to retire.

- **Discussion:** Why do you think the Federal Government seeks to protect individuals above 40 years of age from discrimination? Why do you think the legal standard for proving a disparate impact case requires a showing of intent by the employer to discriminate? Is this change in standard fair or does it unduly benefit employers? Why?
- **Practice Question:** Arthur is in his mid-fifties. He is applying for a job at ABC Corp to be a software engineer. He meets all of the qualifications for the job. During the interview it became obvious that the interviewer was worried that his computer skills and work speed would be negatively impacted by his age. One of the questions from the interviewer queried whether Arthur finds himself at a disadvantage when working on projects with 20-year-old colleagues? Arthur did not get the job. Do you think Arthur has a legal cause of action against ABC Corp?
- **Resource Video:** <http://thebusinessprofessor.com/age-discrimination-in-employment-act/>

14. What is the “Americans with Disabilities Act”?

Overview

The Americans with Disabilities Act (ADA) is the primary law protecting individuals with disabilities from various forms of discrimination. The ADA specifically prohibits employers from discriminating against job applicants or employees based upon:

- having a disability,
- having a disability in the past, or
- being regarded as having a disability.

The ADA applies to employers with 15 or more employees. Intentional forms of discrimination include hiring, advancement, termination, compensation, training, or other terms, conditions, or privileges of employment. The ADA also prohibits employers from requiring a pre-employment medical examination or asking questions about the job applicant's medical history. The employer can only ask job related medical questions after a job has been extended.

Covered Disability

The ADA defines a disability as “any physical or mental impairment that substantially limits one or more of an individual's major life activities.” Individuals with an impairment that is “transitory and minor,” do not fall under the ADA protections. The employment discrimination provisions apply to individuals with a “qualified disability”. A qualified disabled is one who, with or without reasonable accommodation, can perform the essential functions of a particular job position. Covered employers must make “reasonable accommodations” to allow the qualified disabled to perform the functions of the job.

Reasonable Accommodation

Reasonable accommodation under the ADA means adjusting a job or work environment to fit the needs of a disabled employee in carrying on her duties. Common examples of a reasonable accommodation include:

- making the workplace disabled accessible;
- restructuring or adjusting the work schedule;
- purchasing or modifying necessary equipment for use by the disabled; or
- providing appropriate training materials or assistance modified to fit the needs of the disabled employees.

Undue Hardship

Employers are not required to make an accommodation that causes the employer an undue hardship. An undue hardship is an action requiring significant difficulty or expense to the employer. The cost of the accommodation, the resources of

employer, the size of the employer, and the nature of the employer's business are considered in determining what constitutes and undue hardship.

- *Note:* The ADA also requires businesses to make reasonable accommodations for customer who use the facilities. This generally includes wheelchair accessible entrances and doorways.

Remedies

The remedies for violation of the ADA are similar to those under the Civil Rights Act (Title VII). Compensatory and punitive damages are not available for disparate impact but are available for intentional discrimination.

- **Discussion:** How do you feel about the protections afforded individuals under the ADA? Why do you think Congress specifically excluded coverage of temporary disabilities? How do you feel about the definition of a qualified disabled? Do you agree that employers should always have to make reasonable accommodations for an individual deemed to be a qualified disabled? When defending allegations of failure to make a reasonable accommodation, are you comfortable with a floating standard of "undue hardship".
- **Practice Question:** Meredith has Parkinson's disease. The disease significantly hinders her physical movements. She is applying for a marketing manager position at ABC Corp. She is highly qualified, but ABC chooses not to hire her for fear that her disease will hinder her ability to adequately perform the job duties. If Meredith seeks to sue ABC Corp, what facts about Meredith's ailment, the position, and ABC Corp will the court examine to determine if there has been discrimination prohibited by the ADA?
- **Resource Video:** <http://thebusinessprofessor.com/americans-with-disabilities-act/>

15. What is the "Rehabilitation Act"?

The Rehabilitation Act aims to "promote and expand employment opportunities in the public and private sectors for handicapped individuals." The Rehabilitation Act prohibits the Federal Government and certain federal contractors from discriminating against employees and contractors based upon a medical disability. The Rehabilitation Act does not distinguish between qualified and non-qualified disabilities, but the anti-discrimination provisions are quite similar to those under the ADA. An individual must still be able to perform the core responsibilities of the position. The federal employer must also make reasonable accommodations for the employee's disability. The Act also requires the application of affirmative action programs to disabled individuals.

- **Discussion:** Why do you think Congress failed to distinguish between qualified and non-qualified disabled individuals for purposes of federal employment? Was this wise? Why or why not?
- **Practice Question:** Bertha is applying for employment with the US Department of Agriculture. She has ocular degeneration, which severely diminishes her eyesight. She is not hired for the position out of fear that her disability will not allow her to perform the job. She is considering filing a complaint under the Rehabilitation Act for discrimination. What would a court review in determining whether a valid complaint exists?
- **Resource Video:** <http://thebusinessprofessor.com/the-rehabilitation-act/>

16. What is the “Genetic Information and Non-Discrimination Act”?

The Genetic Information Nondiscrimination Act (GINA) prohibits employers (those covered by Title VII) from discriminating (hiring, firing, refusing to hire, or otherwise discriminating) based upon an employee or perspective employee’s genetic information. Genetic information includes any information acquired through an individual’s genetic test or the test of her family members. This could include information about a disease or disorder in the family medical history. GINA also prohibits certain activities by employers that seek to identify or solicit information about an individual’s genetic information.

- *Example:* An employer is prohibited from requiring any information about genetic tests of the individual, past family members, requests for genetic service, etc. Further, an employer cannot request, require, or purchase genetic information with respect to an employee or the family member of an employee.
- **Discussion:** Why do you think Congress decided to protect individuals from discrimination based upon their genetic information? Do you agree that prohibiting employers from requesting such information is appropriate? Why or why not?
- **Practice Question:** ABC Corp provides a service of generating genetic sequence information for customers. Jane applies for a position at the company. ABC Corp requires that all new employees submit to a genetic screening. Jane is afraid that the genetic sequence will expose all sorts of private information about her family and health. She refuses to complete the screening and is not hired. Does Jane have a potential cause of action against ABC Corp?
- **Resource Video:** <http://thebusinessprofessor.com/genetic-information-nondiscrimination-act/>

17. What laws protect employees from discrimination in receiving health insurance coverage?

The Health Insurance Portability Accountability Act of 1996

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) is a primary law protecting the rights of employees with regard to obtaining and continuing health insurance coverage. Specifically, HIPAA prohibits group health plans and health insurance providers from discriminating against employees based upon certain factors. A common practice when an individual applies for health insurance coverage is to examine the individual’s medical history for prior health conditions. The insurance provider will often limit coverage for pre-existing ailments and injuries. This situation becomes a major issue for someone who loses employer-provided, health insurance coverage when leaving her current employment. HIPAA seeks to remedy this situation by granting an employee who leaves one job the ability to continue her same level of health coverage under a subsequent health plan without being excluded for pre-existing conditions. The key requirement is that an individual must never have a considerable break in insurance coverage between canceling one plan and beginning another. If an individual has a break in coverage, the insurer can exclude pre-existing conditions present during the previous 12 months (18 months if a late enrollee in the new plan). For the above-stated reason, individuals losing their employer-provided health coverage must purchase interim insurance to continue coverage during the interim. Coverage is generally available pursuant to the Consolidated Omnibus Budget Reconciliation Act. If the employee maintains coverage, a subsequent insurer cannot exclude or limit coverage of an individual because of health

status, medical condition or history, genetic information, or disability.

- **Note:** The insurer can, however, charge more for the entire plan – which is paid for by the group of employees. Small businesses may be disadvantaged by insurer practices, as they will charge higher rates for the small group policy due to the increased risk of loss by one group member becoming sick.
- **Discussion:** How do you feel about Congress's regulation of insurance companies? Should insurers be required to cover employees with pre-existing conditions if they become a member of a group plan? Why or why not? Do you think these provisions offer sufficient protections to employees or are they too strenuous on insurers? Why?
- **Practice Question:** Ellen is an employee of ABC Corp. She purchases her health insurance through an employer-sponsored plan. She is considering changing jobs to work for 123 Corp. She previously had a heart attack and is worried about losing health coverage for this condition if she changes employment. Does HIPAA offer any protections for Ellen?
- **Resource Video:** <http://thebusinessprofessor.com/health-insurance-portability-and-accountability-act/>

The Affordable Care Act of 2014

- **Requirements of Individuals & Government** - The Affordable Care Act in 2014 (ACA) changes the insurance landscape considerably. The ACA requires that all US citizens purchase health insurance either privately or through their employers. Individuals who fail to purchase health insurance are fined or incur a tax penalty calculated as a percentage of their annual income. Low-income earners are eligible for federal subsidies to aid in the purchase of health insurance coverage. To make insurance available, the ACA establishes federal exchanges through which individuals may purchase coverage. It also provides subsidies for states to establish their own insurance exchanges through an expansion of the state's Medicaid program. As part of the mandatory insurance requirements, insurance companies cannot exclude applicants based upon pre-existing conditions. Collectively, these provisions make health insurance available to all US citizens.
- **Requirements of Businesses** - The ACA also places requirements on businesses to sponsor health insurance plans for employees. A business with 50 or more full-time employees (defined as working 30 hours per week during any week of work) must allow employees to purchase health insurance for themselves and their dependents through the employer-sponsored plan. Covered employers who fail to sponsor insurance plans may be subject to fine or tax penalty. The employer incurs a penalty if any employee who qualifies for a federal subsidy based upon her level of income purchases insurance through a federal or state insurance exchange.
- **Discussion:** How do you feel about federal requirements for employers to sponsor insurance plans for employees? Why do you think health insurance plans are linked to employment? Can you make an argument for any other methods of providing health insurance access to individuals?
- **Practice Question:** Mica is an employee of ABC Corp, a large employer in her state. She makes a very low hourly wage and is worried about her responsibility to purchase health insurance or face a tax penalty. What are the requirements on ABC Corp to sponsor an employer healthcare plan that Mica can purchase? If Mica cannot afford the insurance coverage, what other options are available to her?

- **Resource Video:** <http://thebusinessprofessor.com/the-affordable-care-act/>

18. What anti-discrimination protections exist for employees who are also military service members?

The Uniform Services Employment and Reemployment Rights Act (USERRA) protects the rights of service members in the military reserves or state national guards from discrimination based upon their military service obligations. Specifically, the law protects the rights of individual who voluntarily or involuntarily leave their employment to undertake military service or certain types of service in National Defense Medical System. It prohibits public and private employers from denying “initial employment, reemployment, retention in employment, promotion, or any benefit of employment based on current, past, or present obligations flowing from military service.” The general requirements for protection under USERRA are as follows:

- the individual must hold a job outside of the Armed Forces or NDMS (a civilian job);
- the employee volunteers or is called to participate in mobilization (such as training, activation, or deployment), on a temporary basis, with the Armed Forces of National Defense Medical Service;
- the employee must inform her employer that she is leaving the position pursuant to the mobilization;
- the period of service must be under “honorable conditions”; and
- the individual must report back to the civilian employer in a timely manner regarding the mobilization and, if necessary, submit a timely application for reemployment.

The USERRA not only establishes re-employment rights but also protects individuals from retaliation (such as firing, demotion, etc.) for exercising their rights under USERRA. This includes protections for those reporting (or testifying against) an employer for violating USERRA. Covered employees can also elect to continue their employer-based health insurance for up to 24 months of the mobilization. If an employee does not continue her health coverage or coverage is lost, the employee may apply to the employer health insurance program without waiting periods or exclusions and request to be reinstated upon return from deployment. As with many other employment laws, the DOL requires that certain employers display notices of USERRA rights for employees. Individuals discriminated against may bring a private action against the employer or file a complaint with the US Secretary of labor.

- **Discussion:** Why do you think the Government established USERRA? Can you think of any arguments against enforcing these provisions? Should there be any exceptions to these rules? Why or why not?
- **Practice Question:** Thomas is a member of the Georgia National Guard. His unit has been called to active duty and will be mobilized to serve as the garrison support unit for Fort Sill, Oklahoma. This will require Thomas to leave his employment for 12 consecutive months. What are Thomas’s rights in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/uniform-servicemembers-employment-and-reemployment-act/>

19. What federal protections exist from discrimination based upon sexual orientation or identity?

Sexual orientation or identity discrimination in the employment context means any form of employment discrimination based upon the real or perceived sexual orientation (gay, lesbian, bisexual, or heterosexual) or identity (transgender association) of an employee. There are currently no federal statutes in place specifically affording protections to individuals based upon sexual orientation or identity. There are, however, common law decisions at the US Supreme Court and Federal Circuit Court levels that associate sexual orientation and sexual identity with sex-based discrimination. Further, in a federal administrative court case involving a federal employee in 2015, the EEOC determined that sexual orientation (and possibly identity) discrimination is a form of discrimination based upon predispositions about an individual's sex. The EEOC's opinion effectively extended sexual orientation protection to all federal employees (as well as employees of federal contractors). Federal courts have not yet extended this logic to discrimination actions against private employers.

- *Note:* Numerous states (and the District of Columbia) and a few local governments have laws or ordinances protecting employees against sexual orientation and identity discrimination by public and private employers.

- **Discussion:** How do you feel about the absence of federal statutory protections against discrimination based upon sexual orientation or identity? Are there any arguments for or against such protections? Do you see a general trend in society toward or against protection?
- **Practice Question:** Bart is an employee of ABC Corp, a large corporation located in State A. State A does not have any state laws protecting employees from discrimination based upon one's sexual orientation or identity. Bart was recently let go from his job for no apparent reason. He believes that he was fired when his employer learned that he is homosexual. What legal options exist for Bart to challenge his firing?
- **Resource Video:** <http://thebusinessprofessor.com/sexual-orientation-discrimination/>

20. What is “affirmative action”?

Affirmative action is a federal executive order prescribed to protect federal employees and employees of certain federal contractors. To be covered by this executive order, contractors must have 50 or more employees and hold federal contracts of \$50,000 or more. Affirmative action principles require covered employers to take actions to ensure that applicants are treated fairly in the application process and that employees are treated fairly during employment. This means that applicants and employees do not suffer a detriment because of their race, color, religion, sex or national origin. Affirmative actions may include result-oriented procedures used to promote equality in workforce employment and hiring practices. Affirmative action programs generally seek to establish workforces that roughly represent the percentages of qualified individuals present in the available applicant pool (such as the immediate community). Affirmative action programs that prescribe specific numbers of minority hires or provide advantages to minority applicants have been held to be unconstitutional based on grounds of reverse discrimination.

- *Note:* Private employers who voluntarily adopt affirmative action programs must be careful to avoid quota systems that run afoul of anti-discrimination laws. The Office of Federal Contract Compliance programs can terminate federal contracts with employers who do not comply with its guidelines and can make them ineligible for any future federal business.

- **Discussion:** How do you feel about affirmative action programs? What are the arguments for and against these programs?
- **Practice Question:** ABC Corp is a federal contractor. The majority of the employees at the corporation are Caucasian, and it is concerned that the demographics of its work force will disqualify it from future federal contracts. What can ABC Corp do to legally diversify its workforce?
- **Resource Video:** <http://thebusinessprofessor.com/affirmative-action-explained/>

21. What is the role of state governments with regard to anti-discrimination laws?

All states have statutes and regulations administered by state agencies to protect employees from employment discrimination. Often, these state laws will provide additional protections for employees beyond those provided by federal statutes. The EEOC generally works in conjunction with state administrative agencies in enforcing federal employment discrimination laws. In some states, the EEOC will refer any EEOC charges to the state agency handling such complaints. This is known as “deferral” or “deferral states”. Other states allow an application that the complaint be dually filed with the state administrative agency and the EEOC. If a state administrative agency begins a proceedings or a state law provides relief to a discrimination charge, the EEOC must notify the state officials and wait 60 days before continuing an action. If the state agency begins the investigation process, the EEOC will generally halt processing the claim while the state agency is investigating. If an employee first files with the state agency, the law extends the time for filing with the EEOC to 300 days.

- **Discussion:** What do you think are the benefits of a state also providing protections against employment discrimination? How do you feel about the procedure for filing both a state and federal action? Why do you think some states accept referral of all EEOC complaints, while others allow for dual processing?
- **Practice Question:** Anna feels that she has suffered discrimination in her workplace when she was recently fired. She is considering making a legal complaint. What are her options under state law and federal law?
- **Resource Video:** <http://thebusinessprofessor.com/employment-discrimination-under-state-law/>

TOPIC 17: CONSUMER PROTECTION

Overview

Consumer protection law concerns the body of statutes and regulations protecting consumers against deceptive practices by merchants or service providers. This chapter introduces the concept of consumer protection and its purpose. It then introduces the numerous federal statutes that protect consumers in specific situations. While these are the primary federal consumer protection laws, states often pass consumer protection laws that are more specific and more stringent than the federal protections.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

- [Consumer Protection Law](#)
 - [Federal Trade Commission](#)
 - [FTC Enforcement Procedures](#)
 - [Admin Penalties for Violations of CP Law](#)
 - [Prohibited Commercial Practices](#)
 - [Equal Credit Opportunity Act](#)
 - [Fair Credit Reporting Act](#)
 - [Users of Credit Information](#)
 - [Credit Reporting Agencies](#)
 - [Furnishers of Credit Information](#)
 - [Truth in Lending Act](#)
 - [Fair Debt Collection Practices Act](#)
 - [Consumer Financial Protection Act](#)
 - [Fair Credit Billing Act](#)
 - [Electronic Funds Transfer Act](#)
 - [Consumer Product Safety Act](#)
 - [Manguson-Moss Warranty Act](#)
 - [Federal Food, Drug, and Cosmetic Act](#)
 - [Labeling Laws](#)
 - [Privacy Act of 1974](#)
 - [Right to Financial Privacy Act](#)
 - [Electronic Communication Privacy Act](#)
 - [Children's Online Privacy Protection Act](#)
 - [State Consumer Protection Laws](#)
-

TOPIC 17: CONSUMER PROTECTION - QUESTIONS & ANSWERS

1. What is “consumer protection law”?

Consumer protection laws are state and federal laws that serve to protect individual consumers from deception or fraud in the marketplace. A consumer is someone who buys something for personal, family, or household use. These laws promote the accurate disclosure of information, facilitate market competition, and deter fraudulent practices. These laws specifically identify practices that are unfair or deceptive and mandate certain practices with regard to consumer disclosure. They protect vulnerable members of society and provide consumers with greater confidence in entering into commercial transactions.

- **Discussion:** How do you feel about laws developed specifically to protect consumers from unfair or deceptive practices by merchants? Do you think that the situation of the consumer in the market justifies the special protections? Why or why not?
- **Practice Question:** Damien has a small business. He purchases equipment for the business and believes that he has been defrauded by the seller. Does the consumer protection laws protect him? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/consumer-protection-law/>

2. What major federal laws protect consumers?

Consumer protection laws exist at both the federal, state, and local levels. Also, there are numerous private organizations that seek to promote fairness in consumer and commercial transactions. The following are the major federal consumer protection laws.

- *Federal Trade Commission Act*
- *Equal Credit Opportunity Act*
- *Fair Credit Reporting Act*
- *Truth in Lending Act*
- *Fair Debt Collection Practices Act*
- *Consumer Financial Protection Act*
- *Fair Credit Billing Act*
- *Electronic Funds Transfer Act*
- *Consumer Product Safety Act*

- *Manguson-Moss Warranty Act*
- *Federal Food, Drug, and Cosmetic Act*
- *Various Labeling Laws*
- *Privacy Act of 1974*
- *Electronic Communication Privacy Act*
- *Children's Online Privacy Protection Act*

REGULATORY AGENCIES

Individuals affected by a merchant's conduct may bring a civil action against the merchant. Further, numerous regulations exist that allow injured consumers to report violations of consumer protection laws. In an effort to stop or punish violations of the law, the government may then pursue administrative, civil, or criminal actions against the merchant. In this section, we discuss the administrative agencies charged with a consumer protection mission and the procedures used to carry out that mission.

3. What is the "Federal Trade Commission"?

The Federal Trade Commission (FTC) is the primary federal agency with the mission of protecting consumers. Authorized under the Fair Trade Commission Act, the FTC is an "independent" regulatory agency charged with keeping competition free and fair and with protecting consumers. The President appoints commissioners to the FTC and Congress approves the agency budget. A special bureau called the Bureau of Consumer Protection (BCP) promotes the consumer protection mission of the FTC. It promotes competition under the antitrust laws as well as protects consumers through the FTC Act's prohibition on "unfair or deceptive acts or practices in commerce." In summary, the overall objective of the FTC is to ensure fair competition by preventing those who deceive consumers from diverting sales or trade from those who compete honestly.

- *Example:* The FTC regulates commercial practices, such as advertising and marketing, sales of financial products and practices, privacy and identity protection, etc.
- **Discussion:** How do you feel about the functions and objectives of the FTC? Do you think it should be the role of a special administrative agency to promote consumer interests in the commercial market? Why or why not?
- **Practice Question:** What is the role and purpose of the Federal Trade Commission with regard to consumer protection laws?
- **Resource Video:** <http://thebusinessprofessor.com/federal-trade-commission/>

4. What are the enforcement procedures of the FTC?

Within the FTC, attorneys working in the bureau of consumer protection enforce the federal laws related to consumer affairs and rules promulgated by the FTC. The FTC enforces these rules and laws through the following methods:

- *Advisory Opinions & Industry Guides* - If a business is uncertain as to the legality of a particular course of conduct, it can request an advisory opinion from the FTC. Upon request, the FTC will advise businesses as to whether a proposed practice is unfair or deceptive. These advisory opinions are not legally binding, but they provide guidance as to how the FTC would view the legality of a certain practice.
 - *Note:* The FTC also publishes industry guides, which specify the agency's view as to legality of a particular industry trade practices.
- *Investigation* - The BCP is the internal group charged with handling the investigation and potential prosecution of FTC violations. The FTC generally initiates investigations pursuant to reports from consumers and businesses, pre-merger notification filings, congressional inquiries, or reports in the media.
- *Consent Orders* - The FTC may enter into agreements with alleged violators to refrain from the continued violation of consumer protection law, known as "consent orders". This is where the alleged violating party consents to an administrative order to modify or correct the challenged practices.
 - *Note:* While voluntary compliance through a consent order is often effective, the FTC has the option to skip the consent order process and file an administrative complaint or initiate federal litigation.
- *Administrative Complaint* - The FTC will bring an action before an administration court. The court may order that the business cease the practice in question. If the findings of the administrative judge are challenged, the case is reviewed *de novo* by the full FTC Commission. If the defendant wishes to appeal the decision of the FTC commission, she can initiate a challenge with the US Court of Appeals.
 - *Note:* The primary remedy for violation of the FTC Act is an administrative cease and desist order.
- *Civil Actions* - The FTC may initial civil actions for violation of administrative statutes or regulations.
- *Criminal Charges* - The FTC is charged with authority to prosecute businesses for committing unfair or deceptive trade practices. Often, however, the FTC supports the prosecution efforts of the US Department of Justice. Criminal charges against a business generally allege violation of Section 5 of the FTC Acts by:
 - committing "unfair or deceptive acts or practices", or
 - violating "trade regulation rule".

None of the above-mentioned methods are exclusive.

- **Discussion:** How do you feel about the FTC enforcement procedure? Does it concern you that adjudication of alleged violations of consumer protection provisions are administrative? Why or why not?
- **Practice Question:** Can you describe the process that the FTC follows in enforcing administrative protection laws against an alleged violator?

- **Resource Video:** <http://thebusinessprofessor.com/ftc-regulatory-enforcement-procedures/>

5. What administrative penalties and remedies may the FTC seek for violation of FTC regulations?

The FTC, through the negotiation of consent orders, has broad powers to fashion appropriate remedies to protect consumers in trade regulation cases, including:

- rescission of contracts (each party must return what has been obtained from the other);
- refund of money or return of property;
- payment of damages to consumers, and
- public notification of trade practice violations.

In an administrative action by the FTC, the administrative court may issue civil fines. The fines must be enforced by filing a subsequent action in the Federal District Court. The basic penalty for trade practice violation under the FTC Act is a civil fine of not more than \$16,000 per violation. Fines may be assessed in three distinct situations:

- for violation of a consent or cease and desist order,
- for a violation of trade regulation rule, and
- for a knowing violation of prior FTC orders against others.

Each separate violation of an order or rule shall be a separate offense.

- **Discussion:** How do you feel about the authority of the administrative court to administer remedies for violations of consumer protection laws? Does it affect your opinion that the fines or other remedies must be enforced through a civil court action? Why or why not?
- **Practice Question:** What is the role of the Federal Trade Commission and what is the extent of its authority and jurisdiction?
- **Resource Video:** <http://thebusinessprofessor.com/ftc-remedies-for-consumer-protection-violations/>

6. What type of commercial practices does the FTC prohibit in an effort to protect customers?

The FTC prohibits commercial practices that are deceptive to customers. This generally concerns the practices of merchants who market or otherwise represent the quality or characteristics of goods or services to customers. In determining what is “deceptive”, the FTC will look at various characteristics about the information disclosed to the public.

- How would a “reasonable consumer” understand the information in the context of the message?

- Are there any express and implied claims about the product or service?
- Would leaving out information from the advertisement give consumers a misimpression?
- Is the claim of deception “material”?

If the representations to customers are deemed to be deceptive, the customer or FTC may bring a civil action against the violator.

- **Discussion:** How do you feel about the reasonable consumer standard in determining whether a practice is deceptive? At what point should an opinion or general information about a product be considered an express or implied representation of the product’s qualities? How do you feel about the uncertain standard as to what type of practice constitutes a material deception?
- **Practice Question:** Mark produces an advertisement for his business ABC, LLC. The advertisement makes claims about the quality and durability of ABC products. ABC receives many complaints that the products they sell routinely break, malfunction, and generally do not meet the standards advertised. If a group of customers band together and file a complaint with the FTC against ABC for deceptive practices, what standard will the FTC apply in determining whether ABC should be held liable?
- **Resource Video:** <http://thebusinessprofessor.com/commercial-practices-prohibited-by-ftc/>

7. What is the “Consumer Financial Protection Act”?

Overview

The Consumer Financial Protection Act was passed in 2010 as part of the Dodd-Frank Act with the purpose of establishing the Consumer Financial Protection Bureau (CFPB). The CFPB and FTC overlap in authority to administer consumer laws. The CFPB has broad authority to regulate federal financial consumer laws including offer and sale of consumer financial products. It seeks to promote market transparency and competitiveness by making certain that consumer financial protection regulations are applied consistently. It has rulemaking and enforcement authority. The CFPB is divided into four offices:

- *Office of Fair Lending and Equal Opportunity* - This office is charged with oversight and enforcement of federal laws intended to ensure access to credit;
- *Office of Financial Education* - This office is charged with educating consumers on financial decisions;
- *Office of Service Member Affairs* - This office is charged with developing and implementing initiatives for military service members and their families; and
- *Office of Financial Protection for Older Americans* - This office is charged with facilitating the financial literacy of individuals 62 years old and older.

Authority & Procedure

The CFPB has exclusive administrative rulemaking authority for most matters affecting consumer protection. The bureau also conducts investigations into allegations of consumer fraud. Based upon the results of investigation, it may bring administrative or civil actions against covered persons for violating consumer protection laws. A “covered person” is any person or business offering or providing consumer financial products or services. Certain entities are exempt from CFPB authority, including: insurance companies, Internet service providers, real estate agents, lawyers, car dealers, and persons regulated by the SEC. The CFPB has exclusive authority to enforce consumer protection laws against non-depository institutions and insured depository institutions with \$10 billion or more in assets.

- *Note:* The CFPB works closely with an authorized consumer advisory board to advise and consult with the CFPB in the exercise of its functions.

State Regulatory Authority

Pursuant to Title X of the CFPA, states may also regulate consumer protection, as long as state regulation does not conflict with federal laws. States may also bring actions to enforce federal consumer protection laws. Title X allows the application of state law to national banks. Federal law does preempt a state’s ability to enforce consumer protection law against national banks and other federal financial institutions if:

- the application of the state law would have a discriminatory effect on the national bank or thrift;
- the state law prevents or significantly interferes with the exercise of the national bank or thrift’s powers; or
- the state consumer law is preempted by another federal law.

- **Discussion:** Why do you think Congress specifically authorized an administrative body to protect consumers in transactions with financial organizations? Do you think this regulatory framework is effective? Why or why not? Why do you think the federal law allows for dual regulation (federal and state) of financial institutions?
- **Practice Question:** What is the role of the Consumer Financial Protection Bureau and what is the extent of its authority and jurisdiction?
- **Resource Video:** <http://thebusinessprofessor.com/consumer-financial-protection-act/>

REGULATION OF CREDIT AND LENDING PRACTICES

This section includes a brief discussion of the various consumer protection statutes relating to the extension of credit.

8. What is the “Equal Credit Opportunity Act”?

The Equal Credit Opportunity Act (ECOA) protects individuals from discrimination in lending money or the extension of credit. It covers financial institutions, retail establishments, credit-card issuers, and other credit-granting firms. The ECOA extended the protections from discrimination under Title VII beyond the work environment. It prohibits a lender from discriminating in the extension of credit based upon race, color, religion, national origin, sex, marital status, or age. The

ECOA went further to protect against discrimination based upon receipt of public assistance (welfare). Examples of discrimination might include:

- refusing to extend credit;
- discouraging someone from pursuing credit based on a protected characteristics;
- charging a higher rate of interest;
- asking about marital status for a single-borrower loan; and
- asking about children or plans to have children.

Business Compliance

The Act imposes special responsibilities on businesses extending credit, as follows:

- issuers must calculate income from all regular sources, such as alimony, maintenance, and part-time jobs;
- issuers must use the credit history for all partners;
- issuers must inform the candidate about the credit decision (granted or denied) within 30 days; and
- consumers must be given a specific reason for denial of credit.

The business must notify the applicant of the reason for a denial of a request to extend credit. Further, the protections extend to any negative action taken pursuant to extending credit.

- *Example:* A business must notify customers of the reason for a denial of credit, closures of a line of credit, changes to terms of the credit relationship (that is not uniform to all creditors), etc.

Remedies for Violation

The ECOA provides several remedies and penalties for violation of the Act, as follows:

- *Private Administrative or Civil Actions* - Individuals may bring private causes of action or pursue enforcement through the FTC or CFPB.
- *Remedies* - Individuals bringing a private cause of action may recover actual damages, punitive damages (up to \$10,000), attorneys fees, and legal costs.
- *FTC Administrative and Civil Actions* - The FTC may also bring an administrative or civil action against the issuer seeking equitable remedies, including injunction against further violations.

- **Discussion:** How do you feel about the broad anti-discrimination provisions of ECOA? How do you feel about the requirements on businesses that extend credit to customers? Are these too broad or too narrow? Why? Why do

you think the ECOA allows for private causes of action and FTC actions for violations?

- **Practice Question:** Sara is the owner of a small lending firm that makes personal loans. Before lending any money, she collects extensive personal and financial information about the prospective borrower. She uses this information to determine whether to extend credit and at what rate. She focuses on the requirement that any borrower have regular income and a proven ability to repay the funds. What limits are placed on Sara as to the type of information she can record and use in the determination of whether to extend credit?
- **Resource Video:** <http://thebusinessprofessor.com/equal-credit-opportunity-act/>

9. What is the “Fair Credit Reporting Act”?

Overview

The Fair Credit Reporting Act protects consumers (not businesses) by regulating the accuracy, fairness, and privacy of consumer information reported to or held by consumer reporting agencies. It protects consumers from the negative consequences associated with inaccurate information in their personal credit reports. The FCRA regulates each stage of the credit reporting process, including collection of information, reporting of that information to credit agencies, dissemination of credit information, and use of a consumer’s credit information (such as in extending new credit). The Act applies to anyone who prepares or uses a credit report in connection with extending credit, selling insurance, or hiring or firing an employee.

- **Note:** The FCRA was amended in 2003 (by the *Fair and Accurate Credit Transaction Act*) to allow consumers to receive one copy of their credit reports each year from each credit reporting agency. It also established rules for credit reporting agencies and businesses to increase identity theft protections. These provisions include placing fraud alerts on credit reports, truncation of debit and credit card numbers, secure disposal of consumer information, etc.
- **Example:** You walk into my store and ask to finance the purchase of a large piece of machinery that I sell. I may request authorization to request your credit report. My request and use of this credit report in my decision of whether to extend you credit will be governed by the FCRA.

- **Resource Video:** <http://thebusinessprofessor.com/fair-credit-reporting-act/>

Requirements on Users of Credit Reports

A “credit report” is a collection of a consumer’s credit history. It includes such information as: past payment history, current credit accountings, late payments, credit limits, any debt or bill collection activity, liens, judgments, bankruptcies, etc. A “user” of a credit report is anyone who employs a report in the decision of whether to extend any form of credit. Extending credit may include financing a sale, establishing a recurring account, hiring, or loaning money. The FCRA places the following requirements on businesses that use credit reports to make decisions affecting the consumer:

- **Notice of Rejection** - The FCRA allows a user of a credit report to request the report for a permissible reason. It requires that businesses inform consumers who seek credit for personal, family, or household purposes if their

request is denied because of an adverse credit report. The notice must include the source of the credit report and notification of the right to make a request within 60 days to the reporting agency regarding the nature of the information received.

- *Note:* The purpose of this provision is to allow the individual to receive the report and challenge its accuracy.
- *Investigative Consumer Reports* - “Investigative consumer reports” are investigations carried out through personal interviews in the consumer’s community to uncover personal details, such as her character, lifestyle, community reputation, etc. A business seeking to acquire such information may only seek such a report after giving 3-days notice to the consumer. The consumer may request information on the scope and nature of the investigation.
 - *Note:* The purpose of this provision is to protect consumers from the negative consequences of personal inquiries.
- *Employer Background Checks* - Employers using consumer reports to screen job applicants or perspective employees must follow specific procedures, including:
 - obtaining written permission;
 - explaining how the credit report will be used;
 - avoiding any inappropriate or non-disclosed uses of the report;
 - providing a copy of the credit report (if the employee is not hired); and
 - allowing the applicant to dispute any information contained in the report before making a final decision.

The above-referenced list of common users of a credit report is not exhaustive. There may be any number of situations in which an individual uses a credit report in decisions affecting an individual.

- *Note:* A major limitation is that the FCRA does not limit the use or consideration of prior history or experiences between the consumer and the user of the credit report. Also, the bank falls under an exception if it gives its opinion of the credit worthiness of the consumer within the report.

- **Resource Video:** <http://thebusinessprofessor.com/fair-credit-reporting-act-users-of-information/>

Consumer Reporting Agencies

A credit reporting agency is any business that collects information about consumers for the purpose of disseminating that information in connection with credit applications, employment, or other evaluations of the individual’s credit. The largest personal credit reporting agencies in the United States are Transunion, Experian, and Equifax. The FCRA requires that credit reporting agencies follow the following guidelines:

- *Procedures* - Put in place procedures to ensure the accuracy of information in a consumer report;
 - *Note:* If it does so, it may not be liable to consumers under state or federal law if it reports false information.
- *Verify Information* - Provide a consumer with notice of the information collected and seek to verify any disputed information;
- *Dispute Negative Information* - Provide a manner for disputing negative information on a credit report.
- *Notification of Negative Information* - If negative information is removed from the reporting agency's file, give a consumer 5 days notice before reinserting that information;
- *Removal of Negative Information* - The reporting agency must remove any negative information from the report within seven years of the date of the reported delinquency;
 - *Note:* The time period is extended for bankruptcy filings (10 years) and tax liens (7 years from when paid).

- **Resource Video:** <http://thebusinessprofessor.com/fair-credit-reporting-act-reporting-agencies/>

Furnishers of Credit Information

The FCRA places obligations upon creditors who furnish a consumer's credit information to a reporting agency. This may include lenders, retailers, collection agencies, etc., that deal with customer credit and report that information to a reporting agency. The FCRA requires that these creditors:

- provide complete and accurate information to the credit reporting agencies;
- investigate consumer disputes received from credit reporting agencies;
- correct, delete, or verify information within 30 days of receipt of a dispute; and
- inform consumers within one month about negative information that is in the process of or has already been placed on a consumer's credit report.
 - *Note:* This normally includes providing notice before and after negative information is reported.

- **Resource Video:** <http://thebusinessprofessor.com/fair-credit-reporting-act-furnishers-of-information/>

Enforcement

The FTC and CFBP enforce the provisions of the FCRA. Further, individuals may bring a cause of action against creditor

reporting agencies or credit providers. In a civil action, a creditor may recover actual damages, attorney's fees, court costs, and punitive damages (if the conduct is intentional).

- *Note:* A consumer must file a civil action within two years of when the violation is discovered or within five years of when the violation occurred.

- **Discussion:** How do you feel about the regulation of all individuals involved in the use of a credit report? Do you find any of the obligations too relaxed or overly stringent? Why?
- **Practice Question:** Eric has a small business selling farm equipment. He routinely finances pieces of equipment for his customers. In this process, he pulls customer credit reports and also contacts other suppliers in the community to learn more about the customer's credit worthiness. He is in need of help in his business, so he is looking for someone to handle the equipment financing. When posting the position publicly, he requires applicants submit to a credit report. What procedures must Eric undertake to comply with the requirements of the FCRA?

10. What is the "Truth in Lending Act"?

Overview

The Truth in Lending Act (TILA) was passed with the purpose of protecting individuals from entering into deceptive or confusing credit relationships. The group of regulations implementing the provisions of TILA is known as "Regulation Z". These regulations contain the bulk of the requirements for businesses to comply with TILA. The CFPB, along with the Federal Reserve Board, has rule-making authority under Regulation Z. The FTC has enforcement authority for TILA.

Applicability

TILA places requirements on businesses that extend credit to consumers to make certain disclosures regarding the terms of the credit. Most notably, it requires a uniform manner of disclosure of the borrowing costs and payment associated with a particular loan. This allows consumers to more readily compare credit terms across lenders. TILA applies to consumer transactions with the following characteristics:

- the lender is in the business of extending credit for loan of money, sale of property, or furnishing a service;
- the debtor is a person;
- a finance charge may be imposed; and
- the credit obtained is primarily for personal, family, household, or agricultural purposes.

Other provisions of TILA protect consumers entering into consumer transactions requiring them to post their personal residence as collateral.

- *Note:* TILA applies specifically to loans made for consumer purposes. Business loans, even for closely-held businesses, are not included.

Disclosure Requirements

Disclosures are required when the buyer pays in four installments or more. TILA requires the following specific disclosures:

- *Finance Charge* - The sum of all charges payable directly or indirectly by the debtor or someone else to the creditor as a condition of the extension of credit.
 - *Example:* Finance charges include: interest, service charges, loan fees, points, finder's fees, fees for appraisals, credit reports or investigations, and life and health insurance required as a condition of the loan.
- *Annual Percentage Rate* - The lender must disclose the finance charge, express it as an annual percentage rate, and specify the methods for making the computation.
 - *Note:* TILA introduced the Annual Percentage Rate (APR) calculation mandated for all consumer lenders.
- *Financing Statement* - Before extending credit, the lender must provide a detailed financial statement to the borrower before extending credit.
 - *Note:* The financing statement must contain the APR, finance charges, any default or delinquency charges from late payment, description of property used as security, the total amount financed, and a separate statement of the debt from finance charges.

Enforcement

TILA allows for various penalties and remedies. Civil remedies for violation of TILA include an amount twice the amount of finance charges, plus attorney's fees. Creditors may avoid liability for an error if they notify and correct the error within 60 days of discovery. The borrower may generally rescind the transaction within 3 days of the transaction or upon receipt of notice of right to rescind. The right to rescind is heightened if there is a failure to adequately disclose on a mortgage loan.

- **Discussion:** What do you think about the underlying objectives of TILA? Do you think the extensive disclosure requirements achieve these objectives? Why or why not? Do you think that the applicability of the provisions are adequate? Why or why not?
- **Practice Question:** Cary owns a small business that sells consumer goods. She routinely extends credit to individuals purchasing her goods. Cary charges a financing charge and interest rate that is based upon the customer's credit score. What disclosures must Cary make to her customers prior to entering into a financing arrangement?
- **Resource Video:** <http://thebusinessprofessor.com/truth-in-lending-act/>

DEBT LIABILITY PROTECTION

This section includes a brief discussion of the various consumer protection statutes relating to consumer liability for certain debts.

11. What is the “Fair Debt Collection Practices Act”?

Overview

The Fair Debt Collection Practices Act (FDCPA) was passed to protect consumers from abusive practices by debt collectors. It establishes limitations on debt collection practices, provides a method for disputing uncertain debts, and prescribes remedies for violation of the Act. The FDCPA applies only to consumer debts collected by debt collectors — business debts are not covered. A “consumer debt” is a debt established for personal, family, or household purposes. A debt collector is defined as “any person who uses any instrumentality of interstate commerce or the mail in any business the principal purpose of which is the collection of any debts, or who regularly collects or attempts to collect, directly or indirectly, debts owed or due or asserted to be owed or due another.” In other words, the FDCPA applies to businesses whose primary business is the collection of third-party, consumer debt.

- *Note:* The Act does not apply to individuals or business collecting their own debts.
- *Example:* Examples of debt collectors include debt collection agencies and attorneys.

Information from Debt Collector

A debt collector must provide the debtor with the following information:

- *Identification* - Any communication from to the debtor must identify the collector and provide notice that any information obtained will be used for the purpose of collecting a debt.
- *Amount* - The communication must contain the amount of the debt.
 - *Note:* The debt must represent the original debt and be in accordance with applicable law regarding interest and fees.
- *Creditor Information* - The communication must contain the name of the creditor to whom debt is owned.
 - *Note:* This includes the name of the collection agency and the owner of the original debt.
- *Notice of Dispute* - Within 5 days of making initial contact, the collector must provide notice that the debtor has 30 days to dispute the validity of the debt.
 - *Note:* Failure to dispute the validity of the debt allows the collector to presume that it is valid.
- *Verification of Debt* - If a debtor disputes the validity of the debt, the collector must provide information verifying that the debt is valid and, if requested, the name of the original creditor. If the original debt was reported to a credit reporting agencies for inclusion on the debtor’s credit profile, notice of any dispute must also be reported to

the credit reporting agencies.

- *Note:* Requiring a debt collector to validate the debt may be difficult when the collector is a third-party agency that purchases debts. It can take time and be difficult for the collector to provide verifying information.

Prohibited Conduct

The FDCPA places the following limits on debt collection practices:

- *Collection Hours* - Collectors may only telephone consumers within the hours of 8:00 a.m. to 9:00 p.m.
- *Workplace Restrictions* - A debt collector may not contact the debtor at her place of employment or contact the employer once made aware that it is unwelcome by the employee or employer.
- *Abusive Collection Practices* - A collector cannot employ abusive practices to collect the debt.
 - *Example:* This may include excessive, harassing phone calls, or abusive language.
- *Deceptive Practices* - The debt collector is prohibited from using deceptive practices or misrepresentations in order to collect the debt.
 - *Example:* The debt collector cannot incorrectly represent that it is an attorney, law enforcement officer, or threaten arrest or prosecution for failure to pay the debt. Further, the debt collector cannot file or threaten to file a false credit report against the debtor.
- *Publicly Communicating Debt* - The debt collector is prohibited from disclosing and discussing the debt with those other than the debtor, the debtor's spouse, or representative. Further, the collector may not publish the debt publicly or list the debtor on a debt collection list. This prohibition extends to communication methods that are used to identify and embarrass debtors.
 - *Note:* The collector may not contact the debtor if aware that she is represented by legal counsel, unless the attorney will not respond. The collector may make limited contact with friends, family, neighbors, or co-workers, but only if necessary to locate the debtor. The collector may not contact any third party more than once. The collector may employ a process known as "skip tracing" to locate the debtor, but it cannot announce the existence of a debt.
 - *Example:* The debt collector cannot mail or otherwise use notification print, postcards, telegrams, or other displays that are deemed to identify and seek to embarrass the debtor. She may, however, indicate her business name on the correspondence.
- *Collection Amount* - Debt collectors may only seek to collect an amount representing by the original debt and in accordance with state law.
 - *Note:* State law may allow the accrual of interest and other fees.

- *Request to Cease Communication* - Consumers may provide collectors with written notice that the debtor refuses to pay (disputes) the asserted debt and request the collector cease any further contact. Once the collector receives this written notice, she cannot contact the consumer except to notify the debtor that collection efforts are halted or that the debtor intends to pursue legal action.
- *Legal Representative* - If a debtor provides notice to the collector that she is represented by legal counsel, the debt collector may not contact the debtor and may only communicate with a legal representative about the debt.
- *Verification of Debt* - If the debtor requests verification of the debt, the collector may not pursue collection efforts until the debt is verified.
 - *Note:* For this prohibition, collection efforts does not include filing a lawsuit. A debt collector or the creditor may begin a legal action at any time to recover the amount owed.

Enforcement of the FDCPA

The CFPB is charged with enforcing the FDCPA. The CFPB may initiate investigations and pursue civil or criminal actions against violators. Consumers may also file a civil action against debt collectors violating the FDCPA. A plaintiff may recover actual damages, statutory damages, attorney's fees, and court costs from debt collectors. A debt collector may avoid liability by demonstrating that violations are unintentional and the result of a good faith error. Likewise, a consumer can be responsible for attorney's fees if the court determines that the consumer filed the action in bad faith.

- *Note:* Numerous state laws also regulate debt collection. The FDCPA does not preempt state laws regulating debt collections so long as they do not conflict with enforcement of the FDCPA.

- **Discussion:** How do you feel about the objectives behind the FDCPA? Do you think the disclosure provisions are adequate? Do you think that the disclosure requirements and prohibitions achieve this objective? Why or why not?
- **Practice Question:** Erin is an attorney who routinely represents business clients. ABC Corp is a client and sends Erin a request to undertake collection efforts against Jerry, a customer of ABC Corp. If Erin communicates with Jerry about the debt, what must she disclose to him? What are the limits on the means that Erin can employ to collect the debt? If Erin employs abusive practices in collecting the debt, what are Jerry's options in protecting his rights?
- **Resource Video:** <http://thebusinessprofessor.com/fair-debt-collection-practices-act/>

12. What is the “Fair Credit Billing Act”?

Overview

The Fair Credit Billing Act (FCBA) was passed as an amendment to TILA with the purpose of protecting consumers against unfair billing practices. The FCBA is administered by FTC and applies within the consumer's home state or 100 miles of home. These provisions are enforced against banks and other financial institutions insured by the Federal Deposit Insurance Corporation (FDIC). The primary protections of the FCBA limit liability on lost, stolen, or misused credit cards

to \$50. It also establishes a method for consumers to address billing errors in open-end accounts, such as credit cards and lines of credit. Further, it allows the credit card holder to assert a defense against paying a merchant for shoddy or defective merchandise.

Methods of Disputing a Debt

Consumers have authority under the FCBA to dispute errors in open-end accounts. To dispute a bill on the account, the consumer must send written notice to the creditor within 60 days of receipt of the account statement containing the error. There are provisions in place to make certain notice is sent to the correct department. The creditor must acknowledge receipt of the dispute within 30 days. The creditor must then investigate the dispute. This generally means undertaking simple substantiation measures with the individual paid by the account, such as a vendor or service provider. The creditor must either correct the disputed debt or explain to the debtor why it believes the debt is valid. The consumer may request all information collected to substantiate the debt.

Enforcement

Enforcement of the FCBA is done through private action. That is, failure of a financial institution to adhere to these provisions gives a consumer the ability to bring a private action against the creditor. The FCBA allows for actual damages, statutory damages of twice the finance charges, court costs, and attorney's fees.

- **Discussion:** Why do you think federal law provides these consumer protections for clients of federally insured institutions? Should these provisions apply outside of just federally insured institutions? Do you think the procedure for disputing a debt is sufficient to protect consumers?
- **Practice Question:** Mandy has a credit card with 1st Federal Bank and Trust. She generally makes certain that the charges on the card draft automatically from her bank account every month. One day, when reviewing her credit card statement, she notices a series of unexplained charges. She now wants to dispute these charges? What information do you need to know to determine if Mandy is protected from having to pay the charges?
- **Resource Video:** <http://thebusinessprofessor.com/fair-credit-billing-act/>

13. What is the “Electronic Funds Transfer Act”?

The Electronic Funds Transfer Act (EFTA) was passed with the purpose of regulating the practice of transferring funds electronically. More specifically, the EFTA applies to electronic transfers of money between two separate institutions. It does not apply to automatic account transfers within the same financial institution. The EFTA is administered by the Federal Reserve Board.

- **Example:** The EFTA does not apply to an automatic monthly account deductions to be deposited into the consumer's saving account in that same financial institution. It does not apply to automatic transfers from accounts held by a financial institution to a consumer's account with that institution, such as where there is an automatic payment for a mortgage held by Big Bank from the consumer's bank account at Big Bank. Rather, it does not apply to cards with a stated value on the face of the card, such as gift cards.

Consumer Protections

The EFTA protects a consumer for lost, stolen, or misused debit cards. These protections are similar to the protection afforded under the FCBA. Responsibility for loss in such situations is allocated between the transferring financial institution and the consumer. A consumer's liability in such a case is limited to \$50 if the consumer follows the appropriate procedure. The consumer must report the misuse of a debit card within 2 days of learning of the misuse. If the consumer fails to report a misuse within 2 days of learning of it, her potential liability moves up to \$500. If she fails to report a misuse for more than 60 days, the EFTA does not place any limits on the consumer's responsibility for losses. The EFTA prohibits creditors from requiring that a consumer repay a debt *via* electronic funds transfer. Lastly, any state law or contract that subjects a customer to greater liability than that mention above is preempted by the EFTA.

- *Note:* The EFTA does not give the consumer the right to stop payment on an electronic transfer.

Responsibility of Financial Institution

If a consumer's card is lost or stolen, the financial institution must provide her with notice of her potential liability. It must also provide a method for reporting the lost or stolen card and provide instructions on resolving the issue. If a consumer reports an erroneous fund transfer, the financial institution must investigate the error and resolve it within 45 days (or 90 days in limited circumstances). If the financial institution takes more than 10 days (20 days for new accounts) to complete the investigation into the transfer error, it must re-credit the customer's account for the amount in question. In any event, the financial institution must notify the customer of the results of investigation. If there is a confirmed error, the financial institution must correct it or make re-credit to the consumer's account final. If there is no error, the financial institution must explain in writing the reason or justification for the transfer. It must also notify the customer that any temporary re-credit to the customer's account will be deducted from the account.

- *Note:* The customer has the right to ask for copies of any documents relied upon in the investigation.

- **Discussion:** How do you feel about the EFTA placing the risk of loss for lost, stolen, or misused debit cards on the financial institution? Can you think of arguments for and against this allocation? What do you think is the purpose of allowing for escalating liability of the cardholder? Do you think the investigation and resolution responsibilities of the financial institution are adequate? Why or why not?
- **Practice Question:** Irene is going on vacation. Immediately before her trip, she notices some strange charges to her bank account. She also realizes that she cannot find her debit card. She decides not to worry about it and continues on her trip. When she returns, she reviews her bank statement there are dozens of unexplained charges. If she now reports the unexplained charges, what are her responsibilities? What are the responsibilities of the bank in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/electronic-funds-transfer-act/>

CONSUMER PRODUCT PROTECTIONS

This section includes a brief discussion of the various consumer protection statutes relating to consumer products.

14. What is the “Consumer Product Safety Act”?

The Consumer Product Safety Act (CPSA) was passed for the purpose of protecting consumers against dangerous products. The CPSA encompasses several consumer protection acts, such as the Poison Prevention Packaging Act (PPPA) and the Consumer Product Safety Improvement Act (CPSIA). The CPSA established the Consumer Product Safety Commission (CPSC), which is charged with administering the provisions of the CPSA along with its regulatory provisions. The CPSC has authority over most consumer products, except those that are expressly relegated to a separate federal agency. The CPSC has authority to establish product safety standards, seek the recall of, and potentially ban, products that are unreasonably dangerous or present a significant risk to consumers.

- *Note:* The CPSIA is an important amendment that protects individuals against retaliation for reporting concerns about product safety. It is also dedicated to ensuring the production of safe products for children.
- *Example:* The coverage of the CPSC is very broad. Examples of consumer products specifically relegated to other federal agencies include: food, drugs, tobacco products, firearms, medical devices, aircrafts, boats, etc.
- **Discussion:** How do you feel about the broad authority granted to the CPSC? Do you feel the authority is sufficiently broad? Why or why not? As you have learned, defective products may create strict liability for manufacturers and sellers. Should this be balanced against the above regulations? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/consumer-product-safety-act/>

15. What are the applicable labeling laws regulating consumer products?

Labeling laws are administered by a combination of federal and state agencies. Federal agencies heavily involved in product labeling laws include the CPSC, FTC, and FDA. Collectively, federal and state laws require manufacturers to place informative labels and warnings on various types of products based upon product category, materials or substance, and applicable safety standards.

- *The Federal Trade Commission (FTC)* - The FTC has broad authority to regulate consumer products that are not otherwise regulated by a separate agency. Most notably, the FTC places consumer goods into product categories and prescribes specific labeling requirements pursuant applicable statutes, regulations, or industry standards.
- *Food and Drug Administration* - The Food, Drug, and Cosmetic Act is the primary federal law administered by the Food and Drug Administration. The FDA classifies goods falling under its regulatory authority into product groups, such as cosmetic and food labeling. The FDA requires extensive testing and labeling to disclose and avoid potential hazards to consumers. In general, the FDA prescribes the content for labels that must be affixed on the inside and outside of product containers, wrappers, or packaging.
- *Consumer Product Safety Commission* - As discussed above, The CPSC is primarily charged with ensuring consumer product safety. As part of this mission, the agency enforces packaging, labeling and other consumer disclosure provisions. Notably, the CPSA enforces labeling provisions under the Consumer Product Safety Act, Federal Hazardous Substance Act, and Poison Prevention Packaging Act.
- *US Customs and Border Protection Service (CBP)* - The CBP regulates and polices the flow of goods into and out of the United States. It is tasked with enforcing US labeling laws for imported goods. Goods incorrectly labeled may be refused entry into the United States, subject to fines, and destroyed.

- **Discussion:** Why do you think authority for the regulation of consumer products is spread over multiple agencies? Can you think of arguments for and against this practice? Can you think of any products or consumer protections that you believe should be governed by a different administrative agency?
- **Practice Question:** Erwin is considering launching a line of baby products. He plans on manufacturing the products in Asia and importing them into the United States. Some of these products are very similar to products that are already on the market. What administrative agencies may regulate this business activity?

The Fair Packaging and Labeling Act

The Fair Packing and Labeling Act (FPLA) is the primary labeling law in the United States. It was passed in 1967 to require labeling of “consumer commodities”. The provisions of the FPLA are enforced by the Food and Drug Administration and Federal Trade Commission. The primary provisions require that labels disclose the following information:

- type of commodity enclosed,
 - *Example:* A package must state the specific items included within. This is important for items that have multiple parts or require the purchase of additional parts (such as batteries) to function.
- amount of contents, and
 - *Note:* The amount of contents may be measured in both metric and inch and pound measures. The type of measurements must be either the weight, size, or numerical count of items.
- the manufacturer or distributor’s name and location.
 - *Note:* This is generally the office address for communications.

It also allows for regulations that protect consumers against deception with regard to ingredients, contents of packaging, pricing, and packaging size. The Act integrates the standards established by the Office of Weights and Measures of the National Institute of Standards and Technology, US Department of Commerce.

- *Note:* The Globally Harmonized System (GHS) is the United Nations System for classifying and labeling chemicals.

- **Discussion:** Why do you think the Fair Packaging and Labeling Act focuses on the type, amount, and origin of a product? Can you think of any other information that you believe should be included on a consumer product label?
- **Practice Question:** Juan is a US citizen, but he has family in Costa Rica. His family produces plantains that are perfect for making plantain chips. He begins bagging and importing the plantain chips for sale in the United

States. What labeling requirements must his product meet to comply with Federal Law?

Other Notable Labeling Laws

- *Federal Hazardous Substance Act (FHSA)*- The FHSA is a federal law administered by the CPSC. The FHSA requires labeling of containers of hazardous products. The label must provide notice of the potentially harmful effects of contact with the hazardous substance and the first aid steps to take in the event of exposure. Pursuant to this Act, the CPSA may ban products that are unreasonably dangerous or not adequately labeled to protect consumers.
- *Toxic Substance Control Act (TSCA)* - The TSCA was passed in 1976 with the purpose of assessing and regulating new and existing commercial chemicals entering the US Market. The act focuses on chemicals deemed to pose an unreasonable risk to the health or environment. The TSCA is administered by the Environmental Protection Agency. The EPA puts in place regulations that require labeling of the chemicals when shipped in the US.
- *Poison Prevention Packaging Act (PPPA)* - The PPPA requires manufacturers to employ child-resistant packaging for certain potentially poisonous items. Covered items include prescription and over-the-counter drugs, household chemicals (such as cleaners), and other hazardous materials (such as poisons).
- *Labeling of Hazardous Art Material Act (LHAMA)* - The LHAMA is a federal act requiring that all art material sold to consumers undergo a toxicology review. The purpose of the review is to identify any potential for adverse health effects and to ensure appropriate labeling of the hazards. Manufacturers must place a statement of compliance with health standards on the substance's container, the consumer invoice, or on the product's retail display.
 - *Note:* Provisions of FHSA apply to art material as well.
- *Federal Insecticide, Fungicide, and Rodenticide Act (FIFRA)* - FIFRA was designed to regulate the distribution or sale of pesticides. This generally includes any mixture of substances used to prevent, repel, destroy, or mitigate the presence of insects, fungi, and rodents. It also includes substances used as a defoliant, desiccant, plant regulator, or nitrogen stabilizer. Manufacturers must meet child-protective packaging and labeling requirements. Further, manufacturers and employers must adhere to EPA and OSHA standards for labeling and worker protection.
- *Flammable Fabrics Act (FFA)* - The Consumer Product Safety Commission was given the authority under the FFA to issue mandatory flammability standards. This includes the requirement to place warnings on tags or labels that indicate the product's flammable nature.
 - *Example:* Consumer goods subject to flammability standards include clothing, film, carpet, rugs, and mattresses.
- *Textile, Wool and Fur Acts* - The FTC administers a number of statutes and regulations aimed at regulating fabrics, furs, and textiles in the US. Notably, these laws require consumer goods be labeled with the fiber content, country of origin, manufacturer (or marketer) identity. In the case of clothing, related laws may also require

additional size labeling standards.

- *OSHA Hazard Communication Standard* - Products used in the workplace are subject to the OSHA Hazard Communication Standards. Manufacturers must label chemical containers and develop material safety data sheets that provide detailed information about the material.

- **Discussion:** How do you feel about the diverse authorities regulating the labeling of consumer products? Are there any benefits or detriments to such extensive legal requirements?
- **Practice Question:** Dolly is a chemist. She has developed several interesting chemical solutions aimed killing insects and rodents, household cleaning of wood and metal, and maintaining industrial equipment. If Dolly decides to sell her solutions to the public, what federal laws will govern the production and sale of her products.

- **Resource Video:** <http://thebusinessprofessor.com/product-labeling-laws/>

16. What is the Federal Food, Drug, and Cosmetic Act?

The Federal Food Drug and Cosmetic Act (FFDCA) was passed for the purpose of ensuring the safety of food, drugs (some medical devices), and cosmetics. The act gave authority to the Food and Drug Administration (FDA) to administer the provisions of the Act. It is a broad Act including provisions for electronic radiation control, provisions for effective testing and marketing of drugs, and bioterrorism preparation. The FFDCA contains both civil and criminal penalties for violation of its provisions. Repeated, intentional, and fraudulent violations of the Act are generally subject to criminal action.

- **Discussion:** Why do you think Congress made special provision for protection of consumers of food, drug, medical, and cosmetic items? Do you think there are other items that should be covered in this category? If so, which ones?
- **Practice Question:** Juliet has a Halloween store. She has decided to launch her own line of Halloween makeup. She will produce the makeup locally and sell it through her store. What consumer protection laws specifically control producing and selling this type of product?
- **Resource Video:** <http://thebusinessprofessor.com/federal-food-drug-and-cosmetics-act/>

17. What is the “Magnuson-Moss Warranty Act”?

Overview

The Magnuson-Moss Warranty Act (MMWA) was passed to protect consumers by regulating the use of warranty and disclaimer provisions by merchants. Generally, warranties are the subject of state contract law. The MMWA is a federal law administered by FTC; but it does not limit a consumer’s rights under any other state or federal consumer protection

law. The provisions of the MMWA regulate how warranties are presented to purchasers of consumer products. It seeks to ascertain that warranties are presented in a manner that is “readily understood” by the consumer. It applies to full and limited warranties of goods, but warranties on services for repairs are not covered. While merchants are not required to provide a warranty on products, if a warranty is provided it must comply with the MMWA provisions.

- *Note:* States have consumer protection laws ranging from the application of warranties under state commercial codes to various antifraud statutes.

Requirements of the Act

The FTC requires that a merchant warranting a consumer product disclose, fully and conspicuously, in simple and readily understood language, the terms and conditions of the warranty. The disclosure provisions are most important when a merchant provides a limited warranty, as the consumer must understand all of the limitations associated with the warranty. When a merchant fully warrants a product against defect, the warrantor must comply with the following provisions:

- *Repair or Replace* - The merchant must fix or replace the product without charge, within a reasonable time. If, after reasonable effort is made to repair the item, the product or a component part still has a defect, the consumer can either receive a refund or free replacement of the item.
- *Limitations on Implied Warranties* - The merchant may not limit the time period for any implied warranties;
- *Limitations on Damages* - A merchant may only limit its liability for consequential damages arising from a breach of any written or implied warranties if that disclaimer is conspicuously written on the face of the warranty document.
- *Branded Components* - A merchant cannot tie the enforceability of warranty provisions to the use of branded parts or materials for repair.
- *Exercise Warranty Rights* - A merchant may not require that a consumer undertake any steps (other than notification of a defect or nonconformity and return to a place of repair) in order to enforce her warranty rights.

The above standards are not required if a merchant can demonstrate that the cause of a defect or malfunction is due to damage, failure to maintain, or misuse of the product while in the consumer’s possession.

Remedies

The MMWA allows for civil actions by the FTC or by private parties. A civil action by private parties may seek damages in state or federal court. A federal court action must have an amount of damages in controversy of \$50,000 or more or have 100 plaintiffs in a class. A successful plaintiff may recover actual damages, court costs, and attorney’s fees. An action by the FTC generally seeks injunction against a merchant barring the subject practice.

- *Note:* The Act also prescribes informal dispute-resolution procedures for resolving an alleged breach of warranty and violation of the MMWA. Merchants, in the sales contract, may require mediation or arbitration of disputes regarding full warranties.

- ***Discussion:*** Why do you think Congress established a federal standard for contract warranty protection? Do you

think that federal law protection beyond state law protection is warranted? Why or why not? Do you think that the mandatory warranty provisions are adequate or excessive? Why or why not?

- **Practice Question:** Carly purchases a mobile generator to use at parties and tailgates. The dealer represents that the generator comes with a full warranty for 12 months. Just one month after purchasing the generator, Carly is using it to power the lights at a tailgate and it catches on fire. When Carly attempts to return the generator to the dealer, the dealer explains that she must complete extensive paperwork that must be sent to the manufacturer before the warranty is honored. Carly is not happy. What are her rights in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/magnuson-moss-warranty-act/>

CONSUMER PRIVACY PROTECTIONS

This section includes a brief discussion of the various consumer protection statutes relating to individual privacy and the collection of information.

18. What is the “Privacy Act of 1974” (Privacy Act)?

The Privacy Act restricts the ability of the Federal Government to collect information about individual US citizens. Specifically, it regulates the use, maintenance, and dissemination of collected personally-identifiable information. “Personally-identifiable information” either contains the name or other information that allows the information to be attributed to a specific individual. These regulations are contained in what is known as the Code of Fair Information Practices. This regulatory framework controls all records in the possession and control of the Federal Government. Any agency in possession of such information must employ administrative and physical security measures to protect against the dissemination of the information. All federal agencies, particularly those that collect personally-identifiable information, must provide public notice of their records and systems *via* the Federal Register. The system must also provide a means by which individuals may seek access to and amend any erroneous material in their records. Consent of an individual is required before the agency may disclose that person’s personal information. There are, however, several exceptions where a federal agency may disclose personally-identifiable information about an individual without notifying the person:

- For statistical purposes by the Census Bureau or the Bureau of Labor Statistics;
- For routine uses within a US government agency;
- For archival purposes "as a record which has sufficient historical or other value to warrant its continued preservation by the United States Government";
- For law enforcement purposes;
- For congressional investigations; and
- Other administrative purposes.

Agencies must also have a Data Integrity Board that reports all complaints about Privacy Act violations to the Office of Management and Budget. The Privacy Act was amended to include provisions regarding the use of Privacy Act information in automated matching programs (such as criminal records programs).

- *Note:* Records held by courts, executive components, or non-agency government entities are not subject to the provisions in the Privacy Act and there is no public right to these records. Information collected pursuant to

criminal investigation may also be exempt from disclosure.

- **Discussion:** How do you feel about the collection of personal information by the Federal Government? Do you think that the requirement that administrative agencies disclose the collection of personally identifiable information is an adequate safeguard of individual privacy rights? Why or why not? Does the ability to dispute inaccurate information affect your opinion? Why or why not?
- **Practice Question:** The National Security Agency (NSA) has decided to monitor computer traffic to websites advocating the overthrow of the US Government. The agency's monitoring reveals a computer user's IP address. The IP address is then matched with a physical address where the IP address is registered. The physical location is matched with the real property records providing the owner's name and personal information. All of this information is stored in case it is needed in a future investigation. What procedures must the NSA follow to comply with federal privacy law protections?
- **Resource Video:** <http://thebusinessprofessor.com/privacy-act-of-1974/>

19. What is the "Right to Financial Privacy Act of 1978" (RFPA)?

The RFPA places limitations on the ability of the Federal Government to seek financial records about an individual from banks or other financial institutions. The RFPA applies only to the Federal Government. It does not govern requests for financial records made by private businesses or state or local governments. Further, the RFPA only protects the records of individuals and partnerships with 5 or fewer partners. It does not protect the financial information of other business entities. The Federal Government may access such records in the following instances:

- the customer authorizes access;
- there is an appropriate administrative subpoena or summons;
- there is a qualified search warrant;
- there is an appropriate judicial subpoena; or
- there is an appropriate written request from an authorized government authority.

If the Federal Government seeks to obtain these records, it must notify the individual whose records are requested. The customer then has 10 days from the date of written notice to challenge the disclosure. The RFPA allows for statutory damages of \$100 for each violation.

- **Note:** The FRPA allows for disclosure without notice to the individual consumer in a number of instances, including use in a civil or criminal proceeding or certain national security investigations.

- **Discussion:** Why do you think Congress placed limitations on the ability of the Federal Government to access the financial records of individuals? Do you believe the requirement to notify the individual of the request and the period to dispute the disclosure adequately protect the individual's privacy rights? Why or why not?
- **Practice Question:** Clayton is suspected of tax evasion and racketeering. The IRS and FBI open an joint investigation into his conduct. These agencies want to access Clayton's financial records with several banks. What process must the IRS and FBI follow before sending a request to these financial institutions for Clayton's records?

- **Resource Video:** <http://thebusinessprofessor.com/right-to-financial-privacy-act/>

20. What is the “Electronic Communication Privacy Act of 1986” (ECPA)?

The ECPA protects individuals against unlawful interception of electronic communications by the Federal Government or individuals. Specifically, it restricts the ability to undertake wire taps, computer transmissions, stored electronic communications, and tracing of telephone communications, etc. It is a federal crime to undertake such activity without first receiving a court order or obtaining consent from a party to the communication. This means that one party to the conversation may record the conversation without another party’s knowledge. The Act protects communications while being made, as well as records of past communications. It is also a crime to use or disclose information obtained through this illegal means.

- **Note:** The ECPA does not cover video recordings without an audio recording component. States may further restrict the ability of individuals and the government to record private communications. Notably, some states require the consent of both parties before a communication may be recorded. The ECPA establishes higher standards for search warrants for active communications. The standard is not raised for records of communications.
- **Discussion:** How do you feel about the ability of the Federal Government and individuals to record private communications? Should the government have broader or narrower rights to record communications? Should both individuals be required to consent before recording an communication? Why or why not?
- **Practice Question:** ABC Corp has a retail store that is very popular. In order to gain greater understanding of their customer’s purchasing habits, ABC Corp sets up cameras and microphones in its stores in hopes of recording information about consumer preference for their products. Is what ABC Corp doing illegal?
- **Resource Video:** <http://thebusinessprofessor.com/electronic-communication-privacy-act/>

21. What is the “Children’s Online Privacy Protection Act of 1986” (COPPA)?

COPPA was passed to protect against the online collection of personal information of children under the age of 13 years. Enforcement of COPPA is charged to the FTC, which issues regulations for its enforcement. The rules regulate commercial websites, online services, mobile apps, etc., that collect personal information from operators of the site. More specifically, COPPA applies to any site that collects personal information and is targeted toward children under 13 years old or sites that collect information with knowledge that children under the age of 13 years are using the site. COPPA also applies to individuals or businesses that collect this type of consumer information off of the websites of others. Operators of such sites must comply with the following provisions:

- **Online Privacy Policy** - Inform users of their practices of recording user information;
- **Parental Consent** - Provide notice to parents of the intent to collect children’s information and obtain parental consent;

- *Limited Disclosure* - Prohibit the disclosure of information collected about children, except in limited circumstances;
- *Parental Review* - Allow parents to review (and request deletion) of the collected information;
- *Parental Limitations* - Allow parents to prevent further use or future collection of the child's information;
- *Confidentiality* - Maintain security in the storage of information; and
- *Limited Retention* - Not maintain the information longer than necessary, and delete the information after it has served its intended purpose.

- **Discussion:** Why do you think Congress provided special privacy protections for children under 13 years of age? Do you believe the current restrictions are effective in achieving the objectives of COPPA? Why or why not? Do you think the requirements on businesses collecting information on the website are overly onerous? Why or why not?
- **Practice Question:** Carole started a website that allows children of all ages to play games that help them learn math. Users are required to log into the site and she records all of the information about the user and how they use the site. What standards must Carole's website meet to avoid a violation of federal law?
- **Resource Video:** <http://thebusinessprofessor.com/childrens-online-privacy-protection-act/>

22. What role do states play in consumer protection?

States pass and enforce any number of consumer protection laws. These laws sometimes offer protections in addition to those offered by federal law. State laws protecting consumers are generally known as Unfair and Deceptive Practices (UDAP) statutes. Common areas regulated by UDAP statutes include: extension of credit, insurance, utilities, post-sales acts, and real estate.

- **Example:** A commonly recognized type of state consumer protection statute concerns the sale of automobiles. These statutes grant the purchaser of an automobile the right to return the automobile within a specified period of time if the purchaser identifies mechanical issues in the vehicle. These are commonly known as "lemon laws".
- **Discussion:** Why do you think states feel the need to offer additional protections beyond those afforded by federal law? Can you think of any advantages to seeking enforcement of one's rights under state, rather than federal, law?
- **Practice Question:** Patrick believes that he has been defrauded by a local used car salesman. He is considering bringing a legal action against the car dealer. What are Patrick's options with regard the jurisdiction and type of legal action to bring against the dealer?
- **Resource Video:** <http://thebusinessprofessor.com/state-consumer-protection-laws/>

TOPIC 18: ANTITRUST LAW

Overview

Antitrust law concerns the regulation of certain business practices that result in lower levels of competition among businesses in the market. A lower level of competition in a given market is generally understood to be detrimental to consumer interests. It can cause higher prices and shortages in supply or availability of products. This chapter introduces antitrust law and the primary federal statutes providing consumer protections. It then examines the various types of conduct or situations that are deemed illegal under these laws.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• Antitrust Law • Federal Trade Commission • The Sherman Act of 1890 • The Clayton Act of 1914 • The Federal Trade Commission Act of 1914 • Contract, Combination, or Conspiracy in Restraint of Trade • Per Se Illegality & Rule of Reason • Monopoly • Exemptions from Antitrust • Sanctions Under Antitrust Law	• Sherman Act: • Horizontal Restraint - Sharing Information - Refusal to Deal - Territorial Agreement - Price Fixing • Vertical Restraint - Exclusive Dealing - Tying Arrangements - Territorial Agreements	• Clayton Act: - Price Discrimination - Special Arrangements - Tying Contracts - Reciprocal Dealing - Mergers & Acquisitions • Federal Trade Commission Act

- [Monopolization](#)
-

TOPIC 18: ANTITRUST LAW - QUESTIONS & ANSWERS

1. What is “antitrust law”?

“Antitrust laws” are a combination of federal and state laws that seek to promote competition among businesses (both large and small). Competition among businesses benefits consumers, as businesses compete by providing better or more goods and services at lower prices. In pursuit of growth and efficiency, business competitors often attempt to share some activities or join together in the performance of business functions. Many types of concerted efforts among competitors are perfectly legal, while others are prohibited by law and can lead to the severe sanctions. Concerted activities, such as sharing of resources and information, are often beneficial to society even though they reduce competition. The question of legality focuses on whether consumers suffer a detriment from the activity.

This area of law gained the name antitrust based upon historical practices by businesses employing trusts to monopolize industries and thwart competition. Basically, individuals or companies would set up trusts that they controlled to hold a controlling ownership interest in multiple industry competitors. In this way, a single individual or group of individuals could effectively exercise control over an entire industry and thereby diminish competition. The federal and state governments began passing laws to break up these holding trusts. As such, the name of such laws became antitrust laws.

- **Discussion:** Why do you think the government concerns it self with industry competition and consumer welfare? Should it? Why or why not?
- **Practice Question:** What are the legislative objectives behind the antitrust laws? Is all business activity that dominates a product market illegal under the antitrust laws? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-antitrust-law/>

2. What are the major antitrust laws in the United States?

Since the inception of antitrust law, the Federal Government has passed three sweeping antitrust laws:

- *The Sherman Act of 1890,*
- *The Clayton Act of 1914, and*
- *The Federal Trade Commission Act of 1914.*

These acts still provide the primary sources of antitrust law effective today. They have been subject to amendment and are the source of an extensive web of regulations used to effectuate these statutes. They provide for both civil and criminal penalties for violations.

3. What entities are charged with carrying out the federal antitrust laws?

The Federal Trade Commission (FTC) is an independent federal agency primarily charged with developing regulations

and preventing violations of the federal antitrust laws. The objective of the FTC is to protect consumers by preventing anticompetitive business practices. In pursuit of this objective, the FTC has broad authority to determine what constitutes unfair competition in the market. The FTC issues trade regulations that apply broadly across industries and trade practice rules that guide businesses operating in specific industries. While compliance with FTC practice rules is voluntary, it provides a safe harbor in the event of FTC inquiry into a business's practices.

In the Sherman Act, Congress broadly defined "unfair" methods of competition to allow administrative agency and federal court interpretation to add specificity. Generally, the FTC makes the determination of what it deems to be "unfair". If there is no deception or obvious antitrust violation, the FTC asks three questions, any of which may lead to a finding of unfairness:

- Does the conduct injure consumers significantly?
- Does the conduct offend an established public policy?
- Is the conduct oppressive, unscrupulous, immoral, or unethical?

The FTC has the authority to regulate and take enforcement action against any business for conduct that it deems to be unfair. This may include coordinating efforts with the Department of Justice if the FTC encounters business activity that violates criminal laws.

- **Discussion:** What do you think about the extent of the FTC's authority to regulate and administer antitrust laws? Does the FTC have too much autonomy in determining what constitutes "unfair" competition? Why or why not? What do the above-referenced questions indicate about the objectives of the FTC in enforcing antitrust law?
- **Practice Question:** What standard does the FTC apply when determining whether conduct runs afoul of the antitrust laws?
- **Resource Video:** <http://thebusinessprofessor.com/federal-trade-commission-enforcing-antitrust-laws/>

ANTITRUST LAWS

4. What is the "Sherman Act of 1890"?

The Sherman Act was the first major federal law passed with the purpose of ensuring competition across and within industries. At the time of its passage, several large companies had nearly complete control over certain industries (steel, oil, and railway) very important to the development of the United States. The effect of this lack of competition was to create exorbitant wealth in a few individuals and higher prices for consumers. The high price to consumers reduced consumption and resulted in lower total economic output.

- **Note:** See Justice Black's opinion in *Northern Pacific Railroad Co. v US*, 36 US 1 (1958) for a description of the Sherman Act purpose.
- **Example:** The most well-known anticompetitive trusts were John D. Rockefeller's Oil Trust (Standard Oil of New Jersey), and J. P. Morgan's Steel Trust (US Steel Corporation). Other examples include Sugar Trust, the Whisky

Trust, the Cordage Trust, the Beef Trust, and the Tobacco Trust.

In response to this reality, Congress passed the Sherman Act, which seeks to preserve competition by prohibiting two types of anticompetitive business behavior:

- Section 1 - *Contracts, combinations, or conspiracies in restraint of trade or commerce*, and
- *Section 2 - Monopolies and attempts to monopolize.*

The Sherman Act fails to define what is a contract, combination, or conspiracy in restraint of trade or a monopoly. As such, much of antitrust law is based in the common law interpretation of federal courts.

- *Note:* The specific types of conduct prohibited under The Sherman Act is discussed below.

- **Discussion:** Do you think the Federal Government is justified in regulating areas of business industry in this manner? Why or why not? Should business rights be balanced against those of consumers?
- **Practice Question:** What type of conduct does the Sherman Act prohibit? What are the differences between the protections of Section 1 and Section 2?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-sherman-act/>

5. What is the “Clayton Act of 1914”?

The Clayton Act is an antitrust law passed to protect consumers by providing a means of preventing early-stage anticompetitive practices. It has a specific focus on the sale of commodities. The Clayton Act is more specific in identifying anticompetitive conduct than is the Sherman Act. It also creates exemptions for certain industries or businesses and establishes an enforcement mechanism to remedy violations of the Act. A notable aspect of the Clayton Act is that it prohibits conduct that does not presently amount to an injury to consumers but has the tendency to lead to consumer injury. In this way, the Act focused on regulating conduct to prevent harm from occurring.

- *Note:* The specific types of conduct prohibited under The Clayton Act is discussed below.

- **Discussion:** How do you feel about the purpose of the Clayton Act? Should the Federal Government be able to prohibit certain business practices that are not presently anticompetitive based upon their tendency to by anticompetitive?
- **Practice Question:** What is the regulatory function of the Clayton Act and how is it distinct from the Sherman Act?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-clayton-act/>

6. What is the “Federal Trade Commission Act of 1914”?

In 1914, the same year that the Clayton Act passed, Congress passed the Federal Trade Commission Act (FTC Act). This act created the Federal Trade Commission, which is an independent administrative agency charged with consumer protection. The FTC bears primary responsibility for enforcing the Sherman Act, Clayton Act, and the regulatory provisions of the FTC Act itself. The FTC pursues civil remedies, while the Department of Justice enforces the criminal (and some civil) provisions of the antitrust laws. State governments and private parties also have the ability to bring civil actions under the antitrust laws seeking civil damages or injunctions.

- *Note:* The specific types of conduct prohibited under The FTC Act is discussed below.

- **Discussion:** What do you think about centralizing enforcement of antitrust laws with a single administrative agency?
- **Practice Question:** What federal agency is charged with enforcing the antitrust laws and what is its statutory authority?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-federal-trade-commission-act/>

THE SHERMAN ACT

The Sherman Act prevents certain contracts, combinations, or conspiracies in restraint of trade or commerce, and industry monopolies and attempts to monopolize. The following are the basic concepts behind the Sherman Act.

7. What is a “contract, combination, or conspiracy” in restraint of trade?

Section 1 of the Sherman Act prohibits “contracts, combinations, and conspiracies in restraint of trade or commerce”, but it does not define these types of agreements. Common law surrounding the Sherman Act identifies numerous forms of concerted actions between market competitors or members of the value chain that have the intent or effect of restraining trade in the relevant product or service market. These relationships are generally broken into “vertical restraints” and “horizontal restraints” of trade. The various types of vertical and horizontal trade are discussed individually.

- *Note:* While these above definitions appear to be broad, interdependent or independent activity is not a restraint of trade and will not give rise to a cause of action under Section 1.
- **Discussion:** What common element do you see among each type of prohibited conduct? Do each of these activities demonstrate the same company intent? Does prohibiting each of these activities seem to serve the same objective?

- **Resource Video:** <http://thebusinessprofessor.com/contract-combination-conspiracy-in-restraint-of-trade/>

8. What is “per se illegality” and the “rule of reason”?

Section 1 of the Sherman Act broadly prohibits actions that in some way restrain trade. If an action is determined to be a

restraint of trade, the following standards apply to determine whether the arrangement is illegal:

- *Per Se Illegal* - A “naked restraint” of trade is one that is explicitly anticompetitive, such as an agreement controlling the price of a good or the output from production. A naked restraint with no pro-competitive justification is generally held to be *per se* illegal. That is, these practices are, by their nature, anticompetitive and thus *per se* illegal. A court will not evaluate any alleged pro-competitive justifications for such activity.
 - *Example:* Agreements setting a minimum or maximum price, output limitations, geographic apportionment of a region, bans on price competition would all qualify as *per se* illegal. Horizontal agreements among competitors are much more likely to be *per se* illegal. In vertical agreements between producer, wholesaler, and retailer, it is often difficult to determine if they are anticompetitive. These types of relationship must be examined under the rule of reason. All of these types of restraint are discussed further below.
- *Rule of Reason* - The rule of reason applies to a restraint that is not deemed a naked restraint. Per Section 1, “every contract, combination, or conspiracy” is illegal if it constitutes undue or “unreasonable” restraint of trade. The test for reasonableness concerns whether the challenged contracts or acts unreasonably restrict competitive conditions in the market or industry. Unreasonableness can be based upon the nature or character of the agreement or surrounding circumstances. The rule of reason balances pro-competitive and anti-competitive effects. In determining whether a restraint of trade is reasonable, the court would consider:
 - facts peculiar to this business,
 - actual and probable effects of restraint (including the effect on competitors);
 - history of the restraint;
 - purpose of restraint;
 - scope of the restraint;
 - convenience to suppliers and consumers; and
 - creation of new products.

In essence, if the activity promotes competition, it may justify the anticompetitive aspects.

- *Quick-Look (or Truncated) Rule of Reason* - This is a test employed by the court in very limited circumstances. It is feasible that a naked restraint may be legal if there is a pro-competitive justification. Under the quick-look test, a court will allow a defendant to introduce evidence that conduct that would otherwise be *per se* illegal has a pro-competitive aspect. If a pro-competitive justification is plausible, the court will employ a full rule-of-reason analysis.
- **Discussion:** Why do you think antitrust law allows for multiple standards for determining whether anticompetitive activity is illegal? Why do you think one type of conduct is *per se* illegal while others are not? Should all typically

per se illegal conduct be treated with the truncated rule of reason? Why or why not?

- **Practice Question:** ABC Corp is challenged by the Federal Trade Commission as entering into a contract with 123 Corp that restrains trade. What process will the court use to evaluate the contract to determine whether it is illegal?
- **Resource Video:** <http://thebusinessprofessor.com/antitrust-rule-of-reason-and-per-se-illegality/>

9. What is a “Monopoly”?

Section 2 of the Sherman Act regulates monopolies or conspiracies or attempts to monopolize any part of interstate or foreign commerce. It is directed at single firms and does not purport to cover shared monopolies or oligopolies.

- **Monopoly** - In *US v. Grinnel Corp*, the federal court defined a monopoly as, "(1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident." "Monopoly power" is generally understood to mean "the power to control prices or exclude competition". The "relevant market" is determined by the geographic area where the product or service is sold, either by the subject party or competitors. Section 2 focuses on acquiring the monopoly through improper means. There must be some anticompetitive conduct, such as exclusionary or predatory practices.
 - **Note:** There must be some monopolistic effect, such as limiting supply or raising prices. This means there must be long-lasting market power, rather than temporary or fleeting power. Any execution of legally acquired market power to acquire or maintain a monopoly may be prohibited.
 - **Example:** Buying up existing competitors in order to secure distribution rights for all products in a given industry would be the willful acquisition of monopoly power.
- **Attempts to monopolize** - In *Spectrum Sports, Inc. v. McQuillan*, the court held that an attempt to monopoly requires proof "(1) that the defendant has engaged in predatory or anticompetitive conduct, (2) with a specific intent to monopolize, and (3) a dangerous probability of achieving monopoly power." The attempt does not have to be successful. It is sufficient that there was intent and a dangerous probability of success exists. For conduct to have a dangerous probability of resulting in a monopoly, a court will evaluate the market or industry and the relative power of the business. The same activity by different firms may be illegal based upon the probability of their conduct resulting in monopoly power.
 - **Note:** Competing hard in an industry does not demonstrate an intent to create a monopoly. Intent to monopolize means a specific intent to eliminate competition and to secure singular or monopoly power for a firm.
 - **Example:** Predatory pricing employed with the objective of pushing competitors out of the market may constitute an attempt to monopolize. If the firm has a dangerous probability of achieving its objective, the attempt may be illegal.
- **Conspiracy** - Conspiracy to monopolize requires an agreement between two or more parties with the specific

intent of acquiring monopoly power. Following the agreement, it requires at least one overt act to accomplish the objectives. Unlike a cause of action for attempt, an actual ability to achieve a monopoly or a show of power is not required.

- *Example:* ABC Corp agrees to share intellectual property rights and jointly sell a product that will eliminate similar products from the market. The companies begin working together to come up with the common design. This level of cooperation with the specific intent to gain monopoly power for the joint venture would constitute a conspiracy to monopolize.

Often a business will develop monopoly power through a competitive advantage (such as a differentiation or cost strategy). It is important to emphasize that, without the intent to eliminate competition and secure monopoly power, this conduct is not illegal. A business that acquires monopoly power, however, must avoid suppressing competition from potential or existing competitors. Such conduct may constitute an attempt to maintain or extend monopoly power.

- **Discussion:** How do you feel about the multiple causes of action under Section 2 of the Sherman Act? Do you agree that an attempt to maintain monopoly power that was not illegally acquired should be illegal? Why do you think a cause of action for attempt to create a monopoly requires a showing of a dangerous probability of achieving the objective? Should a conspiracy require a probability of achieving a monopoly or is an overt act in that direction sufficient? Why or why not?
- **Practice Question:** ABC Corp is a competitor in the cable Internet space. The company has extremely efficient operations and strong customer service. As a result, it holds approximately 55% of the available market share. ABC generally buys any smaller companies that attempt to enter the space. They are also in a price battle with the second largest competitor. They are currently pricing phone plans at a loss in hopes of acquiring a greater market share. There have been preliminary negotiations to halt the price war and to work with the competitor to effectuate an increase in both company's market share. Which of the following activities could be subject to challenge under Section 2 of the Sherman Act? Why?
- **Resource Video:** <http://thebusinessprofessor.com/sherman-act-monopoly/>

10. What businesses are exempt from the provisions of the Sherman Act?

Businesses in certain industries may be exempt from some of the antitrust provisions of the Sherman Act. These businesses do not receive a blanket exemption; rather, they receive specific exemptions for certain practices or activities. Examples of exempted businesses include:

- *State Action Exemption* - State actors (or state-owned entities) are exempt from Sherman Act regulations. This is known as the “*Parker v. Brown Doctrine*”. The key is that the state entity must be acting in its sovereign capacity.
- *Lobbying Exemption* - Efforts to lobby government officials is exempt from antitrust regulation, despite the anticompetitive purpose and potential effect. This is known as the “*Noerr-Pennington Doctrine*”. The justification for this exemption is that regulation of lobbying activity may violate an individual's First Amendment rights to petition the government for redress of a grievance. This doctrine extends First Amendment protections to these business organizations.

- *Note:* Lobbying activity may be actionable as anticompetitive if a company uses efforts to lobby the government with the true purpose of disrupting or interfering with a competitor's business.
- *Patent Law (or Trademark Law)* - Grants of intellectual property rights are exempt from the Sherman Act. For example, awarding the creator of a patented item is a limited form of monopoly granted in that item.

- **Discussion:** How do you feel about exemptions from antitrust regulation of state actors, intellectual property, and lobbying efforts? What arguments exist for regulating these activities under the antitrust laws?
- **Practice Question:** Devan works for ABC Corp, a company that installs solar power systems on personal residences. His primary responsibilities are to promote the interests of ABC Corp to state and federal lawmakers. Part of his efforts include seeking the heightened regulation of businesses installing these types of systems. He is trying to push out of the market competitors who cannot meet these heightened regulatory standards. This may have the effect of creating monopoly power in ABC Corp. Is this activity prohibited by antitrust law?
- **Resource Video:** <http://thebusinessprofessor.com/exemptions-from-antitrust-regulation/>

ANTICOMPETITIVE ACTIVITY REGULATED BY THE SHERMAN ACT

The various types of conduct regulated by the Sherman Act can generally be divided into horizontal restraints and vertical restraints.

11. What are the commonly recognized types of “horizontal restraint”?

While there are several established types of horizontal restraint, any situation that meets the following elements may be illegal.

- *Agreement* - Was there an agreement between or among market participants?
- *Restraint* - Was there an identifiable restraint of trade? If so, was the restraint:
 - Naked with no pro-competitive justification? If so, it is *per se* illegal.
 - Naked with a pro-competitive justification? Then apply the quick-look rule of reason.
 - Not a naked restraint? Then the rule of reason applies.

Remember, there is no requirement that a business have extensive market power for conduct to be illegal under § 1.

- **Discussion:** Why do you think a horizontal restraint requires an agreement among two or more businesses? How do you feel about the fact that market power is not required under Section 1?

- **Practice Question:** ABC Corp sells a product throughout the US. ABC's largest competitor is 123 Corp, which sells a similar product. ABC and 123 enter into an agreement to work together in selling their products. If the arrangement between ABC and 123 is challenged by the FTC, what will a court look at to determine whether the situation constitutes a horizontal restraint of trade that violates antitrust law?
- **Resource Video:** <http://thebusinessprofessor.com/sherman-act-horizontal-restraint-of-trade/>

Below are several horizontal restraints on trade commonly understood to be illegal.

- **Sharing Information** - Under the Sherman Act § 1, sharing of information among competitors with the purpose of restraining trade (i.e., a naked restraint of trade) is *per se* illegal. So, the question of whether information sharing is illegal turns primarily upon whether there is some way the information sharing is or could be harmful to competition and restrain trade. If no, the practice is not a naked restraint and therefore not *per se* illegal. As such, a court will generally apply the rule of reason and look at the actual effect of the sharing activity. Factors used in determining whether information sharing is harmful may include the:
 - **Nature of the Information** - Were the parties are sharing future, present, or past information?
 - **Actions taken by Either Party** - Was there any enforcement of the sharing relationship by either party, monitoring of another party's activity, or coercive mechanisms involved with the sharing of information?
 - **Availability of Information** - Was the information available to insiders, publicly available, or available at a reasonable cost?
 - **Market Structure** - Is the market concentrated to the point that sharing between the parties looks like collusion?

If the pro-competitive justifications outweigh the anti-competitive aspects of the activity, it may not violate the Sherman Act.

- **Discussion:** Why do you think the court does not deem the sharing of information among competitors to be *per se* illegal? Do you agree? Why or why not? Do you agree that the above-referenced considerations are adequate for determining whether the sharing of information is *per se* illegal?
- **Practice Question:** ABC Corp and 123 Corp occupy 55% of in-store consumer goods sales in the Midwest. ABC Corp regularly shares information with 123 Corp about product sales and customer transactions within its store. 123 Corp, in turn, shares the same information with ABC Corp from its operations. This information is strictly guarded from disclosure to the public or other competitors. If the FTC challenges this sharing of information, what factors would a court consider in determining legality?
- **Resource Video:** <http://thebusinessprofessor.com/sherman-act-sharing-of-information/>

- **Refusal to Deal** - Under the Sherman Act § 1, refusals to deal with or boycotts of market participants can be

illegal as horizontal restraints of trade. This may be the case when the refusal has anti-competitive aspects but no pro-competitive justification. If the refusal to deal is not a pure restraint of trade, a court would use the rule of reason to determine whether a sufficient restraint of trade is present to make the conduct illegal. The greater the amount of commerce involved in the boycott situation, the more likely it is to be an illegal restraint of trade.

- *Example:* A boycott of a supplier that includes cooperative buying arrangement would be *per se* illegal if the boycotters possess extensive market power or control some element that is essential for competition. If, on the other hand, an agreement to boycott a particular supplier is suggested, it may not be a restraint of trade. But, if the boycott is monitored by either party and enforced in some manner, it is likely a sufficient restraint on trade to be illegal.

- **Discussion:** What factors should a court use to determine whether a refusal to deal with market participants is a naked restraint of trade? Should the effect on trade be examined before a determining whether conduct is *per se* illegal? What are the arguments for and against this approach?

- **Practice Question:** ABC Corp is a large manufacturer of widgets. 123 Corp is a supplier of material parts used in the manufacture of widgets. ABC refuses to deal with 123 Corp and directs all of its purchases to XYZ Corp, which has an agreement to only supply parts to ABC. ABC believes that limiting orders to 123 Corp will reduce volume and push up the cost per unit. This will hurt all of ABC Corp's competitors. Is there any problem with ABC's conduct?

- **Resource Video:** <http://thebusinessprofessor.com/sherman-act-refusal-to-deal/>

- *Horizontal Territorial Agreements* - Under the Sherman Act § 1, a territorial agreement that allocates geographical areas among competitors may be a horizontal restraint of trade. In a horizontal territorial agreement, competing businesses enter into an agreement not to compete with or infringe upon another competitor within an exclusive geographic territory. The agreement not to compete is generally a naked restraint of trade that has no pro-competitive justification. As such, it is *per se* illegal under the Sherman Act.

- *Example:* ABC Steel Inc., and 123 Steel Inc., are large steel suppliers in the US. They agree to allow ABC to service the entire Northeast and California markets, while 123 is allowed to service the rest of the US. Each company agrees not to sell in the other's territory. This would be a naked restraint of trade with no apparent pro-competitive justification.

- **Discussion:** How do you feel about deeming territorial agreements to be illegal? Can you think of a scenario where a territorial agreement could have a pro-competitive justification?

- **Practice Question:** ABC Steel and 123 Steel are two of the largest suppliers in the industry. ABC routinely bids against 123 to supply steel in most major construction projects across the country. ABC and 123 enter into an agreement whereby ABC will not bid on projects east of the Mississippi river and 123 will not bid on projects in the West. Are there any legal issues with this agreement?

- **Resource Video:** <http://thebusinessprofessor.com/sherman-act-territorial-agreement/>

- *Horizontal Price Fixing* - Under the Sherman Act § 1, an agreement among competitors to establish a fixed price among all producers or sellers of goods or services is a horizontal restraint of trade. This type of naked restraint on trade is a purely anticompetitive and is *per se* illegal. Businesses may develop all sorts of arrangements to control the ultimate price of a good or service. It does not matter if the fixed prices are fair or reasonable. The anticompetitive aspects of agreeing on a price detracts consumers. This is true even when small competitors agree not to compete in an attempt to remain competitive in a market with larger competitors. (Note: The purpose of increasing the number of competitors in the market does not justify the restraint on trade and the detriment to consumers.) Further, an agreement among competitors to undertake efforts to stabilize a price that otherwise fluctuates is *per se* anticompetitive.
 - *Note*: “Conscious Parallelism” is the practice of competitors following pricing practices without an express agreement. If no collusion occurs, this practice is legal. Another exception to the prohibition against price fixing is when competitors enter into joint ventures for a specific purpose and establish a single price for similar goods. While these types of agreements could still be the subject of challenge, they may not be *per se* illegal.
 - *Example*: Rob’s Widgets, LLC and Hank’s Widgets LLC both sell the same type of product. They are smaller suppliers in an otherwise large market. They both want to grow their market share, so they agree to charge the same price for their widgets in all circumstances. This is price fixing and is *per se* illegal.
- **Discussion**: Do you support the rule that agreements among competitors should be considered *per se* illegal? Can you think of any pro-competitive justifications for competitors agreeing to set a price?
- **Practice Question**: ABC Corp sells similar goods to 123 Corp. ABC and 123 enter into an agreement to price their goods equally. ABC also agrees to match the low price from any local competitor. Are either of these arrangements illegal?
- **Resource Video**: <http://thebusinessprofessor.com/sherman-act-horizontal-price-fixing/>

12. What are the commonly recognized types of “vertical restraint”?

Vertical restraint is an arrangement or agreement between members of a supply chain (such as manufacturers, wholesalers, distributors, or retailers) to fix the price or supply of goods. The following are common types of vertical restraint:

- *Resale Restraint (Vertical Price Fixing & Price Maintenance)* - Under the Sherman Act § 1, an agreement among manufacturers or distributors of a product to control the retail price for a product is an illegal restraint of trade. A manufacturer controlling the final price of a product is known as “vertical price fixing”. A manufacturer controlling the maximum price at which distributors can resale a product is known as “price maintenance”. Both of these types of agreements have a tendency to reduce competition and harm consumers. Vertical price fixing involving an agreement among competitors is a naked restraint of trade and is *per se* illegal. Resale price maintenance, on the other hand, is not generally considered a naked restraint of trade. As such, a court examining such a relationship will apply the rule of reason to determine if the restraint is anticompetitive and therefore

illegal.

- *Note:* Under the Colgate Doctrine, a manufacturer may simply announce its prices and refuse to deal with those who fail to comply with this price structure. However, a manufacturer's attempt at retail price maintenance is illegal if there is coercion or pressure other than the announced policy and its implementation.
- *Example:* ABC Corp Manufactures widgets. 123 Corp is a wholesaler of ABC's widgets. ABC Corp enters into an agreement to force 123 Corp to resell its widget at a specific price. This is price maintenance and is subject to a rule of reason analysis. If ABC Corp attempts to enter into an agreement with a final retailer regarding the sale price of the good, this would be price fixing and is *per se* illegal.

- **Discussion:** How do you feel about the practice of establishing a price among members of the supply chain? Why do you think vertical price fixing is generally *per se* illegal, while vertical price maintenance is only illegal if there is an anticompetitive effect? Can you think of pro-competitive justifications for these types of agreements?
- **Practice Question:** ABC Corp is a manufacturer of a special line of car accessories. ABC Corp sells through distributors to retailers. ABC Corp routinely encourages distributors to sell products at a 40% markup, but this is not mandatory. ABC knows that a manufacturer will not be able to charge much more than this, as ABC Corp retains the right to approve all retailers carrying its products. These retailers must agree to charge a specific price for the product in order to carry the product. Are there any legal issues with either of these arrangements?
- **Resource Video:** <http://thebusinessprofessor.com/sherman-act-vertical-price-fixing-and-maintenance/>

- *Exclusive Dealing* - Under the Sherman Act § 1, as well as § 3 of the Clayton Act, exclusive dealing agreements between suppliers and manufacturers can be anticompetitive vertical restraints on trade. In a typical exclusive dealing arrangement, a seller requires that a buyer of a product only purchase that product from that seller. These agreements are essentially requirements contracts. The primary concern is that manufacturers are foreclosed from entering the market due to these exclusive dealing relationships with established manufacturers. This is not generally considered a naked restraint on trade. As such, a court would evaluate such an agreement under the rule of reason and examine its pro-competitive justifications.
 - *Note:* Pro-competitive reasons for exclusive dealing contracts are that buyers may be assured of supply at a given price and sellers may be assured of customers. Further, if a buyer is required to buy one brand, it may help to promote that brand and enhance inter-brand competition. Also, exclusive dealing may lessen free riding on one brand's promotional efforts.
 - *Example:* ABC Corp is a manufacture of widgets. ABC will only sell its widgets to sellers who agree to only purchase widgets from ABC. 123 Corp enters into one of these agreements. In this situation, a court would apply the rule of reason to determine if the agreement is anticompetitive and illegal. ABC Corp would need to demonstrate a pro-competitive justification for its policy.

- **Discussion:** How do you feel about the legality of exclusive dealing arrangements? Should these arrangements be subject to the rule of reason or *per se* illegal? Why? Do the pro-competitive justifications listed in the material note affect your opinion? Why or why not?
- **Practice Question:** ABC Corp is the sole manufacturer of certain parts used in the assembly of touch screen devices. While it is possible to manufacture devices without using these parts, it is difficult to produce a product of similar quality. 123 Corp is the largest manufacturer of touch screen devices. 123 seeks an exclusive dealing relationship with ABC Corp to purchase all parts that ABC manufactures. 123 offers ABC a price well above its current price to secure this deal. Is there any problem with this proposed relationship?
- **Resource Video:** <http://thebusinessprofessor.com/sherman-act-exclusive-dealing-arrangements/>

- **Tying** - Under the Sherman Act § 1, as well as § 3 of the Clayton Act, tying the purchase of one product to the purchase of another competitor's product may be anticompetitive and a restraint of trade. Tying, in its most basic form, is when a seller requires that a buyer agree that if seller sells product A, the buyer can only buy product B from the seller (or another identified seller). In order to be illegal, this practice must have a substantial impact on trade or commerce. To have a substantial effect on trade, a seller must generally hold substantial market power. As such, a tying arrangement must generally have the following elements:
 - **2 or More Products** - The sale of one product, the tying product, is tied to the buyer also purchasing a separate product - the tied product.
 - **Coercion** - Buyers are coerced by the tying relationship to purchase the tied product.
 - **Market Power** - The defendant must have substantial market power in the tying product.
 - **Commercial Impact** - The tying arrangement forecloses a substantial volume of commerce in the tied product (affects competition).

Tying situations are very common when a company sells an industry-leading product and also sells accessories to that product.

- **Example:** ABC Corp is the only seller of a specific type of farm equipment. 123 Corp also sells an attachment to ABC's equipment that is sold by a number of other firms in the market. ABC requires that anyone buying the piece of equipment must also purchase the attachment from 123. This is product tying and may be a restraint of trade.

Tying arrangements are generally not considered a naked restraint of trade. If the above elements are present, a court will examine to see if there are any pro-competitive justifications for tying. Examples of pro-competitive justifications include:

- **Product Quality** - The seller may claim that selling the products together ensures functionality or quality of operation. This argument may be effective when operational effective relates to the company's brand or

strategic position.

- *Single Product* - A seller may be able to demonstrate that the two items should be treated as one single product. For example, it is sensible for a car manufacturer to include wheels and tires on a vehicle when selling it to dealers.

- **Discussion:** How do you feel about tying relationships between products? Should these arrangements be illegal? Why or why not? Does it affect your opinion if the tied products are sold by the same seller? Are you convinced by the competitive justifications for tying arrangements?

- **Practice Question:** ABC Corp sells a particular type of widget. The widget is compatible with components sold by lots of other vendors. ABC Corp requires that any purchaser of an ABC Corp must also purchase an ABC component. What factors will the court review in determining whether this situation is illegal?

- **Resource Video:** <http://thebusinessprofessor.com/sherman-act-product-tying/>

- *Vertical Territorial Agreements* - A vertical territorial agreement is an agreement between a manufacturer and a distributor of a product that grants an exclusive territory in which to distribute the product. The manufacturer agrees not to sell to other distributors in that territory in exchange for the dealer agreeing not to operate outside of her assigned area. These types of arrangements are very common and are not naked restraints on trade. If, however, such an agreement has the effect of restraining trade in the area, it may be illegal. If such actions are challenged, a court will apply the rule of reason in determining whether the conduct is sufficiently anticompetitive to constitute an illegal restraint on trade.

- *Example:* ABC Corp enters into agreements with 123 Corp, 456 Corp, and 789 Corp to distribute its product in specific geographic areas. If ABC Corp is the sole manufacturer of a vital consumer product, these agreements could thwart competitive selling by the distributors. As such, it could have a negative impact on the price customers pay. If ABC Corp cannot generate a pro-competitive justification, it may be deemed illegal.

- **Discussion:** How do you feel about vertical territorial agreements? Can you think of situations in which these agreements would restrain trade? Can you think of pro-competitive justifications for such arrangements?

- **Practice Question:** ABC Corp manufactures and distributes products across the US. The products that ABC produces require lots of a particular type of precious metal. It is difficult to find suppliers of this material. ABC has agreements with companies throughout the US. ABC entered into exclusive sale and purchase agreements with companies in different regions of the US. What will a court evaluate to determine whether these agreements are legal? What arguments might ABC put forward in defense to these agreements?

- **Resource Video:** <http://thebusinessprofessor.com/sherman-act-vertical-territorial-agreements/>

13. What is “monopolization” under the Sherman Act?

The Sherman Act § 2 makes illegal the willful acquisition or maintenance of monopoly power in a relevant market when such power is the result of something other than pure competition. Simply possessing monopoly power is fine if such power results from a superior product, better processes, stronger business acumen, or other form of competitive advantage. Obtaining such market power is illegal when it is the result of some act or series of actions that have an anticompetitive effect in the market. Below are some common examples of monopoly power obtained through anticompetitive means:

- *Exclusionary Act* - Monopoly power obtained through an exclusionary act is prohibited. If a competitor undertakes an anticompetitive act that harms the competitive process in the market (not just a single competitor in the market), that act is illegal. Examples of anticompetitive, exclusionary acts may include:
 - *Closing of Resources* - Buying up raw materials (especially if you do not need them) to the exclusion of other competitors;
 - *Note:* This does not exclude material purchases that have an operational or financial objective that is not anticompetitive.
 - *Example:* Buying up all raw material, particularly when a quantity is not needed or will go to waste, in an attempt to cause shortages with other competitors may be anticompetitive.
 - *Exclusive Sales Agreements* - Enforcing agreements with suppliers requiring them not to sell to your competitors;
 - *Note:* This may also run afoul of § 1.
 - *Tying Relationships* - Tying the sale of one product to the purchase of a separate product;
 - *Note:* This practice may also run afoul of § 1.
 - *Forced Acquisition* - Forcing a competitor to sell its business to you to eliminate competition;
 - *Example:* Threatening a price war and market blacklisting if a company does not agree to be purchased.
 - *Mandatory Leasing* - Requiring long-term leases or foreclosing a secondary market by leasing and not selling a product are examples of exclusionary acts.
 - *Example:* ABC Corp has proprietary machinery that it will only lease (rather than sell) to customers. This causes a lack of secondary market for this type of equipment and provides ABC with monopoly power in the market.

The acquisition of monopoly power will be reviewed pursuant to the rule of reason. If a court determines that an

anticompetitive effect exists, the defendant may offer a pro-competitive justification for the activity.

- *Example:* A competitor may be able to demonstrate that the activity is pursuant to simple product improvement or meeting consumer demand. The court will then determine whether the anticompetitive harm outweighs the pro-competitive justification.
 - *Refusing to Deal* - Acquiring monopoly power in a market may be illegal under Sherman Act § 2 if such power is obtained through refusal to deal with competitors. Generally, there is no duty for a competitor to deal with other competitors. There are, however, exceptions to this rule when a refusal to deal has no valid business justification and the refusal is economically harmful to market competition in the long run. Generally, the refusal must be part of a scheme intended to result in increased market power for the company.
 - *Note:* There is a general presumption that a refusal to deal is legal. A plaintiff challenging the refusal must demonstrate the anticompetitive effects and the presence of monopoly power.
 - *Example:* ABC Corp sells cell phones and electronic components. ABC refuses to sell components to 123 Corp, which sells cell phones. The refusal to deal with competitors is generally permissible. If, however, ABC and 123 are the only sellers of smartphones in the US, failing to serve as a component supplier to 123 Corp may be anticompetitive. In such a case, the court would employ the rule of reason to determine legality.
 - *Predatory Pricing* - Predatory pricing exists where one competitor prices a product arbitrarily low in an effort to monopolize a market. The low price is used to force competitors out of the market. The Sherman Act § 2 makes such conduct illegal *per se*. Proving a predatory pricing case requires a demonstration of a competitor's predatory pricing purpose and the dangerous probability that the competitor will recoup those losses by raising prices after other firms are driven out of the market.
 - *Example:* ABC Corp sells the same product as 123 Corp. ABC Corp drops its price to below its average variable cost and thus takes a loss on each sale. ABC's objective is to take all sales from 123 Corp. ABC can withstand the losses until 123 Corp is forced out of business. Once 123 Corp is defunct, ABC Corp will raise prices again.
- **Discussion:** Why do you think the law provides exemptions for monopolies acquired through competitive means? How is the effect on the market different when a company acquires a competitive (rather than anticompetitive) monopoly? Do you agree that monopoly power acquired through any of the above-listed, exclusionary acts should be reviewed as anticompetitive?
 - **Practice Question:** ABC Corp is a major player in its industry. It has come under the scrutiny of the FTC for possessing excessive market power bordering on that of a monopoly. ABC maintains that it gained its industry position through competitive means. What will the FTC look for in examining whether ABC holds an illegal monopoly?
 - **Resource Video:** <http://thebusinessprofessor.com/sherman-act-monopolization/>

CLAYTON ACT ANTITRUST CASES

The Clayton Act was passed to protect against anticompetitive activity in the purchase or sale of commodities. The Act covers only the sale of goods, not services.

14. What is “Price Discrimination”?

Price discrimination under the Clayton Act means charging a different price for a commodity based upon something other than quality, quantity, or cost of selling. The Robinson-Patman Act, an amendment to the Clayton Act § 2, addressed the issue of a seller charging purchasers of commodities different prices. This practice can be anticompetitive when the price is below costs and gives one customer a competitive edge in the market that is not related to operational superiority. A claim under the Robinson-Patman Act must meet the following requirements:

- *Commodities* - It involves the purchase of commodities.
- *Like Kind & Quality* - The commodities must be effectively the same.
- *Injury to Competition* - There must be some effect on the market (interstate commerce), in either:
 - *Primary line* - The reduction of prices for a buyer in a specific region causes an injury to competitors in that market.
 - *Secondary Line* - Buyers who are customers of a seller’s supplier receive a particular discount.

This rule protects smaller buyers who cannot secure the advantages of larger buyers. Ensuring equal prices for resellers of commodities promotes competition. Specifically prohibited conduct includes:

- Section 2(c) - limits brokerage commissions related to the sale of goods.
- Section 2(d) - outlaws granting promotional allowances or payments on good bought for resale, unless such allowances are available to all competing customers.
- Section 2(e) - prohibits giving promotional facilities or services on goods bought for resale, unless they are made available to all competing customers.

The statute also makes predatory pricing illegal outside of the context of Sherman Act § 2, which primarily covers pricing below marginal cost for a prolonged period to drive out competition. The Clayton Act does allow for defenses to or justifications for price discrimination, including:

- *Cost Justification* - Price differentials based on differences in the cost of manufacture, sale, or delivery of commodities are permitted.
- *Good-faith Defense* - A seller in good faith may meet the equally low price of a competitor.

Either of these defenses are a pro-competitive justification that might outweigh the restraints placed on competition.

- **Discussion:** Why do you think the Clayton Act focuses on vertical price discrimination by sellers of commodities? Do you think the limitations expressed above achieve these objectives? Can you think of other methods of regulating price discrepancies between purchasers?
- **Practice Question:** ABC Corp is a seller of industrial cement. ABC prefers to sell in large quantities because of the lower warehousing and shipping costs. ABC particularly likes to deal with 123 Corp, which has its own warehousing and logistics system that ABC Corp may employ when selling 123 cement. As such, ABC provides special deals and incentives to 123 Corp, which has helped 123 Corp dominate the commercial construction market. If ABC's practices are challenged by the FTC, what would a court examine to determine legality?
- **Resource Video:** <http://thebusinessprofessor.com/clayton-act-price-discrimination/>

15. What are "special arrangements" prohibited by the Clayton Act?

Section 3 of the Clayton Act limits the use of certain types of contracts involving goods when the impact of these contracts may substantially lessen competition or tend to create a monopoly. These contracts may be *per se* illegal if monopolistic behavior is present. Examples of contractual arrangements that may tend to lessen competition or create a monopoly include:

- **Exclusivity Contracts** - Many supply contracts, requirements contracts, and exclusive dealing agreements are *per se* illegal. The primary concern is that manufacturers are foreclosed from entering the market due to these exclusive dealing relationships with established suppliers (and vice versa). The Clayton Act § 3 only applies to situation when a seller requires a buyer to only purchase from it or another seller. It generally does not apply to situation when a buyer requires that a seller refrain from selling to other buyers. This situation may, however, violate Sherman Act § 1. Legality turns on the question of whether the activity substantially lessens competition. To make this determination, the court will look at:
 - **Line of Commerce** - Does this activity prevent competitors for achieving a sustainable size? If economies of scale do not require competitors to be a certain size in order to compete in the market, the exclusivity contract is less likely to be illegal.
 - **Area of Effective Competition** - How large is the geographic limitation on competition? The court will examine the extent to which sales boundaries are confined and potential effect in that region.
 - **Barriers to Entry** - How difficult is it for new competitors to enter the market?

To be illegal, the agreement must have a tendency to foreclose competition in a substantial share of the relevant geographic area and line of commerce. A defendant may be able to rebut a Clayton Act § 3 allegation by demonstrating that:

- There is no foreclosure of competition;
- The contract is short-term in nature;

- There are other available modes of distribution; or
- The pro-competitive aspects of the agreement may outweigh the anticompetitive effects under the rule of reason.

One exception is a franchise agreements that requires that all goods purchased come from the franchisor. These are legal, so long as the product is linked to quality of goods. Sourcing things not related to quality of goods cannot be prohibited through a “exclusive source of supply” provision. A challenge to a franchise agreement is subject to the rule of reason.

- **Discussion:** How do you feel about making exclusive purchase agreements illegal? Do you believe the above-listed factors demonstrate anticompetitive effects in the market? Does the ability to rebut these concerns affect your opinion? Why or why not?
- **Practice Question:** ABC Corp is the seller of hydraulic fluid. ABC requires that many of its customers only purchase ABC’s products. What will the court examine to determine whether these requirements are legal?
- **Resource Video:** <http://thebusinessprofessor.com/clayton-act-section-3-special-arrangements/>

- **Tying Contract** - A tying contract is one in which a product is sold or leased only on the condition that the buyer purchase a different product or service from the seller or lessor. A common type of tying, known as “full-line forcing”, is where a seller compels the buyer to take a complete product line from the seller. That is, the buyer cannot purchase just one product in the line. Another situation involves tying unpatented products to a patented product. Such a practice is *per se* illegal if the following elements are present:
 - **Separate Products** - The tying and tied product are two separate products;
 - **Market Power** - The defendant has substantial market power in tying the product market;
 - **Forecloses Trade** - The tying agreement prevents a substantial amount of trade in the relevant market;
 - **Forced Sale** - The defendant effectively forces a substantial number of customers to purchase the tied product under conditions where they may otherwise look to other sellers in the market;
 - **Harm to Competition** - There must be an identifiable lessening of competition in the market, and
 - **No Competitive Justification** - No legitimate pro-competitive justification exists.

The general defenses of maintaining company goodwill, pro-competitive or strategic objectives, and generating market efficiencies are available to combat a finding of anticompetitive effect.

- **Example:** A common example of an illegal tying arrangement involves tying a patented drug to an unpatented medicine dispenser. This seeks to extend the monopolistic rights allowed to patent holders to

non-patented items.

- **Discussion:** How do you feel about prohibiting tying goods from a single provider? Do you believe the above-listed elements are sufficient to identify anticompetitive practices? Why or why not? Should general, pro-competitive defenses be sufficient to justify tying contracts? Why or why not?
- **Practice Question:** ABC Corp carries a line of products. One of its products is subject to a utility patent and is the only product of its type currently on the market. Lots of market competitors make accessories for this product. ABC, however, requires that any purchaser of this product also purchase several of ABC's accessory products? If the FTC challenges these sales agreements, what elements would a court use to determine whether the practice is anticompetitive?
- **Resource Video:** <http://thebusinessprofessor.com/clayton-act-tying-arrangements/>

- **Reciprocal Dealing Contracts** - This is an agreement where a buyer offers to buy a seller's goods under the condition that the seller buy other goods from the original buyer. These agreement are only illegal if there is a distinct anticompetitive objective with a substantial effect on the product market. Any pro-competitive justification may serve as a defense to a challenge to these practices.
 - **Example:** ABC Corp agrees to purchase machinery that distributes chemicals from a 123 Corp if the 123 agrees to purchase all of the chemicals from the ABC. This conduct will be illegal if a challenger can demonstrate that ABC and 123 have an anticompetitive objective that substantially affects the market for farmers purchasing these machines and chemicals.

- **Discussion:** How do you feel about banning reciprocal dealing agreements that deemed anticompetitive? Can you think of situations where such an agreement would have an anticompetitive effect in the market? Can you think of any pro-competitive justification for these arrangements?
- **Practice Question:** ABC Corp and 123 Corp are manufacturers of material used in radios. ABC Corp supplies rubber materials to 123 Corp. 123 Corp supplies glass materials to ABC Corp. They have an exclusive, reciprocal dealing agreement. Under what conditions might this relationship be subject to challenge?
- **Resource Video:** <http://thebusinessprofessor.com/clayton-act-reciprocal-dealing-arrangements/>

16. How does the Clayton Act regulate “mergers and acquisitions”?

The Clayton Act § 7 makes certain mergers and acquisitions illegal. Basically, one company cannot acquire another company's stock or assets (or otherwise combine with another entity) if the combination is reasonably likely to substantially lessen competition or tend to create a monopoly. Such activity may also be illegal under Sherman Act § 2 if such activity results in a company acquiring monopoly power following the transaction. Mergers are generally classified as horizontal, market extension, vertical, or conglomerate.

- *Note:* Originally the Clayton Act only prohibited horizontal mergers. The Celler-Kefauver Amendment to the Clayton Act covers vertical mergers that lessen competition.
- *Horizontal Merger* - A horizontal merger combines competitors or two businesses in the same industry. To determine whether such a merger is anticompetitive, begin by defining the product and geographic market. These two factors define the market share of each entity. If the merger will result in less competition, it may be illegal. The court may examine any justifications for the anticompetitive activity, such as:
 - procompetitive results of the merger, or the offsetting pro-competitive market responses, such as new competitors entering the market; and
 - gains in the market efficiency.
- *Vertical Merger* - A vertical merger brings together companies that are in the same chain of commerce. That is, it brings together buyers and suppliers. Such a merger may be illegal where it will:
 - erect barriers to entry for competitors,
 - promotes collusion, or
 - allows the companies to evade regulations.

In reviewing a vertical merger, a court may consider the pro-competitive attributes of the merger.

- *Conglomerate Merger* - This type of merger is between non-related businesses. These businesses do not compete or operate in the same chain of commerce. This type of merger is illegal when it effectively makes it difficult for new competitors to enter the market.

- **Discussion:** How do you feel about the regulation of mergers as potentially anticompetitive activity? Do you think the factors listed above are adequate to demonstrate an anticompetitive effect on the market? What pro-competitive justifications might justify some of these mergers?
- **Practice Question:** ABC Corp is a manufacturer of televisions. 123 Corp is a primary supplier of glass used in HD televisions across the market. ABC Corp buys all of its glass from 123 Corp. 123 Corp also sells to XYZ Corp, the largest competitor to ABC Corp in the television manufacturing space. ABC Corp needs to spend any excess corporate cash and is considering a buyout of 123 Corp or XYZ Corp. If the FTC decides to challenge either of these mergers, what factors would the court apply in making a determination of legality?
- **Resource Video:** <http://thebusinessprofessor.com/clayton-act-mergers-and-acquisitions/>

17. What is the “Federal Trade Commission Act “and how does it regulate unfair competition?

The FTC Act §5 proscribes “unfair or deceptive acts or practices” and “unfair methods of competition.” Violations for the Sherman Act and Clayton Act will also violate the FTC Act, so most challenges are raised pursuant to those Acts. The Federal Trade Commission Act, Sherman Act, and Clayton Act, serve to "protect the process of competition for the benefit of consumers, making sure there are strong incentives for businesses to operate efficiently, keep prices down, and keep quality up." The FTC enforces all of the federal antitrust laws.

- *Note:* This broad authority includes protection for consumers from false advertising practices.

The primary importance of the FTC Act is the regulatory and enforcement authority that it vests in the FTC, which include:

- *Regulatory Authority* - The FTC promulgates regulations to effectuation the objectives of the relevant statutory law;
- *Investigate* - The FTC investigates allegations against individuals or organizations alleged to violate antitrust law;
- *Civil Actions* - The FTC may bring civil actions halt or seek redress for activity violating the antitrust laws;
 - *Note:* This includes issuing cease and desist order to curb unfair corporate practices.

- **Discussion:** How do you feel about the extent of enforcement and regulatory authority vested in the FTC? Why do you think the FTC Act provides a second layer of prohibition against anticompetitive practices?
- **Practice Question:** ABC Corp faces scrutiny from the FTC over its growth and business practices. What is the authority of the FTC in seeking to prevent unfair, deceptive, and anticompetitive practices?
- **Resource Video:** <http://thebusinessprofessor.com/federal-trade-commission-act-antitrust-deceptive-practices/>

18. What sanctions are available under the antitrust laws?

Together the Sherman Act, Clayton Act, and FTC Act allows for four legal sanctions:

- *Injunctions of Activity* - Injunctions order a party not to violate or continue violating antitrust provisions. These can be administrative or judicial.
- *Treble (triple) Damages* - Plaintiffs may recover civil damages suffered as a result of violation of the antitrust laws. Section 4 of the Clayton Act authorizes victims in a civil action (private parties or the US Government) to collect three times the damages they have suffered, plus court costs and reasonable attorneys' fees.
- *Criminal Fines and Imprisonment (felonies)* - Individuals fined up to \$1 million and 10 years in prison. Corporations may be fined up to \$100 million per offense.
- *Nolo Contendere* - Defendant's will often plead *nolo contendere* in a criminal action and focus on defending the civil action case. The reason is that a criminal conviction is largely conclusive in proving violation in the civil court. A *nolo contendere* plea avoids this scenario.

The FTC, DOJ, state governments, and private parties may bring actions to enforce antitrust laws and may seek any combination of the above sanctions.

- **Discussion:** How do you feel about the sanctions associated with violations of the antitrust laws? Should there be criminal penalties attached to this conduct?
- **Practice Question:** MicroData, Inc, produces software for use personal computers. MicroData has been pricing its product at below its cost of production in an effort to force its primary competitor, DataServe, out of the market. MicroData received a cease and desist order from the FTC, but it has continued the practice. What are the possible sanctions that MicroData could face in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/sanctions-under-antitrust-law/>

TOPIC 19: SECURED TRANSACTIONS

Overview

Security interests are a cornerstone of finance and lending. Secured lending relates directly with the amount of risk a lender faces when extending credit to a borrower. A secured transaction is one in which a lender or seller acquires an interest in the property sold or purchased with the funds provided to the borrower or debtor. The law of secured transactions regulates the relationship between the secured lender and the borrower/debtor. It also regulates the relationship (or rights) between multiple secured lenders. This chapter introduces the concept of a security interest. It begins by exploring security interests in the context of real property before moving on to personal property. It examines the rights of the secured party and the debtor in numerous situations (or transactions) involving security interests. Notably, it explains the key concept of priority among secured parties. Priority is instrumental in assessing the risk to the secured party in a given transaction.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

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 - [Benefits of Security Interest](#)
 - Security Interests in Land
 - [Mortgage](#)
 - [Deed of Trust](#)
 - [Land Sales Contract](#)
 - [Mortgage Rights of Secured Party](#)
 - Foreclosure (Strict & Sale)
 - Right of Redemption
 - Deficiency Judgment
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TOPIC 19: SECURED TRANSACTIONS - QUESTIONS & ANSWERS

1. What is a “Security Interest”?

A security interest is a form of property interest in real or personal property. It is given by the owner of the property to provide assurance to a third party that the property owner will perform an obligation or pay a debt. Generally a security interest arises when one party loans money to another party. The borrower provides a security interest in property to give assurance that she will repay the loaned funds. Often the money borrowed is used to purchase the property securing the loan. If the borrower fails to repay the loan, the lender may seek to take possession of and sell the property securing the loan. The proceeds from sale of the property are then used to repay the debt.

- *Note:* The most common types of security interest are mortgages of land and security interests in personal goods under Article 9 of the UCC.
- **Discussion:** What role do security interests play in a vibrant economy? What role do security interests play in the assessment of risk in finance?
- **Practice Question:** Arthur is considering borrowing money from Brand Bank. He is trying to evaluate whether the bank will lend him the money and at what interest rate. What is a primary consideration for the bank in determining whether to loan the money to Arthur?
- **Resource Video:** <http://thebusinessprofessor.com/security-interest-defined/>

2. What are the benefits of a security interest to creditors?

Taking a security interest in collateral to secure a debt reduces the risk to the creditor. It dissuades the creditor from defaulting on the loan for fear of losing the collateral. Also, it provides the secured creditor the ability to recuperate some or all of the debt by repossessing and selling the collateral. A security interest in property entails the secured party's right to “repossess” and “foreclose” upon the collateral in the event of default. Foreclosure is the use of the property to satisfy the outstanding debt. There are two types of foreclosure:

- **Strict Foreclosure** - Strict foreclosure is when a secured party repossesses and retains possession of the collateral in complete satisfaction of the outstanding debt. The secured party is required to provide written notice to the debtor of this intent and, if something other than consumer goods, notice to other creditors. The debtor or any creditor may object to a strict foreclosure and force the foreclosing creditor to undertake a foreclosure sale.
 - *Note:* This is generally only an option when the foreclosing creditor is the only secured party or when all creditors agree to the foreclosure. If other creditors agree, the foreclosing creditor acquires the property clear of liens and security interests.
- **Foreclosure Sale** - A foreclosure sale is the process of selling the collateral in a private sale or at public auction. The foreclosing creditor must provide notice to the debtor and, if the goods are other than consumer goods, to other creditors. The sale must be carried out in a commercially reasonable manner.

- *Note:* A purchaser at foreclosure sale acquires the property free and clear of all inferior security interests and liens. If, however, there is a superior security interest (one with higher priority) on the property, the purchase does not take the property free and clear. This can cause serious issues for individuals who purchase the collateral at sale and are unaware of the superior security interest or lien.

A debtor generally has the right to repay the outstanding debt and reclaim the property at any time prior to the creditor foreclosing on the property. This is known as a “right of redemption”. In some jurisdiction, debtors have a statutory right of redemption for a specified period following foreclosure. This is common in foreclosures of real estate.

- **Resource Video:** <http://thebusinessprofessor.com/benefits-of-a-security-interest-in-collateral/>

SECURITY INTERESTS IN LAND

3. What are the common types of “security interest in land”?

Land or real property is an expensive asset that is often purchased through financing arrangements. As such, purchases of real property are often subject to a security interest. The most common forms of security interest in land include:

- *Mortgages*
- *Deeds of Trust*
- *Land Sales Contracts*

Each of these arrangements demonstrates the core principle of security interests. That is, there is an obligation (generally to make payments) that is secured by an interest in the real property. Each of these types of security interest is discussed in greater detail below.

- **Discussion:** Why do you think that most real estate transactions throughout the United States are made pursuant to a secured transaction? How do you think this reality affects the price of real estate and the lending habits of financial institutions? Do you understand the role of secured real estate lending had on the economic recession of 2008?

4. What is a “mortgage”?

A mortgage is a loan that is secured by real property. A borrower acquires a loan and provides a security interest in the real property owned by the borrower to be purchased with the borrowed funds. This is a common method of using “equity” or one’s ownership interest in real property to obtain funds for other purposes.

- *Note:* The real property may serve as a security interest for more than one loan. If so, this brings up the issue of priority of the security interest, which is discussed further below.

- **Discussion:** Can you find out how many homeowners in the United States own homes that are subject to a mortgage? Does this number help you to understand the role mortgages played in the economic slowdown in 2008? How do you feel about the ability to use real property to secure a loan that is unrelated to the purchase of property? What do you think about the ability of an owner of real property to have multiple loans secured by the same property?
- **Practice Question:** Veronica is considering opening a small business. She knows that she will need capital to undertake the venture, but she does not have the funds. She is considering her options. She owns a home and has a part-time job as a source of revenue. Can you identify a valid financial option for her?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-mortgage/>

5. How does a security interest protect the mortgage holder?

If the borrower fails to repay the loan pursuant to the terms of the loan agreement, the mortgage holder may “foreclose” upon the property securing the mortgage loan.

- **Foreclosure** - Foreclosure is the process by which the mortgage holder takes control of the property securing a debt. The mortgage is foreclosed and the property is repossessed. Once repossessed, the property is sold at public auction to generate funds to repay the loan.
 - **Note:** A party may also undertake strict foreclosure.
- **Deficiency Judgment** - If the property, once repossessed, does not generate sufficient proceeds from sale to repay the outstanding loan, there is a “deficiency”. Depending upon the mortgage foreclosure process employed by the secured lender, the property owner may still be liable for this deficiency. If so, the lender can bring a civil action asking for a “deficiency judgment” against the debtor.
 - **Note:** A deficiency judgment can be used to execute against the borrower’s other property or assets. This means that the loan holder may seek to repossess and sell the debtors other assets.
- **Right of Redemption** - Many states offer protections to borrowers who default on loans and lose their properties to foreclosure. One of these protections is known as a “right of redemption”. This right affords a borrower a specific amount of time to repay the amount owed on the foreclosed property and regain possession.
 - **Note:** This inhibits the lender’s ability to sell the land until that redemption period has passed.
 - **Example:** A lender forecloses on property securing a loan. If the state recognizes a right of redemption, a borrower, following foreclosure of his property, has the right, for a statutory period, to pay the lender the whole amount owed. This is normally done by obtaining refinancing of the property with a different lending institution.

The government (generally the local Sheriff’s office) is involved in the process of repossessing and selling the foreclosed

property. In foreclosures involving a personal residence, the process often begins with the lender seeking an eviction order against the residents of the property. Once eviction is complete, the lender may follow state procedures to list the property for sale. State law governs the sale of the property, which must be “commercially reasonable” in light of the circumstances. If the secured party pursues strict foreclosure, she may keep the collateral in complete satisfaction of the debt. In this situation, the secured lender cannot pursue a deficiency judgment against the debtor.

- **Discussion:** How do you feel about the ability of a secured lender to evict an individual from her residence? Do you think the borrower should have any additional protections in the foreclosure process? Why or why not? Why is foreclosure generally a poor option for a mortgage holder to collect the money owed from the debtor? Hint: Think in terms of time and expenses.
- **Practice Question:** Murphy owns a small tract of land. He decides to start a business and takes out a loan secured by the property to build on the land and start his business. The market is far more competitive than Murphy assumed. He is soon forced to shut down his business and defaults on the loan. What is the process the lender will follow in seeking repayment of the loaned funds?
- **Resource Video:** <http://thebusinessprofessor.com/mortgage-lender-and-benefit-of-security-interest/>

6. What is a “deed of trust” or “security deed”?

A “deed of trust”, or “security deed”, as it is known in some jurisdictions, is a form of mortgage. A borrower of money signs a promissory note demonstrating the debt owed to the lender. The promissory note will generally recite the purpose of the loan and indicate that it is secured by real property. The borrower then takes possession of the land and records her ownership. The borrower signs a deed of trust, which transfers the land to the lender. The deed cannot be recorded except upon default. This effectively grants the lender a security interest in the real property as security for the loan. The difference between a deed of trust and a standard mortgage arises in how the security interest is recorded. A traditional mortgage simply records the security interest in the public records (registrar of deeds office) where the property is located. The deed of trust takes a different tact. A third party serves as trustee and holds the deed transferring legal ownership of the land during the pendency of the mortgage. In some jurisdictions, the secured party will hold the deed, as apposed to employing the services of a third-party trustee. Once the mortgage is repaid, the trustee will surrender the deed to the purchaser. If the loan is not repaid, the lender will request that trustee turn over the deed. The lender will then record the deed in the public records to assume ownership of the property. The process of foreclosing on a deed of trust is commonly referred to as an “administrative foreclosure”. After recording the deed, the lender must then sell the property to recuperate the lent money.

- **Note:** If the sale produces more funds than those owed along with foreclosure fees, the excess funds are returned to the borrower. The notable aspect of this arrangement is that the lender may not seek a deficiency judgment if the funds from the sale of the land are insufficient to pay off the loan.
- **Discussion:** How do you feel about the traditional mortgage scenario versus a deed of trust scenario? In what way is an administrative foreclosure by way of a security deed or a deed in trust advantageous to the mortgage holder? How do the benefits to the borrower compare to the benefits to the lender?
- **Practice Question:** Kara lost her job and has fallen on difficult financial times. She has been unable to make her

mortgage payments and is afraid that her mortgage holder is going to foreclose on her home. Kara's mortgage is pursuant to a deed of trust arrangement. If the lender does foreclose, what is the legal process that Kara will face?

- **Resource Video:** <http://thebusinessprofessor.com/deeds-of-trust-and-security-deeds/>

7. What is a “land sale contract”?

A land-sale contract is a situation where the owner of land sells it subject to the condition that the seller retain title to the land until the buyer pays the full purchase price. Basically, it is a seller-financing scenario, where the seller retains ownership of the land until it is fully paid off. The rights of the buyer during this period are determined by agreement between the buyer and seller. Generally, the buyer acts as if she is the owner during the payment period. She has the legal right to possess and use the land and is responsible for paying taxes and insurance. If the purchaser fails to make any scheduled payment, she defaults under the agreement and forfeits her right to purchase the property.

- *Note:* Most states have laws protecting the purchaser in land-sale contracts. Basically, the purchaser does not forfeit her entire interest in the land in the event of a missed payment. Rather, the law recognizes an equitable interest in the land that accrues as the purchaser makes payments.
- **Discussion:** How do you feel about these types of arrangements? Can you think of situations where this arrangement could be inequitable to the purchaser? Should the law provide additional protections for the purchaser? If so, what?
- **Practice Question:** Geoffrey is considering selling his farm. Much of the farm consists of land that is suitable for hay or grazing livestock. After listing the property for several months, the only bid on the farm is from a buyer requesting the seller to finance the purchase. Geoffrey is uncomfortable with surrendering ownership of his farm until the purchase price is paid. What option might Geoffrey employ to alleviate his concerns?
- **Resource Video:** <http://thebusinessprofessor.com/land-sale-contracts-explained/>

SECURITY INTEREST IN PERSONAL PROPERTY

8. What is a security interest in personal property?

A security interest in personal property involves using any form of personal property or fixture to secure a debt. A borrower signs a promissory note that identifies the personal property that will serve as collateral to secure the loan. Personal property that may serve as collateral includes tangible and intangible assets, commercial paper, and commercial liens.

- *Tangible Assets* - Consumer goods, business equipment, farm products, and inventory.
- *Commercial Paper* - Documents of title, chattel paper, and negotiable instruments.
- *Intangible Assets* - Intellectual property, accounts receivable, and general intangibles.
- *Floating Liens*: After-acquired collateral, future advances on collateral, and proceeds from the sale of collateral.

- *Note:* Security interests in personal property are governed by the state law version of Article 9 of the Uniform Commercial Code. Article 9 does not cover security interests that are not commercial in nature.
- **Discussion:** Can you think of any business transaction that gives rise to a security interest in personal property? Hint: Think about financing situations that go beyond the traditional borrower-lender relationship.
- **Practice Question:** Curtis wants to borrow money and is concerned over what he can provide as collateral for the loan. Can you describe to him that types of personal property that can serve as collateral for a secured loan?
- **Resource Video:** <http://thebusinessprofessor.com/secured-transactions-defined/>

9. How does one establish a security interest in personal property?

A security interest in property begins when personal property is identified as collateral for a loan. This is known as “attachment” or “attaching” the property. Attachment takes place when the following conditions are met:

- *Security Agreement* - The secured party and the party granting a security interest (debtor) must enter into a written security agreement. The security agreement must be signed by the debtor and contain a reasonable description of the collateral.
- *Value Given* - The secured party must give or transfer value to the debtor. This generally means that the loaned funds are transferred to the borrower.
- *Ownership in Collateral* - The debtor must acquire ownership of the collateral. The debtor does not necessarily have to own the collateral at the time of entering into the security agreement. In some cases the debtor will use the value received from the secured party to purchase the collateral. Also, the security agreement may include an “after-acquired collateral” clause. This means that property acquired by the debtor after the loan is made can serve as collateral for the original loan.
 - *Example:* Jack loans Katy money to buy inventory to sell. Every new set of inventory replacing the sold inventory can be made subject to the security agreement.

- **Discussion:** Why do you think the law requires the above-referenced elements before a security interest attaches? Can you think of situations where any of the above elements are absent, but fairness would indicate that a security interest should attach? How do you feel about the ability of the secured party to acquire an interest in collateral that is later acquired by the debtor? Does it affect your opinion if the “after-acquired property clause” is very broad and includes all assets of the debtor?
- **Practice Question:** ABC Inc., enters into an agreement with Sasha to purchase equipment that he sells. Sasha agrees to finance the purchase but wants to establish a security interest in the equipment to make certain that ABC pays the full purchase price. What elements must be present for Sasha to establish as security interest?

- **Resource Document:** <http://thebusinessprofessor.com/attachment-of-a-security-interest/>

PERFECTION OF A SECURITY INTEREST

10. What is “perfection” of a security interest?

“Perfection” is the process of putting the entire world on notice that the secured party claims a security interest in the debtor’s collateral. Recall, a security interest is enforceable against the debtor at the time that it attaches. That is, the attached security interest will allow the secured party to repossess the assets of the debtor in the event of non-payment of the secured debt. A problem arises when other creditors of the debtor seek to establish a security interest in the debtor’s property, including the collateral already securing existing debts. These parties are effectively claiming an interest in the collateral that competes with the original secured party’s interests. Secured parties must make certain that the security interest is enforceable as against third parties who claim a competing interest in the collateral. The security interest is only enforceable as against these third parties once it is perfected. Perfection allows the secured party to maintain “priority of payment” or “priority” above other creditors in the event the collateral must be repossessed and sold to pay outstanding debts. The concept of priority of security interests is discussed further below.

- *Note:* Any party with a security interest in collateral can repossess and sell the collateral upon default by the debtor. Priority establishes a party’s entitlement to the proceeds of sale.
- **Discussion:** What do you think about the ability of multiple secured parties to claim a security interest in the same collateral? Why do you think a secured party is required to perfect (provide notice to the world) of a security interest for it to be effective as against third parties?
- **Practice Question:** Cienna sells a piece of equipment to Patrick and finances it over 12 months. She takes a security interest in the collateral to secure payment. She knows that Patrick has other loans, what should Cienna do to protect her interests?
- **Resource Video:** <http://thebusinessprofessor.com/perfection-of-a-security-interest/>

11. What methods exist for perfecting a security interest in personal property?

Establishing or making one’s security interest effective as against third parties is known as “perfection” of the security interest. Perfection takes place when the security interest has attached and the creditor has taken all proper steps required by Article 9 for perfection. Generally, Article 9 allows a secured party to perfect her security interest through the following methods::

- **Financing Statement** - The most common way of perfecting a security interest under Article 9 is to file a financing statement in the appropriate public office. State law establishes the system and location for filing a public financing statement. Most states allow for filing through the secretary of state’s office, while other states allow for filing at a public office (such as the courthouse) in the area where the collateral is located.
- *Note:* Perfection by filing is appropriate for any collateral, except negotiable instruments.

- *Possession or Control* - In some cases, the secured party may perfect a security interest by establishing possession of or control over the collateral securing the obligation. The theory behind this method of perfection is that a third party would not reasonably extend credit and take a security interest in collateral that the debtor supposedly owns but does not possess and cannot otherwise demonstrate ownership.
 - *Note:* Control may include holding a certificate of title of physical possession of the collateral.
- *Automatic Perfection* - Some security interests are automatically perfected, either permanently or temporarily, upon attachment of the security interest to the collateral.
 - *Example: A Purchase Money Security Interest (PMSI)* is a transaction in which a lender provides funds or financing to purchase the collateral securing the loan. If the collateral is a consumer good, the lender is automatically perfected. If the collateral is a non-consumer (business) good, the security party is automatically perfected for a temporary amount of time.

Each of these methods of perfecting a security interest is discussed separately.

- **Discussion:** Why do you think the law allows secured creditors to perfect their security interests *via* multiple methods? What are the justifications for the above methods? What is the common characteristic in each of the methods of perfecting a security interest?
- **Practice Question:** Tom sells a piece of equipment to May to use in her business. He provides financing that allows May to pay for the equipment over the next 24 months. Tom and May undertook the steps necessary to attach a security interest in the equipment. What methods might Tom use to perfect his security interest?
- **Resource Video:** <http://thebusinessprofessor.com/methods-of-perfecting-a-security-interest-in-personal-property/>

12. How does a secured party establish a security interest in real property (land)?

Secured parties must perfect a security interests in land by publicly filing notice of the security in accordance with state recording statutes. Generally, mortgages and deeds of trust must be publicly registered in a government office where the land is located. This is typically known as the “recorder” or “register of deeds” office. This recording method is deemed necessary to give notice of ownership rights and interests to those who are interested in purchasing or loaning money for or against the property.

- *Note:* In addition to providing notice, registration (filing) of mortgages also establishes priority for repayment if multiple people loan or lend money secured by the property.
- **Discussion:** Why do you think securities interests in land must be filed in the government office where the land is located? Why is perfection by possession insufficient? Why do you think providing notice of security interest is particularly important for real property? Hint: Think about the nature and frequency of home purchasing *via* mortgages in the United States.

- **Practice Question:** Meredith enters into a contract to purchase real estate from Chase. Chase is going to finance the purchase for Meredith over the next 10 years. What process must Chase follow to establish his security interest in the real estate?
- **Resource Video:** <http://thebusinessprofessor.com/establishing-a-security-interest-in-real-property-land/>

AUTOMATIC PERFECTION

13. What is “automatic perfection” of a security interest?

In certain types of transactions, a secured party’s interest in collateral is automatically perfected without filing a financing statement and without taking possession or control of the collateral. This is known as “automatic perfection”. Depending upon the nature of the collateral, automatic perfection may be permanent or only last for a temporary period. Temporary automatic perfect allows a party a window of time to undertake procedures to permanently perfect the security interest. Below are the most common types of automatically perfected security interest:

- Purchase Money Security Interests in Consumer Goods,
- Purchase Money Security Interests in Non-Consumer Goods,
- Perfection in Proceeds from the Sale of Goods, and
- Assignments of Accounts Receivable and Contract Rights.

Each of these types of security interests and the automatic perfection attributes are discussed in a separate lecture.

- **Discussion:** What do you think is the justification for allowing automatic perfection of security interests in certain types of goods? Do you think it is necessary to allow for automatic perfection of security interests in the above types of goods?
- **Practice Question:** Carly finances the sale of goods to Derek. She is curious as to whether the sale is perfected or no. What information do you need to know to determine whether her security interest is perfected?
- **Resource Video:** <http://thebusinessprofessor.com/automatic-perfection-of-a-security-interest-in-goods/>

14. What is a “purchase money security interest” (PMSI) in consumer goods?

A purchase money security interest (PMSI) arises in situations where the secured party provides the funds necessary to purchase the subject collateral. This can arise through a loan for identified collateral or when the secured party sells and then finances the collateral for the purchaser. A PMSI is automatically perfected when the security agreement attaches to collateral that is consumer goods. Consumer goods are goods primarily for personal use by the purchaser — rather than for business use or resale.

- *Note:* Consumer goods do not include vehicles subject to a certificate of title or fixtures.
- *Example:* I purchase a refrigerator from Appliance World for my personal use. Appliance World finances the purchase by allowing me to pay over the next 12 months. We undertake the steps necessary for the security interest to attach. Appliance world has an automatically perfected security interest in the refrigerator.

An automatically-perfected PMSI in consumer goods is subject to certain exceptions. These exceptions allow subsequent purchasers of the collateral to take the collateral free of the secured party's security interest. The purchaser of the consumer goods from the seller will take free in clear if all of the following conditions are met:

- *No Knowledge of Security Interest* - The buyer cannot know about the security interest in the collateral;
 - *Note:* This means that the security interest is not filed in an appropriate public office, the secured party is not perfected by possession, and the purchaser has not been given notice of the security interest.
- *Provide Value* - The buyer must provide value for the goods;
 - *Note:* This means that the debtor cannot give me the goods as a gift. If I do not provide value (money or goods) in exchange for the goods, the goods are still subject to the secured party's security interests.
- *Personal Use* - Must primarily use the goods for personal, family, household purposes.
 - *Note:* So, the seller-debtor must have originally purchased the goods for personal use and the subsequent purchaser must use the goods for personal use. If either party purchases the goods for business use it will destroy the exemption.

- **Discussion:** Why do you think it is important to grant automatic perfection to individuals who sell and finance or provide purchase money for consumer goods? Also, why do you think it is important to allow purchasers who meet the above conditions to take the collateral free and clear of an automatically perfected security interest?
- **Practice Question:** Martha purchases a new vacuum cleaner from ABC Corp and finances it for 12 months. Martha signs a security agreement that grants ABC a security interest and satisfies all of the requirements of attachment. After the purchase, she does not like the vacuum cleaner and sells it to George. Will George receive the vacuum cleaner subject to ABC's security interest? What information do you need to know to answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/purchase-money-security-interest-in-consumer-goods/>

15. What is a "purchase-money grace period" for a purchase-money security interest in non-consumer goods?

Sellers of non-consumer goods receive temporary automatic perfection of an attached PMSI in the collateral sold. As the name applies, the security interest is temporary in nature. The seller has a 20-day grace period for filing a financing statement following the attachment of the purchase money security interest in the collateral. If the financing statement is filed during this 20-day period, the date of permanent perfection dates back to the date the security interest attached to the

collateral. If the secured party fails to file a financing statement during the 20-day grace period, the temporary automatic perfection is lost.

- *Note:* In that event the automatic PMSI is lost, the first secured party to perfect her security interest has priority in the collateral.
- **Discussion:** Why do you think it is important to allow a grace period for a secured party to permanently perfect her security interest in non-consumer goods? Does this create a risk to any subsequent purchaser of the goods from the original purchaser? Should such risk be balanced against the interests of the secured party? Why or why not?
- **Practice Question:** ABC Corp sells 123 Corp a piece of equipment. ABC finances the purchase over 12 months and attaches a purchase money security interest. What must ABC do to perfect its security interest?
- **Resource Video:** <http://thebusinessprofessor.com/purchase-money-grace-period-for-secured-parties/>

16. How does one continue perfection of or permanently perfect a purchase money security interest in non-consumer goods?

A secured party who takes a PMSI in non-consumer goods has a grace period to file her financing statement. To establish permanent perfection beyond the temporary grace period, she must file the appropriate financing statement within 20 days of the purchaser receiving the asset. If the secured party files the financing statement during this period, her security interest is perfected and has priority from the date of the extension of credit. Her security interest also extends to any proceeds from a later sale of the assets. This is particularly important if the goods are inventory to the purchaser. Failing to file a financing statement within this period can cause the secured party to lose priority to conflicting secured parties or lien holders who later perfect their security interests in the collateral.

- *Note:* This rule is particularly important when the debtor's assets are subject to an after-acquired collateral clause.
- **Discussion:** Do you think a secured creditor should have 20 days from the date the debtor takes possession of the collateral to file the security interest? Why or why not? Can you think of a situation where someone could be prejudiced by this right?
- **Practice Question:** ABC Corp purchases equipment from 123 Corp and finances it for 12 months. The parties validly attach the security interest to the collateral. ABC Corp immediately sells all of its assets to XYZ Corp in a buyout. What must 123 Corp do to protect its security interest in the collateral? What would this mean for XYZ Corp?
- **Resource Video:** <http://thebusinessprofessor.com/permanent-perfection-of-purchase-money-security-interest/>

17. What is “temporary automatic perfection” in “proceeds” from the sale of goods?

Proceeds is the money, assets, or value received in exchange for selling or transferring something. A perfected security

interest in collateral automatically extends to the proceeds from the sale of that collateral (with certain exceptions) for 20 days following the sale. This is a form of temporary automatic perfection. The temporary period for automatic perfection terminates at the end of the 20 days. Any of the following scenarios will extend the period of temporary perfection past the 20-day period:

- *Financing Statement & Similar Type of Collateral* - The secured party must have a filed financing statement covering the original collateral at the time it was sold. Further, the secured party must be able to perfect a security interest in the proceeds of sale of that collateral by filing a financing statement in the same government office. This means that the proceeds from sale must also be some form of goods.
 - *Note:* If the proceeds are cash (rather than more assets) then the perfected security interest may continue if the original security agreement identifies assets that could be purchased with cash proceeds and the seller indeed uses those proceeds to purchase that type of asset.
 - *Example:* ABC Corp has a security interest in equipment owned by 123 Corp. ABC files its security interest in the appropriate government office. 123 Corp later sells or trades the equipment for a newer model of equipment. ABC would file a security interest in the new equipment in the same government office. As such, the security interest filing extends to the newly acquired equipment.
- *Identifiable Proceeds* - The cash or other proceeds from the sale of the collateral must be identifiable. This means that the cash or other proceeds is not so intermingled with other funds so as to no longer be traceable to the sale of the subject collateral. This can be an issue when cash proceeds are disbursed into multiple accounts that have constantly rising and falling balances.
 - *Note:* Article 9 contains several rules for tracing proceeds and when proceeds remain identifiable.
 - *Example:* ABC Corp has a security interest in equipment owned by 123 Corp. 123 Corp later sells or trades the equipment for cash. The cash is deposited in a specific bank account and no funds are spent from that account. The funds are easily traceable and the security interest in the original collateral extends to these proceeds.
- *File New Financing Statement* - The party may perfect a new security interest in the proceeds within 20 days of the sale of the collateral. If so, the security interest continues from the date of the original security interest in the collateral.
 - *Note:* This applies when new collateral is purchased with or received as proceeds. The proceeds are not the same type as sold or there is no security interest filed before the sale.
 - *Example:* ABC Corp has a security interest in equipment owned by 123 Corp. 123 Corp later sells or trades the equipment for a different type of equipment. ABC Corp may continue its security interest by filing a new financing statement against the newly acquired equipment.

It is important to note that a debtor generally cannot sell property subject to a security interest without the permission of the secured party. Further, selling an asset to a party and failing to indicate that it is subject to a security interest may constitute fraud against the purchaser.

- **Discussion:** Why do you think it is important to grant a secured party a continued security interest in the proceeds from the sale of goods? In the same vein, what do you think is the justification for extending this security interest beyond 20 days in each of the above-indicated scenarios? Should the above protections of secured parties be balanced against the rights of the subsequent purchaser?
- **Practice Question:** ABC Corp sells equipment to 123 Corp and attaches a security interest. ABC later files the security interest in the appropriate state office. 123 Corp later sells the equipment in exchange for a combination of cash and other equipment. What are ABC Corp's options for maintaining its security interest in the proceeds of the sale?
- **Resource Video:** <http://thebusinessprofessor.com/temporary-automatic-perfection-in-proceeds-from-sale-of-goods/>

18. How is a security interest created through the “assignment of accounts receivable” and “contract rights”?

Generally, the sale or assignment of rights in accounts, payment intangibles, or promissory notes (account) creates a security interest for the individual to whom the account is assigned. This attaches the security interest to the account. Article 9 requires that an individual file a financing statement to perfect a security interest in an account. There are, however, two exceptions that allow the assignee of the account to perfect a security interest without publicly filing a financing statement.

- *Single Account to Satisfy a Debt* - The assignment of a single account in satisfaction of a preexisting debt;
 - *Example:* ABC Inc., transfers and account payable to 123 Inc., in satisfaction of a debt that ABC owed to 123. While ABC maintains control over the account payment, 123 has a security interest in the account that is perfected without filing a financing statement.
- *Automatic Perfection* - The assignor transfers a limited number of accounts to the assignee that does not constitute a significant number of the assignor's accounts.
 - *Note:* For automatic perfection to apply in this situation, the transferred account cannot constitute a significant percentage of the outstanding accounts of the transferor and the recipient cannot regularly take assignment of accounts in satisfaction of debts.

- **Discussion:** How do you feel about the ability of an assignee to perfect a security interest in an intangible account? Why do you think it is important to grant the assignee of an account receivable or contract benefits a security interest? Hint: Think about who is in control of the accounts receivable and contract rights before and after the assignment. Do you agree with the above-referenced exceptions to the requirement to file a financing statement? Why or why not?
- **Practice Question:** ABC Corp sells product at wholesale. It regularly takes payment on accounts for 90 days. These accounts sit in accounts receivable until paid. ABC Corp transfers several of these accounts to 123 Corp but maintains control over the account in order to effectuate collections. What do we need to know about this transfer

to determine whether 123 Corp has a perfected security interest in the accounts?

- **Resource Video:** <http://thebusinessprofessor.com/security-interest-in-assignment-of-accounts-receivable-or-contract-rights/>

SECURITY INTEREST BY POSSESSION or CONTROL

19. How does one perfect a security interest by “possession “of the collateral?

Article 9 allows a secured party to perfect a security interest in goods, instruments, negotiable documents or tangible chattel paper by securing possession of the collateral. Securing possession can mean personal possession or possession by an agent. If an agent secures possession on behalf of the secured party, perfection may require the agent’s authenticated acknowledgement that the collateral is held on behalf of the secured party.

- *Note:* The debtor or an agent of the debtor cannot also serve as an agent of the secured party for purposes of perfecting a security interest.
- **Discussion:** Do you think the law should allow perfection of a security interest in certain types of collateral by simply taking possession of the collateral? Why or why not? Do you think this meets the objectives of requiring perfection of a security interest?
- **Practice Question:** Tom agrees to purchase Amy’s lawnmower. He agrees to pay for the mower by making equal payments over the next 6 months. They sign a security agreement granting Amy a security interest. Tom agrees to allow Amy to remain in possession of the lawnmower until the purchase price is paid. Is Amy’s security interest perfected?
- **Resource Video:** <http://thebusinessprofessor.com/perfection-of-a-security-interest-by-possession/>

20. How does one perfect a security interest by “control” of the collateral?

Article 9 allows for perfection of a security interest in certain types of collateral by control. These types of assets include deposit accounts, investment properties, letter-of-credit rights, and electronic chattel paper. Control is related to possession and is generally established by a control agreement granting the secured party control over the account or naming the party as owning the account. The authority that the secured party has over the collateral equates to possession.

- **Discussion:** Why do you think it is important to allow perfection of a security interest in certain types of collateral by exercising control over the collateral (in the absence of possession)?
- **Practice Question:** First Bank is a local consumer bank. Gladys is a customer of the bank and has both checking and savings accounts. She needs money, so she goes to the bank and takes out a loan. The bank requires that Gladys sign an agreement granting the bank control over the savings account, which will serve as collateral for the loan. Does the bank have a perfected security interest?

- **Resource Video:** <http://thebusinessprofessor.com/perfection-of-a-security-interest-by-control/>

PERFECTION BY FILING

21. What information is required in a “financing statement” filing?

Generally, to perfect a security interest, a secured party may file a security agreement in the appropriate government office. To be enforceable under the UCC, a financing statement must contain the following information:

- *Debtor’s Name* - Generally this requires a first and last name. It may also require any aliases or fictitious names necessary to identify the individual;
 - *Note:* This is particularly important when the debtor is a business operating under a fictitious name.
- *Secured Party’s Name* - Name of the secured party or her representative; and
- *Identifies Collateral* - A description of the collateral must be sufficient to identify the collateral or indicate that the financing statement covers “all assets” or “all personal property” of the debtor.

Additionally, the financing statement must meet the following requirements:

- *Standard Form* - It must be in the form authorized by the filing office.
 - *Note:* UCC §9-521(a) provides an acceptable form financing statement.
- *Filing Fee* - Must include a sufficient filing fee;
- *Debtor’s Mailing Address* - This requires an address where the debtor may receive notices with regard to the filing.
- *Entity Status and Information* - Debtor’s status as an organization (type, jurisdiction, organizational ID); and
- *Secured Party’s Address* - This requires an address where the secured party may receive notices with regard to the filing.

- **Discussion:** Why do you think it is important to include all of the above information in a filed financing statement? How do you feel about the ability to include a description indicating “all assets” or “all personal property”?
- **Practice Question:** Ervin is preparing a financing statement to secure payment of property he sold to Mandy. What information must he include in the financing statement?
- **Resource Video:** <http://thebusinessprofessor.com/perfection-of-security-interest-by-filing-financing-statement/>

22. What authorization is required to file a financing statement?

A secured party must be authorized to file a financing statement against the assets of the debtor. If the debtor is bound by a security agreement, authorization to file a financing statement is implied. If the debtor is not bound (or not yet bound) by the security agreement, the debtor must authenticate the financing statement. This is normally done by signing a confirmation document. If the financing statement is not authorized, it is ineffective and the secured party is obligated to file a termination statement (or the debtor may do so). The UCC provides for a statutory penalty of \$500 against the unauthorized filer.

- **Discussion:** Why do you think the law provides detailed instructions on when a financial statement may be filed and when a party must terminate or withdraw the filing? Should the law allow for a secured party to file a financing statement if the debtor is not yet bound by a security agreement? Why or why not?
- **Practice Question:** Mark agrees to purchase Eric's tractor. The parties have signed a promissory note, but have not yet established a written security agreement. Eric goes ahead and files a financing statement to perfect a security interest in the tractor until it is paid. What additional procedures must the parties follow?
- **Resource Video:** <http://thebusinessprofessor.com/authorization-required-to-file-financing-statement/>

23. Where is the appropriate office to file a financing statement?

Financing statements covering goods are generally filed or processed through the state secretary of state's office. Some states, however, require that the financing statement be physically filed at the local courthouse where the debtor is located. If the debtor is a business entity, the appropriate location for filing the jurisdiction where the debtor is organized. If the collateral is real estate, timber, as-extracted collateral, or fixtures, the financing statement must be filed in the local public property records. Financing statements covering goods and real estate converge when personal property becomes a fixture. In such cases, the financing statement covering goods may need to be filed in the real property records where the real estate is located.

- **Discussion:** Why do you think financing statements covering goods are filled in a central government office? Why do you think financing statements covering real estate are filed in the local office of property records?
- **Practice Question:** Sean finances the sale of a piece of equipment to Zoey. He now wants to record as security interest in the collateral. Where should Sean file the security interest?
- **Resource Video:** <http://thebusinessprofessor.com/appropriate-office-to-file-a-financing-statement/>

PRIORITY OF SECURITY INTERESTS

24. What is "priority" of a security interest?

The priority of a secured party regards the party's right to payment in the event of default by a debtor. If a debtor defaults,

a secured party with a security interest in collateral will have a claim of ownership in the collateral. As such, she can repossess the collateral, sell it, and use the proceeds to satisfy the debt. Many issues arise, however, when there are multiple creditors of the debtor. The situations gets more complicated when there are multiple secured parties claiming an interest in the subject collateral. This is when the concept of priority is most important.

- *Priority* - Priority establishes the order of who has the highest claim to assets or the proceeds from the sale of those assets. A secured party with the highest priority in collateral will receive payment of her claim before any other creditors receive payment. Subordinate secured creditors will only receive payment once the highest priority secured creditor is paid in full. Once the highest priority creditor is paid, the next highest priority creditor is paid, and so on.
 - *Note:* The secured party with the highest priority faces the lowest risk of nonpayment. The terms of secured-party lending reflects the risk associated with the borrower's priority.
- *Risk and Creditor Status* - The lower the priority of a creditor, the greater the risk that she will not receive any money from the sale of the collateral in the event of default. If a creditor's claim is not paid in full, she becomes an unsecured creditor of the debtor. Unsecured creditors generally have the highest risk of non-payment. This is particularly troublesome if the debtor files for bankruptcy protection. In the event of debtor bankruptcy, unsecured creditors generally receive a fraction, if anything, of their claim amount. Secured creditors, on the other hand, must either be paid in full or they can force the sale or surrender of the collateral securing the obligation.
 - *Note:* A debt to an unsecured creditor that is not paid in full from the debtor's bankruptcy estate is discharged. This means the debtor cannot later seek payment from the debtor and must accept the loss.

- **Discussion:** How do you feel about the priority system for establishing which creditors are paid first in the event of sale of the collateral or bankruptcy of the debtor? Is this system fair? Why or why not?
- **Practice Question:** Devon purchase equipment from Julia, who takes a security interest in the equipment. Devon has outstanding loans to Gerard and Fred. Devon defaults on all of his loans. What information do you need to determine who has priority in the collateral or proceeds from sale of the collateral?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-priority-of-a-security-interest/>

25. What role does perfection play in establishing the priority of a secured party?

A secured creditor must perfect her security interest to establish the priority of her security interest with relation to all other creditors. The first secure party to perfect a security interest in the collateral generally gives her priority above any other creditors who later attempt to establish a security interest in the collateral. In turn, failing to perfect a security interest allows a later creditor who perfects her security interest in the collateral to receive priority over the unperfected security interest. Most notably, an unperfected security interest is subordinate (lower priority) to certain lien creditors or a trustee in the event of bankruptcy. In short, perfecting a security interest is essential to ensure maintenance of the benefits of the security interest.

- *Note:* There are limited situations that allow a secured creditor to receive priority over an earlier secured creditor.

This generally arises in the event of the debtor's bankruptcy. When a secured creditor is willing to extend new credit to the debtor in exchange for higher priority of her claim against the debtor.

- **Discussion:** How do you feel about the first creditor to perfect a security interest receiving priority in collateral? Is this unfair to earlier secured creditors who failed to appropriately perfect her security interest? Why or why not?
- **Practice Question:** Ester sells a piece of equipment to Sandra. At the time of the sale, Sandra has an outstanding loan to First Bank. The loan agreement with First Bank includes a security agreement covering all of Sandra's property. It also contains an after-acquired property clause. Sandra also has several unsecured loans outstanding. Ester files a financing statement covering the equipment that she sells to Sandra. Who has priority in the equipment? Do things change if Sandra files for bankruptcy?
- **Resource Video:** <http://thebusinessprofessor.com/perfection-and-priority-of-a-security-interest/>

26. What are the common types of conflicts regarding the priority of security interests?

The following types of security interest are often in conflict:

- *Lien Creditors vs. Security Interest* - A lien creditor who establishes an interest in a debtor's property prior to perfection by another secured party has priority over that secured party. Depending upon the type of lien, a lien creditor may have priority in collateral above a perfected secured party. This is true for "possessory liens" but not "non-possessory liens".
 - *Example:* Fay holds a perfected security interest in an antique piece of furniture that John owns. Don performs restoration work on John's furniture. If John does not pay for the work, Don may retain possession of the furniture pursuant to a possessory lien. This lien has priority over Fay's perfected security interest.
- *Buyers of Collateral vs. Security Interest* - Generally, buyers who take possession of the collateral in many situation take the collateral subject to a perfected security interest. Two notable exceptions arise when 1) the collateral is a consumer good for personal use being sold to another consumer for personal use, and 2) when the collateral is inventory for the debtor. In either situation, a buyer of collateral subject to a security interest generally takes the collateral free of a security interest if the collateral is inventory for the seller or the security interest has not been perfected.
 - *Note:* A purchaser of goods subject to an unperfected security interest takes the goods free of the security interest only if the purchaser is unaware of the existence of the security interest.
 - *Example:* Hazel owns a small store. Gail holds a security interest in all of Hazel's assets, which consists of some equipment and lots of inventory. Ira purchases goods from Hazel. She takes these goods free of Gail's security interest because the goods are inventory for Hazel's business. Juliet later purchases a piece of equipment from Hazel that is not part of her inventory. If she is unaware of the existence of the security interest at the time of her purchase, she takes the equipment free of Gail's security interest.

- *Note:* Gail likely has a security interest in the proceeds from the sale of Hazel's inventory.
- *Perfected vs Unperfected* - A perfected security interest in collateral has priority over an unperfected security interest in the same collateral. This is true regardless of the timing of attachment of the security interest.
 - *Example:* Kyle takes a security interest in Leo's property on October 1. He never perfects his security interest. On December 1, Marty takes a security interest in Leo's property and perfects his interest by filing in a public office. Marty's security interest has priority over Kyle's security interest.

Each of these scenarios are discussed in greater detail below.

- **Discussion:** Why do you think the priority of the above types of secured creditor often comes into conflict? Do you generally agree with the order of priority? Why or why not? Do you notice any common principles reflected in the established order of priority?
- **Practice Question:** Beverly purchases a piece of equipment from Eve. Eve establishes an attached security interest in the collateral. Carlos later purchases the equipment from Eve. What additional information about this situation do you need to determine whether Carlos' equipment is subject to Eve's security interests?
- **Resource Video:** <http://thebusinessprofessor.com/priority-regarding-conflicts-in-security-interests/>

27. What is the priority of parties secured by “common law and statutory liens”?

Possessory Liens - A possessory lien is a common law or statutory interest in an asset that:

- secures a payment for services or material furnished in the ordinary course of business;
- is create pursuant to statute or common law; and
- the asset is under the control of the lien holder.

A possessory lien, as the name implies, gives priority in situations where an individual has physical possession of the collateral.

- *Example:* Common types of possessory lien include: repair and storage, boarding of animals, and labor performed or material supplied in course of performance.

Non-Possessory Lien - A non-possessory lien generally arises through judicial or administrative order.

- *Example:* A common form of non-possessory lien is a judgment that is attached to a debtor's property.

A possessory lien has priority over an Article 9 security interest, unless the common law or statutory authority for creating the lien indicates otherwise. A non-possessory lien, on the other hand, does not have priority over a security interest that is

perfected prior to the establishment of the lien. It does, however, have priority over an unperfected security interest.

- **Discussion:** Why do you think the law allows a possessory lien to claim priority over a perfected security interest? Should a non-possessory lien be given priority over a perfected security interest? Why or why not? Should a non-possessory lien be given priority over an unperfected security interest? Why or why not? Can you identify a common objective among these priority rules?
- **Practice Question:** Nate holds a perfected security interest on Mandy's lawn mower. She takes the mower to Olivia's shop for repairs. While the mower is being repaired, she is held liable to Patrick in court. The court issues a judgment in favor of Patrick that he seeks to execute by attaching it to Mandy's mower. Who's security interest likely has priority in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/priority-of-parties-holding-statutory-and-common-law-liens/>

28. What is the “priority of buyers of collateral” that is subject to a security interest?

Generally, a buyer of collateral subject to a security interest takes the property subject to that security interest. That is, if a debtor sells collateral that is subject to a security interest, the security interest continues in the collateral following the sale to the buyer. This is true for validly perfected security interests or if the buyer knows about the security interest at the time of purchase. If the security interest remains with the collateral, this means that the secured party can repossess the subject collateral in the event of default on the original loan or obligation.

- **Note:** Repossessing goods from the purchaser of collateral subject to a security interest may require bringing a conversion action against the debtor in possession of the collateral.

The following exceptions apply to this rule:

- **Authorization of Secured Party** - A primary exception to this rule is when the secured party authorizes the sale. A secured party's failure to object to the sale of the collateral may constitute authorization. Also, allowing prior sales of collateral without objecting may constitute an implied agreement authorizing the debtor to sell the collateral.
- **Buyers in the Ordinary Course of Business** - A “buyer in the ordinary course of business” (BOCB) takes collateral free of any security interests created by the seller. This is true whether the security interest is perfected or no.
- **Consumers Purchasing Consumer Goods from Other Consumers** - A purchaser of consumer goods from another consumer may take the goods free of an existing security interest. Two provisions protect consumers in this situation, UCC § 9-320(b) and the “Shelter Principle”.

Each of the above rules protecting purchasers of collateral subject to a security interest is explained below.

- **Discussion:** How do you feel about the principle that a purchaser of collateral subject to a security interest takes the goods subject to the security interest? Do you think the above-referenced exceptions to this rule are necessary? Why or why not? Are they adequate?

- **Practice Question:** Mark purchases a piece of equipment from Iris. Mark has become concerned that the equipment was subject to a security interest when Iris sold it to him. What information will you need to know to determine whether Mark's equipment is still subject to the security interest?
- **Resource Video:** <http://thebusinessprofessor.com/priority-of-a-secured-party-vs-a-buyer-of-collateral/>

29. What is required to be a buyer in the “ordinary course of business”?

A buyer in the ordinary course of business must meet the following characteristics:

- *Good Faith* - The purchaser of the collateral must buy it in good faith and without the intent to defraud or deceive;
- *Not Aware of Violation of Rights* - The buyer cannot know that the sale of the collateral violates the security interest of a third party. She can know about the security interest but cannot be aware that the sale of the collateral is not authorized; and
- *Ordinary Course of Business* - The buyer must purchase the goods under normal purchasing conditions from a seller of goods of that kind. Basically, the collateral purchased must be inventory that is regularly sold by the seller.
 - *Example:* Buying a used piece of operational equipment from a business that does not regularly sell that type of equipment would not qualify.

The buyer-in-ordinary course exception only applies to security interests that were validly entered into by the seller of the goods of this kind. It does not protect anyone who later purchases the collateral from the BOCB. This harsh result is addressed *via* UCC § 9-320(b) and the Shelter Principle.

- *Note:* The UCC intentionally excludes pawnbrokers from buyers in the ordinary course. It also excludes bulk transfers of goods or the transfer of goods as a security interest or in satisfaction of an existing debt.
- **Discussion:** What do you think about the buyer in the ordinary course exception? What objective is served by this rule? Is the rule too broad or overly narrow in its protections of purchasers? Why?
- **Practice Question:** Rosa purchases and finances her inventory from Sam. Sam takes a security in Rosa's inventory. Tom purchases a good from Rosa. Does Tom take the goods subject to Sam's security interest? What facts do we need to know to answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/protectations-of-a-buyer-in-the-ordinary-course-of-business/>

30. What statutory provision protects individuals purchasing goods from a buyer in the ordinary course?

The buyer-in-the-ordinary course protection does not apply to subsequent purchases from a buyer in the ordinary course because the seller is not a seller of goods of the kind. So, if a BYOC subsequently sells the collateral purchased, the

purchaser will take the goods subject to the original secured party's security interest. This is a harsh result for the unsuspecting purchaser. UCC § 9-320(b) may remedy this harsh result by offering protections to the buyer if the security interest is not perfected. Under § 9-320(b) the buyer takes the collateral free of the security interest under the following conditions:

- *Consumer Goods* - The goods are consumer goods in the hands of the seller;
 - *Note*: The buyer in the ordinary course cannot be a business.
- *No Knowledge of Security Interest* - The buyer buys without knowledge of the security interest;
- *Provide Value for Goods* - The buyer buys the collateral for value (generally cash);
 - *Note*: The recipient of a gift is not protected.
- *Personal Use* - The buyer buys the collateral for his own personal, family, or household purposes; and
- *No Financing Statement* - The secured party has not filed a financing statement covering the goods prior to the purchase.

This is a very limited protection when the secured party does not perfect or relies on automatic perfection of a security interest in the sale of consumer goods. Further, the buyer and in the ordinary course and the subsequent buyer must be consumers.

- **Discussion**: What do you think about this extension of protections to purchasers who do not qualify as buyers in the ordinary course? Is this protection adequate or is it too narrow in its protections? Why?
- **Practice Question**: Venus has a lawnmower that she purchased from ABC Corp. Venus financed the purchase through ABC Corp. She later offers to sell her lawn mower to Wyatt. Wyatt agrees to purchase the mower. What information do we need to know to determine whether Wyatt takes the lawn mower subject to ABC's security interest?
- **Resource Video**: <http://thebusinessprofessor.com/security-interests-in-goods-purchase-from-one-consumer-by-another/>

31. What is the “Shelter Principle” - Section 2-403(1)?

The shelter principle offers additional protections for buyers of collateral from other consumers. Basically, this equitable principle states that a good faith purchaser of property acquires all of the rights that the transferor of that property. The shelter rule will provide the purchaser with a claim of interests that may be superior to a previously perfected secured creditor. The shelter principle is broader than the BYOC and UCC 9-320 protections. It protects consumer and non-consumers who purchase collateral from a buyer in the ordinary course. Further, it protects the buyer in situations where the secured party has filed a security interest covering the collateral, which is outside of the scope of 9-320.

- *Example:* Suppose Biz, LLC purchases a good used personally by a consumer, Tom. The good was subject to a perfected security interest as inventory in the hands of the seller, Seller, Inc., when it was originally sold to Tom. Tom, as a consumer, would have taken the item free and clear of the security interest in the inventory. When Tom later sells the item to Biz, LLC, the shelter principle is the only rule to protect it. Biz, LLC does not qualify as a purchaser in the ordinary course and is not protected as a consumer under UCC 9-320. Biz, LLC, as a subsequent purchaser or transferee of that collateral from the buyer, receives all of Tom's rights in the collateral. As such, Biz, LLC takes the collateral free and clear of the original security interest. It does not matter whether Seller, Inc., filed a financing statement to perfect the security interest.

- **Discussion:** How do you feel about the Shelter Principle? What do you think are the objectives behind the Shelter Principle? Is the rule adequate or overly broad? Why? Do the protections for business and consumers against filed and unfiled security interests affect your opinion?
- **Practice Question:** Yolanda purchases a couch from ABC Inc. ABC perfects a security interest in the couch. Yolanda later sells the couch to Zora. Is Zora's couch still subject to ABC's security interest? What information do we need to know to answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/the-shelter-principle-and-buyers-of-collateral/>

PRIORITY OF PERFECTED & UNPERFECTED SECURITY INTERESTS

32. What are the general “priority rules” for security interests?

The following are the general priority rules for security interests:

- *Perfected vs Unperfected Security Interests* - A perfected security interest has priority over an unperfected security interest. This is true even if the unperfected security interest was established well before the perfected security interest.
 - *Note:* This fact can give rise to issues when a party's security interest has temporary automatic perfection.
- *Unperfected vs Unperfected Security Interests* - Unperfected security interests have priority based upon the order of attachment of the security interest. In this case, the earlier party to establish the security interest has priority over those coming later.
 - *Note:* A later unsecured party may establish priority by filing her security interest (or otherwise perfecting) before the other secured parties.
- *Multiple Perfected Security Interests* - The first secured party to file or perfect is entitled to priority over secured parties later acquiring or perfecting their interest in the subject collateral. This situation also brings up an issue for temporary automatic perfection. If a party takes the steps necessary to continue the temporary automatic perfection, her perfection date is retroactive back to the date and time that the security interest attached. This becomes an issue when the collateral is also subject to an “after-acquired collateral” clause. If she fails to take the steps necessary to continue the security interest, any third party may establish a security interest in the

collateral and gain priority over her unperfected security interest.

- *Note:* An issue arises for collateral that is used to secure “future advances”.

These are default rules. Any of these rules can be changed pursuant to agreement between the parties. That is, a party can agree to subordinate her security interest to the security interests of others. This is important when new lenders require priority of a security interest before extending new credit to a debtor.

- **Discussion:** How do you feel about the above-stated priority rules applicable to security interests? Is it fair that a party can establish priority over an earlier security interest by being the first to file? Why or why not? Can you think of any situations where the automatic temporary perfection rules could cause an issue?
- **Practice Question:** Heidi purchases a piece of equipment from Indira. Indira finances the purchase and attaches a security interest. Heidi has a loan outstanding to Jan that has an after-acquired property clause in the security agreement. After the purchase of the equipment, Heidi borrows money from Kyle, who takes a security interest in all of Heidi’s assets. If Heidi defaults on all of her debts, who has priority of payment from the sale of the equipment? What other information do we need to know to answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/priority-rules-for-conflicting-security-interests/>

33. Who has “priority in proceeds” from the sale of collateral?

A secured party who perfects her security interest in collateral may have a continued security interest in the proceeds from the sale of that collateral. Thus, a secured party with priority in collateral will also maintain priority in the proceeds from sale of that collateral. In this case, the date of perfection of the security interest in the proceeds is the same as the perfection date for a security interest in the collateral. The priority of secured parties following the sale of collateral is generally as follows:

- **Cash or Similar Property Proceeds** - A secured party has priority over a conflicting security interest in proceeds if she has perfected her security interest and the proceeds of sale are cash or of the same type as the collateral.
 - *Example:* Mark and Jay have security interests in Tom’s asset. Mark’s security interest has priority over Jays. If Tom sells the asset and receive cash or another similar asset, Mark and Jay maintain a security interest in the cash or similar equipment. Mark’s security interest retains priority.
- **Non-Filing Collateral** - Special rules apply to a security interest in collateral that can only be perfected in a manner other than filing (control or possession). Common types of collateral perfected by possession include chattel paper, deposit accounts, negotiable documents, instruments, investment property, and letter of credit. Priority of security interests in the proceeds from the sale of non-filing collateral ranks according to the time of filing of a security interest in that collateral. This rule provides priority to the first secured party to file a security interest in the newly acquired proceeds. Secured parties that have already filed a security interest on “all equipment” of the debtor at the time of sale of the non-filing collateral generally have priority.
 - *Example:* Leo has numerous creditors who have security interests in all of his assets. He owns and has

possession over some chattel paper. When he sells the chattel paper and acquires equipment, his creditors have priority in the equipment based upon the timing of filing of a security interest.

- **Discussion:** Do you agree with the premise that a secured party should have priority in proceeds from the sale of the collateral? Why do you think special rules exist for non-filing collateral? Do you agree with the first-to-file rule applicable to non-filing collateral? Why or why not?
- **Practice Question:** Merrill has a security interest in “all assets” of Nancy. Oscar also has a security interest in “all assets” of Nancy, but it was filed at a later time. Oscar’s security agreement contains a provision providing for a security interest in “after-acquired collateral”. Nancy later sells some negotiable instruments and receive some cash and a painting. Merrill immediately files a financing statement covering the painting. Who has priority in the proceeds and why?
- **Resource Video:** <http://thebusinessprofessor.com/special-priority-rules-for-proceeds-from-sale-of-collateral/>

34. What is a secured party’s priority in “future advances” of funds to the debtor?

Future advances of funds are funds provided to a debtor based upon an existing lending agreement. This is common when a debtor establishes a line of credit with a lender. The lender will advance funds to the debtor when requested. Generally, a security agreement will provide that the lender is secured by any collateral securing a future advance or new collateral acquired with the advanced funds. The rules for priority in future advances are as follows:

- **Time of Perfection** - Generally, the time of perfection of a security interest establishes priority with respect to future advances. That is, if a lender makes an advance of funds based upon a prior agreement, the priority of the lender’s security interest in collateral securing the advance is determined by the time of the filing of the financing statement covering the collateral. If the debtor has secured creditors with priority above that of the lender, these creditors retain priority in the collateral despite the future advance.
 - **Example:** First Bank lends money to Mark and takes a security interest in Mark’s lawn mower. Mark later borrows money from Second Bank that takes a security interest in all of Mark’s assets. As such, First Bank’s security interest in the lawn mower has priority over that of Second Bank. If First Bank makes a future advance to Mark pursuant to the original lending agreement, First Bank will have priority based upon its original security agreement and financing statement. If, however, First Bank’s security agreement does not cover future advances, Second Bank’s security interest in the collateral will have priority over a subsequent security interest filed by First Bank against the collateral to secure payment of the future advance.
- **Priority over Lien Creditors** - A secured party that advances additional funds and claims a security interest against the original collateral has priority over a lien creditors of the debtor if:
 - The secured party made the advance of new credit within 45 days after the lien attaches, or
 - The secured party made the advance of funds more than 45 days after the lien attaches, but without knowledge of the lien or pursuant to a prior agreement entered into without knowledge of

the lien.

- *Example:* First Bank lends money to Katherine and takes a security interest in Katherine's jewelry. A creditor receives a judgment against Katherine and establishes a lien against her jewelry. First Bank later makes a future advance to Katherine that is secured by her jewelry. If First Bank made the advance within 45 days of the lien creditor establishing its lien, then First Bank will have priority. If First Bank makes the future advance more than 45 days after the lien is established, it will have priority if the future advance was pursuant to the original lending agreement providing for a security interest in the collateral or if First Bank had no knowledge of the other creditor's lien at the time of the advance.
- *Priority over Buyers of Collateral* - A secured party who makes future advances against collateral has priority over a buyer of the collateral in the ordinary course if:
 - The secured party's advance is made within 45 days and without knowledge of the purchase; or
 - The advance was made pursuant to a commitment established within 45 days of and without knowledge of the purchase.
- *Note:* This provision keeps a debtor from selling collateral and then seeking a future advance secured by the collateral.
- *Example:* First Bank has a security interest in ABC's inventory. ABC sells an item of inventory to Fanny. Fanny takes the item subject to First Bank's security interest in the inventory if the advance was made within 45 days of the sale or the advance was made pursuant to a security agreement entered into within 45 days and without knowledge of the sale to Fanny.

- **Discussion:** How do you feel about the rules providing for priority for future advances? Do you agree that with the priority rules for future advances above that of lien creditors? Why or why not? Do you agree that with the priority rules for future advances above that of buyers of the collateral in the ordinary course? Why or why not? Can you think of situations where this rule would unduly prejudice lien creditors or buyers in the ordinary course?
- **Practice Question:** Luther borrows funds from First Bank. First bank establishes a security agreement and perfects a security interest in Luther's tractors. Luther later takes out loans from Second Bank and Third Bank. Both banks establish security agreements in all of Luther's assets. Luther also becomes subject to a lien creditor. Troubled with money issues, Luther sells the tractor without notifying his creditors. Soon thereafter, First Bank makes a future advance to Luther secured by the tractor. Which creditor's security interest, if any, has priority in the collateral? What additional information do we need to answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/secured-party-priority-in-future-advances-to-debtor/>

PRIORITY OF PURCHASE MONEY SECURITY INTERESTS

35. What is the priority of a purchase-money security interest in goods (other than inventory and livestock)?

A purchase-money security interest (PMSI) is a security interest in collateral purchased with the value extended by the creditor. A seller or lender may also acquire a PMSI in goods sold if it finances the purchase. A perfected purchase-money security interest in goods (other than inventory or livestock) has priority over conflicting security interests if the security interest is perfected within 20 days of the debtor receiving possession of the goods. Also, the PMSI provides for priority in identifiable proceeds of the collateral if sold. There is, however, a potential conflict in this situation with secured parties perfected by control over deposit accounts. If the PMSI collateral is sold and the proceeds deposited in a controlled deposit account, a party with a security interest in the deposit account would have priority to the funds.

- *Note:* A secured party does not lose PMSI protection because the underlying obligation is renewed, refinanced, or restructured.

- **Discussion:** How do you feel about a purchase-money lender's ability to establish priority for its security interest in goods acquired with the value extended to the debtor? Should the purchase-money lender's security interest lose priority if not filed within the 20-day period? Why or why not? Can you think of any conflicts between lenders that could arise because of the 20-day filing window for continued perfection?
- **Practice Question:** ABC Corp sells printer equipment. 123, LLC purchases a new office printer. ABC finances the purchase over 12 months and attaches a security interest. What will ABC Corp need to do to perfect or continue perfection of its security interest?
- **Resource Video:** <http://thebusinessprofessor.com/priority-of-purchase-money-security-interest-in-collateral/>

36. What is the priority of a purchase-money security interest in inventory?

Special rules apply to purchase money security interests in inventory. In order to qualify for PMSI priority in inventory, the secured transaction must meet the following requirements:

- *Perfection at Time of Possession* - The PMSI must have been perfected at the time the debtor takes possession of the inventory. This means the security agreement and value extended must have taken place prior to the receipt of the inventory.
 - *Note:* This can be temporary automatic perfection that is later extended by filing within the 20-day window. The key aspect is that the security agreement must have already attached.
- *Notice to Secured Parties* - The secured party must provide authenticated notification to any holders of conflicting security interests in the debtor's collateral prior to perfection. The holder of the conflicting security interest must receive the notice within 5 years prior to the debtor obtaining possession of the collateral.
 - *Note:* Lenders who finance the purchase of inventory often send blanket notices to secured creditors that they will be extending credit and perfect a security interest.
- *Description of PMSI Collateral* - The notification to other secured parties must state that the creditor intends to take a PMSI in the debtor's inventory and it must describe the inventory.

The UCC extends PMSI priority to identifiable proceeds from the sale of the collateral. The priority in cash is limited, however, if the cash is deposited in a deposit account.

- **Discussion:** Why do you think the law requires additional notification procedures to claim a PMSI in inventory? Why do you think the law requires perfection at the time the debtor takes possession? Does this right detriment existing secured creditors? Why or why not?
- **Practice Question:** ABC Corp is a lender that regularly finances inventory purchase for small businesses. ABC loans money to 123, LLC to purchase inventory. LLC has numerous creditors with perfected security interests in all of 123's assets. What process must ABC follow if it intends to lend money to 123 to purchase inventory and wishes to perfect a purchase money security interest?
- **Resource Video:** <http://thebusinessprofessor.com/purchase-money-security-interest-in-inventory/>

37. What is the priority of conflicting purchase-money security interests?

Often a debtor will acquire property subject to multiple purchase-money security interests. This happens when multiple parties lend money for the purchase (enabling loans) and the seller of the good finances part of the purchase. In such a situation, the UCC provides priority for the individual financing the purchase over individuals providing a financing loan. If all of the financiers or enabling lenders are the same, the UCC provides that the first to file or perfect the security interest determines priority.

- **Discussion:** Why do you think the law prefers financing sellers over enabling lenders? If all lenders have similar PMSIs, how do you feel about the first to file system?
- **Practice Question:** ABC Corp purchase equipment from 123, LLC. ABC places a down payment of 50% of the value and finances the remaining 50% through 123. 333, Inc., and 444, Inc., make separate loans in equal amounts to ABC to provide the money to place the 50% down payment. In this situation, what is the priority of security interests?
- **Resource Video:** <http://thebusinessprofessor.com/priority-of-purchase-money-security-interest/>

FIXTURES AND SECURITY INTERESTS

38. What is the priority of security interests in fixtures?

A fixture is a piece of personal property that is installed on and made one with real estate. The primary characteristic of a fixture is that it is not readily moveable. It has assumed a state of semi-permanence on the real estate. The downside to this situation is that it causes issues regarding the priority of security interests in the real estate and in the fixture. Under the UCC, a secured party with a security interest in a personal good that will become a fixture must make a fixture filing in the appropriate government office to establish the priority of her security interest in the fixture. If the secured party fails to make a fixture filing, a security interest in the fixture is subordinate to a conflicting interest of the owner of real property or party holding a security interest in the real property.

- **Discussion:** How do you feel about the requirement to affirmatively claim priority of a fixture? Why do you think the law places the burden upon the owner of the fixture to maintain a security interest rather than the owner of the real estate to establish a claim in the fixture?
- **Practice Question:** Alvin has a security interest in a piece of equipment he sold to Beatty. Beatty permanently installs the equipment on his real estate that is subject to a mortgage owed to First Bank. Whose security interest has priority in the equipment? What information do you need to know to accurately answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/priority-of-security-interest-in-fixtures/>

39. What is the scope of fixture priority rules?

The following rules govern the priority as between secured parties with security interests in fixtures and persons who claim an interest in real property to which the fixture attaches.

Purchase-Money Priority in Fixtures - The UCC provides for priority for purchase money security interest in fixtures. To establish priority over conflicting security interests in the real estate, the following conditions must be met:

- *Recorded Interest in Real Estate* - The debtor has a record interest in or possession of the real estate;
- *PMSI in Fixture* - The secured party holds a purchase-money security interest in the fixture;
- *Prior Ownership of Real Property* - The interest of the mortgage holder of the real property arose before the goods became fixtures; and
- *Prior Fixture Filing* - The security interest is perfected by a fixture filing before the goods became fixtures or within 20 days thereafter.

The twenty-day grace period can cause issues for the secured party holding a PMSI in the equipment. If a third-party perfects a security interest in the real estate after the fixture is installed but before the PMSI secured party can make a fixture filing, the third-party has priority in the fixture. The way to maintain priority is either file before the fixture is installed or the PMSI holder files before any third parties file an interest in the real estate.

- *Note:* A security interest in a fixture (whether perfected or no) has priority over a conflicting security interest in real property if the owner of the real property has consented to the security interest or disclaimed an interest in the goods as fixtures in an authenticated record.

- **Discussion:** How do you feel about the requirement for a party with a PMSI in a good to file a financing statement within 20 days of the good becoming a fixture? Does this run counter to the objectives of providing priority to a PMSI over other security interests?
- **Practice Question:** ABC Corp loans money to 123, LLC to purchase equipment for its business operations. ABC Corp attaches a security interest in the equipment and files a financing statement. 123 intends to install the

equipment on its real estate that is subject to a mortgage held by First Bank. ABC initially forbids 123 from permanently installing the equipment, but they withdraw their objection when First Bank acknowledges ABC's rights in the equipment in an email. 123 later falls on hard times and defaults on all of its obligations. What is the priority of security interests in the fixture? What do you need to know about this situation to accurately answer this question?

- **Resource Video:** <http://thebusinessprofessor.com/priority-of-fixture-filer-vs-mortgage-holder/>

TOPIC 20: COMMERCIAL PAPER

Overview

Commercial paper is a document that promises to pay a sum of money to the holder or possessor of the instrument. It is very common to use commercial paper as consideration in a business transactions rather than cash. This chapter introduces commercial paper. It identifies the main types and requirements (elements) of commercial paper. It explains the rights of a holder or possessor of the commercial paper and the obligations of the payor of the instrument. It also provides for the rights of subsequent transferees or purchasers of the commercial paper. Notably, it introduces the concept of a holder in due course. Lastly, it provides for the potential liability of any maker, drawer, transferor, signor, or individual presenting the commercial paper for payment.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

- [Commercial Paper](#)
 - Note
 - Draft
 - [Holder](#)
 - [Negotiable Paper](#)
 - [Requirements of Negotiable Paper](#)
 - [Unconditional Promise to Pay](#)
 - [Payable on Demand or on Time](#)
 - [Order Paper & Bearer Paper](#)
 - [Payee Identification](#)
 - [Rules to Determine Negotiability](#)
 - [Negotiation of Instrument](#)
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 - [Payment of Lost Instruments](#)
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 - Defenses
 - [Personal Defenses](#)
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 - [Drawer \(Maker\) Liability](#)
 - [Transfer Warranty](#)
 - [Indorser Warranty](#)
 - [Presentment Warranty](#)
 - [Warrantor Liability Upon Dishonor](#)
 - [Time Limitation on Warranties](#)
 - Discharge of Warranties
-

TOPIC 20: COMMERCIAL PAPER - QUESTIONS & ANSWERS

1. What is “Commercial Paper”?

Commercial paper is a broad categorization of financial instruments (also referred to as an “instrument”) promising to pay or ordering payment to a person legally entitled to enforce the instrument. Because it has value for the individual in possession or holding the instrument, it is used as a substitute to money in commercial transactions.

- *Example:* A check is commercial paper that orders a third party to pay money. A promissory note is another form of commercial paper that evidences a loan and outlines the duty of the maker of the note to make payment to the holder of the note.
- **Discussion:** Why do you think it is necessary for commercial paper to entail an “unconditional” right to be paid? How is commercial paper different from a contract?

2. What are common types of commercial paper?

When examining the attributes of commercial paper, it is important to differentiate between the most common types of instrument. The types of commercial instrument include:

- *Notes* - This is a promise to pay money. It involves two parties. The maker of the note makes an unconditional promise to pay the payee. The payee is the person entitled to payment of the note. This is normally the holder of the notes. The payment may be due at a date certain or on payable on demand.
 - *Note:* Most notes, such as a promissory note, have some form of the word note in the name. Bank notes are called certificates of deposit (CD). The UCC generally lists CDs as a completely separate type of instrument from a note because they are the subject of numerous special rules.
 - *Example:* Amy creates a document in which she promises to pay the holder of the note \$500. She gives the note to Brenda as payment for a contract to purchase goods. Brenda is now the holder of this note (commercial paper). Because no date is stated on the note, it is payable on demand. That is, Brenda or some other holder can present the note to Amy at any time and ask for payment. If the note states that it will be paid on October 1, 2017, it is payable on time or at this stated date.
- *Drafts* - This is an order directing someone else to pay money. It involves three parties. The “drawer” is the maker of the draft. The “drawee” is the party ordered to make payment to the “payee” or holder of the draft. A draft can involve a drawee who is an individual or business.
 - *Note:* A check is the most common form of draft. In the case of a check, the drawee is a bank. The UCC generally lists a check as a completely separate type of instrument from a draft because checks are the subject of numerous special rules. Nonetheless, a check functions similarly to any form of draft.
 - *Example:* Charlie owes Doug money. Doug creates a document indicating that Charlie is ordered to pay

the owed money to Evan. The document (a draft) states that Evan can present the draft to Charlie at any time for payment. This is a draft payable on demand.

Either of these types of types of instrument can be a negotiable instrument if they meet specific requirements.

- **Discussion:** Why do you think notes and drafts are categorized separately in the context of commercial paper? Can you think of situations where a note might meet the requirements of commercial paper but the draft would not? Vice Versa?
- **Practice Question:** Phillip enters into a contract with Henry to sell him construction supplies. Henry asks Phillip if he is willing to accept commercial paper as payment instead of cash. Can you explain to Phillip what is commercial paper and the requirements for each type?
- **Resource Video:** <http://thebusinessprofessor.com/types-of-commercial-paper/>

3. Who is a “holder” of commercial paper?

A holder is one who has possession of and is entitled to enforce the instrument. So, a person who is named as payee and possesses an instrument is a holder. If the commercial paper is not payable to a particular person (i.e., it is payable to anyone in possession of the paper), anyone who has possession is a holder. An individual who is issued a note or draft is a holder. A person can also become a holder by receiving the draft through “negotiation” of the instrument. Negotiation is discussed separately.

- **Note:** There are certain exceptions for this rule when the instrument is forged (i.e., the signature of the payor or payee is not genuine). A forged signature does not make the instrument payable to the forger or validly make the instrument bearer paper. A thief or finder of bearer paper, however, is a holder.
- **Example:** Harriet writes a check to John. John is a holder of this draft. If he indorses the check and transfers it to Kyle, Kyle is the new holder. If, however, Kyle had stolen the check from John and forged John’s signature, Kyle is not a legal holder of the paper, as he is not legally entitled to enforce the instrument.

- **Discussion:** Why do you think the definition of a holder excludes certain individuals who do not gain possession of the paper through a legal method?
- **Practice Question:** Gary writes a check to Hannah. Irene steals the check from Hannah’s mailbox and endorses the check to herself. Is Hannah a holder of the draft? Why?
- **Resource Video:** <http://thebusinessprofessor.com/who-is-a-holder-of-a-negotiable-instrument/>

NEGOTIABILITY

Negotiability is a core concept in the transfer or sale of an instrument.

4. What is “negotiability” and why is it important?

Negotiation is the transfer of negotiable paper from one holder to another. To be a substitute for money, commercial paper must be freely transferable in the marketplace. That is, the paper must be “negotiable”. Negotiability concerns the rights of the holder of commercial paper. Paper that is not negotiable may still be transferred; however, it is far less valuable than negotiable paper. This is because the holder has fewer rights in enforcing payment of the non-negotiable, commercial paper. The rights of a holder of each type of paper is as follows:

- *Non-negotiable Commercial Paper* - An individual in possession of a non-negotiable instrument stands in the shoes of the original issuee. That is, she has the exact same rights in the instrument as the original issuee held. This means that, if the original party loses his right to be paid (think of defenses to payment of a contract), so does the transferee of the commercial paper. As such, the value of non-negotiable instrument is far less valuable to a subsequent transferee who cannot be certain that she will receive payment without being subject to a payor defense.
 - *Example:* Sarah enters into a contract to sell equipment to Robert. Robert gives Sarah a non-negotiable promissory note to pay for the goods. So, Sarah is the holder of a promissory note that is non-negotiable. She transfers the note to Tim, who is now the holder. If Robert has a defense against his obligation to pay Sarah for the equipment (e.g., the equipment is faulty), he could assert that defense against his obligation to pay Tim if he presents the promissory note for payment. This possibility makes the note far less valuable to Tim.
- *Negotiable Commercial Paper* - The holder of negotiable paper may have greater rights than the original issuee. That is, when paper is negotiable and validly negotiated to a subsequent holder who qualifies as a “holder in due course”, the holder may acquire greater rights to enforce the instrument against the payor or maker. The holder in due course will have a greater right to payment because the maker or payor cannot assert certain defenses (personal defenses) to payment against the holder in due course.
 - *Example:* In the above scenario, suppose Robert provides Sarah with a negotiable promissory note. This means that it is transferable without conditions. If Tim later presents the note for payment, Robert’s defense against paying Sarah on the underlying contract does not apply to the promissory note. Robert will be liable if he fails to pay it. Robert may still sue Sarah, but this right is completely separate from his obligation on the promissory note.

- **Discussion:** Can you explain the concept of holder risk in terms of negotiable and non-negotiable paper? Is there any reason that the issuer of the commercial paper may prefer the paper to be negotiable or non-negotiable? Why? What about the original holder of the negotiable paper?
- **Practice Question:** Franklin receives a promissory note from Geo. The promissory note is transferable and Franklin immediately gives the note to Heath. Geo sues Franklin stating that he was defrauded into giving Geo the promissory note. How does this affect Heath’s ability to receive payment on the promissory note?
- **Resource Video:** <http://thebusinessprofessor.com/negotiability-of-a-commercial-instrument/>

5. What is required for commercial paper to be “negotiable”?

An instrument is negotiable if it meets the following qualifications:

- *Writing* - The instrument must be in writing,
 - *Note*: The writing must be permanent in nature and must be moveable.
 - *Example*: Drawing the terms of an instrument in the dirt would not be permanent, and spray painting the terms of an instrument on the side of a building would not be moveable.
- *Signed by Issuer* - The issuer must sign the instrument. A mark may constitute a signature if the issuer intends for the mark to be a signature.
 - *Example*: Valid marks constituting signatures may include seals, auto-pen signatures, personal stamps, etc.
- *Unconditional Promise to Pay* - The instrument must contain an unconditional promise to pay. A condition is any requirement that a holder must undertake before she has the right to present the paper for payment.
 - *Note*: The only acceptable condition is providing a time when the note becomes valid. That is, the note can state that it may only be presented for payment after a certain date. Further, any “acceleration” or “extension” clauses are valid and do not destroy negotiability. Reciting that consideration was provided for the instrument does not harm negotiability. Limiting the payment to a specific fund may destroy negotiability, unless it is an order instrument drawn on a specific account.
 - *Example*: “I promise to pay money to the order of bearer, if the bearer is a US citizen” is not an unconditional promise to pay.
- *Definite Amount* - The instrument must state a specific amount of money that it will pay.
 - *Note*: The promise cannot be to pay in anything other than money. If the instrument pays an interest rate, the interest rate may reference a standard rate for calculation.
 - *Example*: “Promise to pay \$3,000 with interest of 3% + prime rate, compounding annually from the date of issuance” is a definite amount.
- *Payable on Demand or on Time* - A “demand instrument” must be paid whenever the holder requests payment, while a payable “on time” instrument indicates a specific date and time.
 - *Note*: An instrument that does not have a specific maturity date or payment time is assumed to be payable on demand.
 - *Example*: A note including the language, “payable on or before 90 days after October 15, 2017” is a definite time.

- *Payable to Order or To Bearer* - To be negotiable, an instrument must be either “order paper” or “bearer paper”. Order paper is payable to a specific individual. This individual’s signature is required if the instrument is transferred to another holder. Bearer paper means that any holder of the paper can present it for payment.
 - *Note:* Order paper can be converted to bearer paper with the holder’s signature (indorsement). A holder can also make bearer paper into order paper by signing and making a restrictive indorsement.
 - *Example:* “Pay to John or order” is order paper. “Pay to the order of _____” or “Payable to bearer” are examples bearer paper.
- *No Further Undertaking* - With limited exception, the instrument cannot require the holder to undertake any action other than present the instrument to receive payment.
 - *Note:* This is an extension of the requirement that the instrument contain an “unconditional” promise to pay.
 - *Example:* A holder, upon presentment, must post a temporary bond. This is a further undertaking that makes the instrument non-negotiable.

Remember, non-negotiable paper may still be transferred. The transferee of non-negotiable paper may have fewer rights than the holder of negotiable paper through a valid negotiation.

- **Discussion:** Why do you think each of the above elements is necessary to make an instrument negotiable? Do you believe that any of these elements should be excluded or other elements added? Why?
- **Practice Question:** Devon is debating whether to accept commercial paper from Clint as payment on a contract. The promissory note was created by a third party and used to satisfy a debt to Clint. It is payable on or after a specific date six months away. The Devon is worried about the liquidity of the instrument and whether the maker of the note has any defenses against its enforcement. Can you explain to Devon the requirements and benefits of a negotiable instrument?
- **Resource Video:** <http://thebusinessprofessor.com/requirements-for-commercial-paper-to-be-negotiable/>

6. When does commercial paper contain an “unconditional promise to pay”?

Any condition placed on the payment makes the instrument non-negotiable. A condition is any requirement that a circumstance come to fruition or that the holder undertake any additional actions in order to receive payment upon presentation of the instrument.

- *Example:* I create a note that says, “I promise to pay to bearer or order the amount of \$5,000. This amount will become payable if the NASDAQ drops below 4500 points.” This would be a condition to payment and would destroy the note’s negotiability.

- **Discussion:** Why do you think the requirement that an instrument be free of conditions in its promise to pay the holder a stated sum of money? Should it matter the nature or extent of the condition? Why or why not?
- **Practice Question:** Thomas and Carter are involved in a business deal. Carter sells Thomas a piece of equipment in exchange for a promissory note. In the note, Thomas agrees to pay Carter \$25,000. He wants to add a clause stating that the note is invalid if the equipment malfunctions within the 1st year of operation. Does this clause affect negotiability and why?
- **Resource Video:** <http://thebusinessprofessor.com/unconditional-promise-to-pay/>

7. What is “payable on demand” paper and “payable on time” paper?

A negotiable instrument must either be payable on demand or payment on time. An on-time instrument is payable at a specific time and date. The date must be able to be determined at the time the instrument is issued. It may be payable after an elapsed period of time that is readily ascertainable at the time the promise or order is issued, subject to rights of prepayment, acceleration, and extensions. If the instrument is not clear, but there is evidence of an intent to make it payable at a specific date and time, the note is not negotiable. An instrument is payable on demand if it states as much or it does not state any time of payment.

- **Discussion:** Why do you think it is important to distinguish an instrument as “payable on time” versus “payable on demand”? Do you think these attributes affect the value or liquidity of a negotiable instrument? Why or why not?
- **Practice Question:** Donovan receives a promissory note from Elvis. The note does not contain any date or time for payment. Is the note payable on time or demand?
- **Resource Video:** <http://thebusinessprofessor.com/negotiable-instruments-payable-on-time-or-on-demand/>

8. What is “order paper” and “bearer paper”?

To constitute a negotiable instrument (both notes and drafts), an instrument must be either order paper or bearer paper.

- **Order Paper** - Order paper must include the words “pay to the order of (identified person)” or “to (identified person) or order”. Including the word “order” indicates that the instrument is not limited to only one person. That is, the payee of the instrument can designate someone else to receive payment. This generally requires the identified person to indorse (sign) the instrument. Signing the instrument makes it bearer paper, unless the signor identifies a person to whom the instrument is being transferred.
 - **Note:** If the note is simply made out to pay a particular person without the word “order”, it is not negotiable.
- **Bearer Paper** - If the commercial paper is made out “to bearer” or it is not made out to any specific person, it is bearer paper. It can be redeemed by any holder of the paper, subject to certain defenses.

- *Note:* Bearer paper may also use the wording “order”. If the paper is made out to “order of gift” or “order of cash” or “pay to order of (blank space)”, it is bearer paper.

If all other requirements are met, the UCC provides an exception to the “order paper” or “bearer paper” requirement for commercial paper to be negotiable, but this exception *does not apply* to notes. Primarily, this exception applies to drafts drawn on third-party institutions that inadvertently leave off the “to order” language, but the nature of the paper is obvious.

- **Discussion:** Why do you think it is important to identify whether the paper is order or bearer paper? Does it affect your opinion knowing that bearer paper can be converted to order paper and vice versa? Why or why not? Can you think of specific uses or order paper versus bearer paper? How does bearer paper limit the liquidity of the instrument? Should this affect the instrument’s value?
- **Practice Question:** Constance creates a promissory note that names Doug as the payee. Is this a negotiable instrument? What would need to be included to make the instrument negotiable order paper? What would need to be included to make the instrument negotiable bearer paper?
- **Resource Video:** <http://thebusinessprofessor.com/negotiable-instruments-order-or-bearer-paper/>

9. How is a payee identified on the negotiable instrument?

A negotiable instrument is payable to the holder of the instrument. A holder may either be an individual named in the instrument (order paper) or an individual in possession of the instrument (bearer paper). An instrument that names a payee may name or identify the payee in any number of methods, including by name, identifying number, office, or account number. As a general rule, an instrument is payable to the person intended by the issuer, whether or not that person’s correct name appears on the instrument. If the payee is identified only by account number, the instrument is payable to the owner of that account. If the payee is identified by account number and name, the instrument is payable to the named person whether or not that person owns the account. If the instrument is payable to “either Identified Person or Identified Person” (this may use the word “alternatively” or some derivative thereof), it may be negotiated or enforced by any or all of the named individuals. If the instrument is made out collectively to two or more individuals (“not alternatively”), it is payable to all of them and must be enforced by all individuals together. That is, all individuals must indorse the instrument for transfer or present it for payment. If it is ambiguous as to whether the paper is payable in the alternative, it is assumed to be payable alternatively.

- **Discussion:** How do you feel about the rules for identifying a payee? Why do you think these requirements are in place? Does the fact that bearer paper does not identify a specific individual as payee affect your opinion? Should a negotiable instrument be able to identify a payee by methods other than name? Why or why not?
- **Practice Question:** Ethan creates a promissory note and identifies the payee as “George or order”. He then transfers the instrument to George Smith. Is this first name sufficient as an identifiable payee to make the instrument negotiable?

- **Resource Video:** <http://thebusinessprofessor.com/negotiable-instrument-how-is-payee-identified/>

10. What rules does the court apply when determining negotiability?

The UCC favors negotiability of commercial instruments. It contains a number of rules to resolve any uncertainty as to the terms of the instrument and to supply missing terms. The following rules apply to situations where terms in a negotiable instrument contradict each other:

- words take precedent over numbers;
- handwritten terms prevail over typed and printed terms; and
- typed terms win over printed or boiler-plate terms.

These rules can allow for any number of general assumptions about the intent and obligations of the parties.

Example: If the applicable interest rate of a promissory note is left off, courts hold that a judgment rate applies.

- **Discussion:** How do you feel about these generally applicable rules of interpretation for negotiable instruments? Is there any argument against the application of these rules?
- **Practice Question:** Hank drafts a check to Ira that is drawn on First Bank. When Ira presents the check for payment, she realizes that the check indicates “Five-hundred dollars” and “5,000.00” in the amount column. What is the likely interpretation of First Bank’s obligation to accept and pay the check?
- **Resource Video:** <http://thebusinessprofessor.com/negotiable-instrument-general-rules-of-interpretation/>

NEGOTIATION OF AN INSTRUMENT

11. How is commercial paper negotiated to a holder?

“Negotiation” means that an instrument has been transferred (either voluntarily or involuntarily) to the holder by someone other than the issuer. If an individual acquires paper by a method other than negotiation, she is a “transferee” and not a “holder” of the paper. The paper is negotiated upon:

- transfer of possession, and
 - *Note:* The transferee may become a holder upon transfer. A holder must be entitled to enforce the instrument. This excludes individuals who forge a signature on order paper. They do not legally become a holder because the signature (a required element of negotiation of order paper) is not present. A thief or finder of bearer paper, however, may become a holder.
- indorsement (signature) by the holder.

- *Note:* Indorsement is not generally required for bearer paper, as the holder is not necessarily named on the instrument.

The holder of the instrument has the right to force the transferor to indorse the instrument. This is very important for purposes of enforcement and liability if the instrument is not paid when validly presented by a subsequent holder. That is, the indorser may be liable for paying an instrument that is dishonored when presented.

- **Discussion:** Can you think of a type of transfer that does not constitute negotiation of order paper? What about bearer paper?
- **Practice Question:** Linda writes a check drawn on First Bank and transfers it to Faye. Faye indorses the check and makes it payable to “Clyde”. The check is stolen from the mail. The thief indorses the instrument in Clyde’s name to make it bearer paper. Is the thief a holder of the instrument? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/how-is-negotiable-instrument-negotiated/>

12. What is the “transfer” of commercial paper?

An instrument is transferred when it is delivered by a person (other than its issuer) with the purpose of bestowing the right to enforce the instrument pursuant to its terms. Transfer vests in the transferee the rights of the transferor to enforce the instrument. While the transferee receives the rights of the transferor, it means the transferee may also be subject to any defenses the payor may have to payment of the instrument. That is, the transferee stands in the same position as the transferor with regard to the payor’s defenses against payment.

- *Note:* As previously discussed, once transferred, the recipient of the bearer paper is a holder of the note. Even if the transfer is involuntary (inheritance or judicial order) or wrongful (theft of bearer paper), the individual in possession of the paper is a holder of the paper.

- **Discussion:** What do you think about the mental intent necessary for transfer of an instrument? Why do you think the definition requires the intent to transfer the right to present and receive payment of the instrument?
- **Practice Question:** Connie issues a promissory note that is payable to bearer. She gives the note to Todd. Todd then delivers the note to Judy. Do we have valid transfers of the instrument? What issues might Judy face in presenting the instrument for payment?
- **Resource Video:** <http://thebusinessprofessor.com/transfer-of-a-negotiable-instrument/>

13. What is “indorsement” of a negotiable instrument?

Indorsement of an instrument means signing it. The indorsement signifies that the individual signing the instrument certifies certain things about it to the primary parties liable on the instrument (maker or drawer) and to any subsequent

holder of the document.

- *Note:* Indorsement indicates that the instrument is payable in accordance with its terms. If the instrument proves not to be payable in accordance with its terms, this can lead to liability for the indorser.

If paper being negotiated is order paper (as apposed to bearer paper), the paper must be indorsed by the person to whom the paper is payable prior to transfer to another holder. Indorsement by the payee may change the paper from order to bearer paper (and vice versa), as well as put other limiting characteristics on the instrument. A payee may indorse the instrument to make it bearer paper or have a special/restrictive/qualified/anonymous indorsements to limit the rights of the future holder of the paper.

- *Note:* Indorsement of an instrument by an imposters and fictitious payee does not destroy a negotiation.

Indorsement is not always required for negotiation of the instrument. No indorsement is required to negotiate commercial paper if the paper in possession of the transferor is bearer paper. As such, the mere transfer of possession is a negotiation. In this case, even involuntary transfer (such as when the paper is lost or stolen) or voidable transfer (such as from an infant, through fraud, duress, misrepresentation, etc.) are sufficient to constitute negotiation.

- *Note:* When an instrument is made payable to two payees with the words "to A and B", signatures of both are required to negotiate it. Agency rules regarding actual and apparent authority apply to the indorsers.

- **Discussion:** Why do you think order paper requires the indorsement of a holder to negotiate the instrument? Why do you think the same rule does not apply to bearer paper? Does it surprise you that indorsement entails a certification or warranty that the paper is payable?
- **Practice Question:** Terry makes a promissory note that is payable to "Dan or order". He then transfers the note to Dan. What must Dan do in order to transfer the note to Arnie?
- **Resource Video:** <http://thebusinessprofessor.com/indorsement-of-a-negotiable-instrument/>

14. What are the various types of indorsement of a negotiable instrument?

Indorsement is the signature of an individual on the commercial instrument. There are several common types of endorsement, each of which has a different effect upon the instrument:

- *Blank Indorsement* - This means signing the instrument without designating any particular payee or making any other form of limiting designation. A blank endorsement turns order paper into bearer paper.
 - *Example:* A promissory note is payable to "Frank or order". If Frank signs the promissory note, it is a blank endorsement that makes the paper enforceable by any holder.
- *Special Indorsement* - Special indorsement is a signature and instruction that limits the instrument to a particular person. A special indorsement may limit the indorser's potential liability, but is not effective to prevent further negotiation by the holder.

- *Example:* Isabelle writes “Pay Tom” or “Pay to the Order of Tom” on a note along with her signature. Remember, however, the the paper must contain “to order” to remain negotiable. Also, “Pay to the Order of Tom” establishes the paper as order paper, but it does not restrict Tom’s abilities. Tom can indorse the paper and negotiate it.
 - *Restrictive Indorsement* - A restrictive indorsement includes the payee’s signature and instructions that limit the instrument to a particular use. Generally, a restrictive indorsement is not effective to prevent further negotiation of the paper. There are, however, special rules that apply to certain restrictive indorsements of checks.
 - *Note:* A conditional indorsement including words such as, "pay Tom if he washes my car" is ineffective. It does not qualify as a restrictive indorsement and does not limit negotiability.
 - *Example:* Signing the instrument and writing “For Deposit Only” is a restrictive indorsement on a check.
 - *Qualified indorsement* - A qualified indorsement is an individual’s signature including the words, "without recourse". The purpose of this form of indorsement is to limit the potential liability of the indorser who is transferring the instrument in the event the payor ultimately dishonors the instrument. The idea is that the indorser is transferring any rights she has in the instrument, but she is not warranting that the payor of the instrument will honor it. While this type of indorsement may limit the indorser’s liability to subsequent holders of the instrument, it does not affect or limit the ability to further transfer or negotiate the instrument.
 - *Example:* Darla is the payee on a note. She signs the note and writes “no recourse”. She then transfers the note to Dawn. Dawn cannot sue Darla to enforce or pay the instrument if the instrument is later dishonored by the payor at the time of presentment.
 - *Anomalous indorsement* - This is an indorsement by someone other than the holder or transferor of the instrument. It is made to guarantee or incur surety liability on the instrument. This can give a transferee confidence in accepting the instrument. This type of indorsement is not necessary for negotiation.
 - *Example:* Neo is the payee of a note. He signs the note and seeks to transfer it Arthur. Arthur is comfortable in accepting the instrument. He agrees to accept the instrument when Mr. Gates agrees to sign the note. By indorsing the instrument, Mr. Gates is stating that the holder can seek payment of the instrument from him if it is first dishonored by the payor.
- **Discussion:** How do you feel about the ability of an indorser to change the nature of the instrument? Should a qualified indorser be able to limit personal liability on the instrument? Why or why not? Can you think of situations when an anomalous indorsement would be common?
 - **Practice Question:** Kelly is the holder and named payee of a negotiable promissory note (order paper). She signs the note and writes the words “Pay Eric” and “Without Recourse”. What are the effects of indorsing the instrument with these additional instructions?
 - **Resource Video:** <http://thebusinessprofessor.com/types-of-indorsement-of-a-negotiable-instrument/>

LIABILITY - OBLIGATION OF PAYMENT**15. How does a holder of commercial paper receive payment of the instrument?**

A negotiable instrument may be traded for value up until the time of payment. If there is no specified payment time, there is no limit on how long or how many times it can be negotiated to another party. A holder of the instrument may seek payment from a person obligated to pay the instrument through a process known as “presentment”. Presentment is simply a demand made by a person entitled to enforce the instrument to an individual obligated to pay the instrument. The process for presenting a note for payment is slightly different than presenting a draft. The holder presents a note to the maker of the note, while a holder of a draft presents the draft to the third-party payor (such as a drawee bank). The person making presentment must exhibit the instrument, give reasonable identification, and surrender the instrument.

- *Note:* Presentment “duly made” means that presentment complied with all agreed requirements (location, time, etc.).
- **Discussion:** Can you think of situations where presenting a note would be preferable to presenting a draft, and vice versa?
- **Practice Question:** Mark is the holder and named payee of a promissory note and a check. What does he have to do to receive cash for the instruments?
- **Resource Video:** <http://thebusinessprofessor.com/presenting-a-negotiable-instrument-for-payment/>

16. Who is potentially liable on (obligated to pay) a negotiable instrument?

The maker of a note or drawee of a draft is “primarily obligated” to pay the instrument. If the maker or drawee pays the note or draft, it is satisfied. If, however, the maker or drawee fails to honor the note or draft, anyone who held and then transferred the instrument may be liable to pay it. These third parties are “secondarily liable” to pay the instrument. By transferring the instrument, they warrant that the instrument being held is valid and payable. This is known as “transfer warranty”. An individual who signs an instrument as indorser is also potentially liable to pay the instrument if it is dishonored. This is known as “indorser liability”. Generally, an indorser is also a transferor and incurs potentially liability as a transferor and indorser; however, in some cases, a third party will indorse an instrument but not be a holder or transferor of the instrument. This is common when third parties are asked to co-sign or act as guarantor of the note. The warranties provided by transferors and indorsers of a negotiable instrument (and other parties’ potential liability to pay the instrument) are discussed separately.

- *Note:* Generally, a holder must present an instrument for payment and that demand must be denied before the holder can seek payment from a transferor or indorser.
- **Discussion:** Why do you think the law makes transferors and indorsers secondarily liable on the instrument? How does transferor and indorser liability relate to the nature of a negotiable instrument?
- **Practice Question:** Olivia is the holder of a note. She presents the note to the payor for payment. The payor

rejects the note and refuses to pay. What are Olivia's options for seeking payment?

- **Resource Video:** <http://thebusinessprofessor.com/liability-to-pay-a-negotiable-instrument/>

17. When is an individual (including businesses) liable for a representative signing a negotiable instrument?

If a representative (an agent) signs a commercial instrument on behalf of a the represented person or business (the principal), the principal is bound and made liable by the representative signing either the principal's name or the agent's name. The representative is not liable on the instrument if:

- the form of the signature shows unambiguously that the signature is made on behalf of the represented person, and
- the instrument identifies the represented person.

This standard goes beyond the contract law standards for agent authority and principal liability.

- *Note:* Special rules apply for promoters of business entities that do not yet exist.
- **Discussion:** Why do you think the standard for holding a principal liable for an agent's signature on a negotiable instrument is more broad than under agency law? Do you think an agent should have the ability to subject a principal to liability in the context of negotiable instruments? Why or why not? Should any additional regulations or other protections apply in this scenario?
- **Practice Question:** Marshal is an agent of Clayton. Marshal signs a promissory note on behalf of Clayton and transfers it to Travis. What procedures must Travis have followed to make Clayton responsible for Marshal's actions?
- **Resource Video:** <http://thebusinessprofessor.com/liability-for-negotiable-instrument-signed-by-agent/>

18. What rules apply if a holder of a negotiable instrument loses the instrument?

An obligor is generally only obligated to pay the instrument upon presentment. If an instrument is lost and has not been presented to the obligor for payment, the obligor may pay the instrument when the party losing the instrument requests payment (without actual presentment of the instrument). Paying the proper payee of a lost instrument will discharge the obligor's duty to pay the instrument, including satisfying the obligor's obligations to other parties who may find the lost instrument. To be entitled to payment of a lost instrument, the payee losing the instrument must prove:

- *Possession* - She was in possession and entitled to enforce when instrument was lost;
- *Accidental Loss* - The loss was not the result of transfer or lawful seizure;
- *Location Unknown* - The instrument's location cannot be determined; and
- *Instrument Terms* - She must provide adequate evidence of the terms of instrument.

Even if these condition are met, the payee must provide adequate protection, such as a surety bond, to protect the payor in the event the instrument is wrongfully paid.

- *Note:* State statutory or common law may provide a cause of action against an individual who has no property rights in an instrument but presents a lost instrument for payment. These state law protections are pursuant to property law and not part of the UCC.
- **Discussion:** Why do you think the UCC allows for payment of a lost instrument? How do you feel about the obligation to pay a holder who finds lost bearer paper? Should there be additional protections under the UCC for holders who lose commercial paper?
- **Practice Question:** Martin is the payee on a note. The note is negotiable, bearer paper. Martin indorses the paper with the purpose of transferring it to Fran. He somehow loses the paper. What must Martin do to seek payment of the note? Can Fran seek payment? What happens if Jason finds the note and presents it to the maker for payment?
- **Resource Video:** <http://thebusinessprofessor.com/lost-negotiable-instruments/>

19. When is payment on a negotiable instrument overdue?

An instrument is overdue when the obligation to pay arises (upon presentment), but it has not been paid. An overdue instrument may give rise to a cause of action against a maker or drawee for failure to pay; also, it may make the instrument unenforceable as against a payor or drawee. When a negotiable instrument becomes overdue varies depending on whether the instrument is payable on time or on demand. A payable on demand instrument is overdue on the earliest of:

- the day after demand for payment is duly made;
 - *Note:* A negotiable demand instrument should be immediately payable. An extended delay in making payment violates the terms of payment.
- for a check, 90 days after its posted date; or
 - *Note:* Special rules apply to checks that do not apply to other drafts. A drawee bank is generally protected from liability if it refuses to honor a check that is 90 days past its posted date.
- after a period of time unreasonably long under the circumstances.
 - *Note:* With any demand instrument, an extended delay could affect payability of the instrument.

An instrument that is payable at a definite time is overdue the day after the due date for making the whole payment or payment of an installment. If the instrument requires presentment for payment, the instrument would be overdue the day after demand for payment is made. If the note has a clause calling for acceleration of all future payments upon default (such as becoming overdue), the document is overdue after the day established as the accelerated due date.

- *Note:* Default on interest payments on a note does not make the instrument overdue if there is no default in payment of principal and the due date has not been accelerated.

- **Discussion:** Why is it important to understand when an instrument is overdue? Do you agree that an overdue instrument should affect the rights or obligations of the parties? Why or why not?
- **Practice Question:** Corbin creates a promissory note payable on demand and issues it to Donald. If Donald presents the instrument to Corbin for payment, under what conditions is the instrument deemed overdue?
- **Resource Video:** <http://thebusinessprofessor.com/overdue-payment-of-negotiable-instrument/>

20. What effect does a negotiable instrument have on the underlying obligation?

Most negotiable instruments arise pursuant to an underlying agreement, contract, or obligation. A maker or drawer creates the instrument and issues it to the holder in satisfaction of her obligation under an underlying agreement. For “ordinary instruments” the underlying obligation is merged and suspended until the negotiable instrument is paid. That is, the issuee may withhold performance of her obligation under the contract (such as delivery of goods) until the instrument is paid. An ordinary instrument is any instrument that does not qualify as a “near-cash instrument”. If the commercial paper is a near-cash instrument, the maker or drawer’s obligation is discharged at the time the instrument is accepted by the party to the underlying agreement. The idea is that these instruments are the equivalent of cash and thus satisfy the maker or drawer’s obligation. Near cash instruments include certified checks, cashier’s checks, and teller’s checks.

- *Note:* If the holder of the ordinary instrument negotiates the instrument to a third party, the underlying contractual obligation is still not satisfied until the instrument is paid to the holder. If the instrument is not properly paid, the issuee may sue the maker or drawer on the note or the underlying obligation. A problem may also arise when the negotiable instrument only constitutes part of a party’s payment obligation. In such a case, the underlying agreement is not fully discharged until the payment on the negotiable instrument satisfies the full obligation. In some situations, the parties will include a “paid-in-full” clause in the contract to indicate that payment of the instrument is in full satisfaction of the payor’s obligation.
- *Example:* I agree to sell you a piece of equipment in exchange for a promissory note from you. I do not have the obligation to transfer ownership of the equipment to you until the promissory note is paid. If, on the other hand, I accept a cashier’s check as payment for the equipment, your obligation on the underlying contract is satisfied (discharged). I would then be obligated to deliver the equipment.

- **Discussion:** What do you think about the use and role of negotiable instruments as consideration in a contract? Why do you think an underlying obligation is suspended until the note is paid? Given the increased risk to the issuee of an instrument, does this affect the value of the transaction?
- **Practice Question:** Oscar agrees to sell equipment to Nyesha. Nyesha creates an on-time promissory note payable to “Oscar or order”. Is the contract fully executed (complete) when Nyesha transfers to the promissory note and Oscar transfers the equipment? Why? What are Oscar’s options if Nyesha fails to pay the note in accordance with its terms?

- **Resource Video:** <http://thebusinessprofessor.com/negotiable-instrument-effect-on-underlying-contract/>

HOLDER IN DUE COURSE

21. What is a “holder in due course” and what are the benefits?

If certain conditions are met, a holder of a negotiable instrument may further elevate her rights to enforcement (receive payment) of the negotiable instrument. That is, the holder of a negotiable instrument is elevated to a higher status than that of a simple holder if she qualifies as a “holder in due course” (HDC).

- **Recap:** As discussed above, the holder of an instrument is someone who possesses and is entitled to receive payment of an instrument. A holder may be the original recipient (issuee) of the instrument from the maker or drawer; or the issuee may transfer or negotiate the instrument to a third party who becomes holder. Recall that negotiation requires voluntary or involuntary transfer of the instrument and, if the instrument is order paper, indorsement by the payee. (A forger of paper cannot be a holder, while a thief of bearer paper can be a holder). An instrument is more valuable to the holder if it is negotiable.

Qualifying as a holder in due course (HDC) makes the negotiable instrument more valuable to the holder, as a HDC has a stronger right to payment of the instrument than an ordinary holder. If a holder is not a HDC, her rights in the instrument are the same as the original payee of the instrument prior to transfer. That is, her right to payment of the instrument depends upon the relationship between the issuer and the original payee. Upon receipt of the instrument, she inherits the rights of the original payee along with whatever claims and defenses that the maker or drawer has against the original payee arising out of the contract. HDC status makes the holder immune from these defenses at the time of presenting the instrument. HDC benefits are as follows:

- The payor of the instrument is estopped (stopped from) denying the validity of the instrument or asserting any personal defenses to payment of the instrument.
- The instrument may be purged of any defects that are not apparent to the holder in due course.
- The holder in due course may assert her right to payment against any prior indorsers or immediate transferor of the instrument if the instrument is dishonored (not paid) upon presentment.

Liability of transferors or indorsers of a negotiable instrument is discussed separately.

- **Discussion:** Why do you think the UCC allows for the elevation of a holder’s rights in an instrument? Do you think a holder should be insulated from a payor’s defenses against payment?
- **Practice Question:** Martha is a holder in due course of a promissory note. Gary is the payor of the note. She received the note from Sam. When she presents the note to Gary for payment, he rejects it based upon Sam’s failure to perform the underlying contract. What are Martha’s rights in pursuing payment of the instrument?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-holder-in-due-course/>

22. What are the requirements for a holder of an instrument to become a holder in due course?

To qualify as a HDC, the holder of the commercial paper must meet the following requirements:

- *Value* - The holder must take the instrument for value. This means that the holder must provide money or goods for the instrument. The transfer cannot be a gift or inheritance.
- *Good Faith* - The holder must receive the instrument in good faith. This means that the holder cannot have the intent to defraud anyone in receiving the instrument. It is easy to imagine any number of schemes in which a transferor would try to manipulate the law by transferring an instrument to a holder with a greater right to repayment.
- *Unaware of Defenses* - The holder cannot have notice that there is a valid defense to enforcement of the instrument. This is generally deemed to be actual notice, but constructive notice from the situation could disqualify the individual as well.

HDC status is determined at the time that the holder receives the instrument. If the holder meets the above requirement at the moment when she takes possession, she is a HDC. It does not matter if afterwards she learns of a potential defense. Each of the elements for HDC status is discussed separately.

- **Discussion:** What do you think about the requirements to qualify as a HDC? Can you identify any objectives behind these requirements? Should there be more or less requirements? Why or why not?
- **Practice Question:** Brad enters into a contract to purchase equipment from Claire. Brad issues a promissory note to Claire as payment. Claire delivers the equipment, but Brad believes that the equipment does not meet the standards represented in the contract. He demands that Claire replace the equipment or he will not pay the note if presented. Claire immediately sells the instrument to Doug, who is unaware of the dispute between Brad and Claire. If Doug refuses to pay the note when Doug presents it, what are Doug's rights? How does that affect Brad and Claire's position?
- **Resource Video:** <http://thebusinessprofessor.com/requirements-for-holder-in-due-course-status/>

23. What does it mean to receive an instrument for value?

The holder must provide some form of value, such as assets, services, or money in exchange for the instrument. Receiving the instrument as a gift is not "for value". Value may also mean taking the instrument as payment of an antecedent debt, as consideration for a fully-performed contract, in exchange for another negotiable instrument, or in exchange for an irrevocable obligation. When exchanging the instrument for services or irrevocable obligations, the key characteristic is that the value must have already been provided. That is, there is no future obligation (such as a promise to sell goods or perform services) as part of the transfer for value.

- **Discussion:** Why do you think the UCC requires that the holder exchange the instrument for value? Why do you think the value cannot be a future obligation? Is there any argument for allowing future obligations in certain instances?

- **Practice Question:** Hannah issues a promissory note to Ilene. Ilene later enters into a contract to pay Juliet to paint her house. Ilene transfers the promissory note to Juliet as payment for Juliet's obligation to paint her house. Is Juliet a holder in due course?
- **Resource Video:** <http://thebusinessprofessor.com/holder-in-due-course-receive-instrument-for-value/>

24. What does it mean to receive an instrument in good faith?

Receiving an instrument in good faith means acting in accordance with reasonable commercial standards and honesty in fact (no fraudulent intent in receiving the instrument). A holder must meet two tests to determine if good faith is present:

- *Subjective Test* - Did the holder believe the transaction was completed without the intent to defraud or deceive?
- *Objective Test* - Would a reasonable person believe the transaction to be commercially reasonable?

Note: The determination of good faith looks only at the recipient of the instrument in the transfer. The intent of the transferor is not considered in determining whether the recipient becomes a holder in due course. Some courts have held that a transferee lacks good faith when she is closely associated with the transferor.

- **Discussion:** How do you feel about the good faith requirement for establishing HDC status? Do you think a subjective and objective test is adequate to identify good faith? Why or why not? Should the intent of the transferor be evaluated in this determination? Why or why not?
- **Practice Question:** Darlene contracts with Gayle to provide design services. Darlene issues a promissory note to Gayle in the amount of \$10,000 to pay for the services. Gayle owes about \$1,500 to Martin. She transfers the instrument to Martin in full payment of her debt. Martin is aware that Gayle is not an honest business woman, but he accepts the promissory note. Gloria later leaves town without performing the services for Darlene. Martin presents the instrument for payment. What are Martin's right to payment of the instrument? What are Darlene's rights?
- **Resource Video:** <http://thebusinessprofessor.com/holder-in-due-course-receive-instrument-in-good-faith/>

25. What does it mean to receive an instrument without notice of a valid defense to enforcement?

A recipient of a negotiable instrument cannot become a holder in due course if she is aware (or has "reason to know") that there are some valid defenses that the payor may assert against payment of the instrument. Remember, status as holder in due course would insulate the holder against these defenses. Valid defenses of the payor against payment of the instrument may include:

- *Overdue* - If the instrument has a stated time for payment and that time or date has passed, it is overdue.
 - *Example:* Checks are overdue 90 days after its posted date. A demand instrument is overdue the day after

it is presented for payment or upon a reasonable time after it was issued. If the individual is subjectively aware that the instrument was presented for payment with no luck, that can indicate overdue status.

- *Dishonored* - If the instrument has been presented for payment and is dishonored.
 - *Example:* If the note or draft has been dishonored by the maker or drawee, there is a defect. Also, checks drawn on insufficient funds, once presented, cannot be transferred to a holder in due course.
- *Default on Collateral Instrument* - This generally arises when the instrument is issued as part of a series of transactions. Knowledge of an uncured default in another instrument issued as part of the same series is notice of a valid defense.
- *Instrument is Altered, Forged, or Incomplete* - An unauthorized alteration, unauthorized filling in of an incomplete instrument, or a forgery of an instrument is a valid defense against payment. Notice of these defenses may be actual or constructive. That is, if the name signed on the instrument is wrong or incorrect, this could be considered constructive notice of a valid defense.
 - *Note:* Remember that an alteration or completion of an incomplete (blank) note or check that is signed by an individual makes her liable for any amount filled in.
- *Notice of Claims or Disputes* - A valid defense includes when a third party has a claim to the instrument or there is a dispute between the original parties to the instrument. This places the risk on the maker or drawer responsible for creating the incomplete instrument.
 - *Example:* A party enters into two contracts where they purport to transfer the same promissory note as value. The other party's claim to the instrument is a valid defense against payment. Also, if the instrument was created as part of a contractual agreement, a dispute between the parties to the contract may be a valid defense to the instrument.

The UCC specifically excludes a list of individuals from HDC status based upon the manner in which they became holder of the instrument. Judgment creditors, bulk instrument purchasers, and heirs inheriting the instrument, for example, do not qualify as HDCs.

- **Discussion:** Why do you think the UCC prevents HDC status for individuals aware of a defense to payment? Should it matter the nature of the defense (such as a weak or partial defense)? Why or why not? Why do you think the UCC specific excludes acquirers of the paper through judgments, debtor sales, and inheritance from HDC status?
- **Practice Question:** Stacy issues a promissory note to Todd. Todd and Stacy have an argument regarding the underlying agreement and Stacy threatens to not pay the instrument. Todd agrees to sell the note to Unis at 50% of the value. Unis is familiar with the UCC and believes that she will qualify as a holder in due course? What rights will Unis have if Stacy denies payment on the instrument because of her contract dispute with Todd?
- **Resource Video:** <http://thebusinessprofessor.com/holder-in-due-course-notice-of-valid-defense/>

26. How does discharge of the underlying obligation affect a holder in due course?

Negotiable instruments are generally created as consideration in a contract between two parties. That is, there is a contractual relationship (known as the underlying agreement) between the original creator (issuer) and recipient (issuee and holder) of the negotiable instrument. If the parties to the underlying agreement fail to carry out their obligations, it may affect the ability of a holder to later enforce the instrument against the payor. This is because the holder (as transferee) receives the same rights and the transferor. She also is subject to any defenses the payor may have against the issuee with regard to the underlying contract. A HDC, however, is not subject to the payor's personal defenses to payment of the instrument.

Pursuant to the above-stated rules, discharge of either party from her obligations under the contract giving rise to the negotiable instrument may serve as a defense to the payor having to pay the instrument. Discharge of the underlying obligation does not, however, affect the payment rights of a HDC who takes the instrument without notice of the discharge. While notice of discharge of the underlying obligation does not constitute "notice of a valid defense", it may affect the HDC's right to seek payment against the payor if the HDC received the instrument with knowledge of the underlying discharge.

- **Discussion:** Why do you think discharge of the underlying obligation is not a defense to payment of a holder in due course of the instrument? Why does this rule change when the HDC has notice of the discharge prior to receiving the instrument? Should there be a distinction? Why or why not?
- **Practice Question:** Venus and William enter into a contract. Venus issues a promissory note to William in consideration for William's obligation to perform services. William sells the promissory to Martina, who meets all of the requirements for a holder in due course. During this time, William is discharged from the contract due to a serious injury he suffered. Does this affect Martina's right to seek payment from Venus? If Martina sells the paper to Billy Jean and notifies her of the underlying discharge, would this discharge affect her right to seek payment?
- **Resource Video:** <http://thebusinessprofessor.com/holder-in-due-course-discharge-of-underlying-obligation/>

27. What is the "Shelter Rule"?

Status as a holder in due course (HDC) may strengthen the rights of a holder to receive payment on a negotiable instrument. When a holder may not qualify as a HDC, the "shelter rule" is a separate principle that may protect her rights. Pursuant to the shelter rule, the transferee of a negotiable instrument receives all of the rights of the transferor of the instrument, unless the transfer is carried out by fraud or illegal means. This is important in situations where the transferor is a holder in due course, but the transferee is not.

- **Example:** A HDC may gift the negotiable instrument to the transferee. In this case, the transferee did not provide value for the instrument and does not qualify as a holder in due course. The shelter rule will allow the transferee to receive all of the rights of the transferor (a holder in due course) and receive the heightened protection. This rule makes the paper more marketable for the holder in due course.

The shelter rule provides liquidity to a HDC who, after accepting an instrument, learns of a defense against its enforcement. The HDC could validly transfer the instrument to another holder who has notice of the underlying defense.

The new holder would have the same rights as the HDC. It is important to note that, if a holder in due course learns that there is a valid defense against enforcement or that the underlying obligation has been discharged, she must disclose that information to the transferee who provides value for the instrument. If not, the transfer by the HDC to the new holder could be deemed fraudulent. This would destroy the shelter principle protections.

- *Note:* An exception to the shelter rule is that it does not apply if the holder in due course transfers the instrument back to a prior holder who was aware of its non-enforceable status and proceeded to transfer it to a holder in due course.
- **Discussion:** How do you feel about the shelter rule? Are you convinced by the objectives of the rule? Are there any arguments against allowing the transfer of HDC rights to a non-HDC?
- **Practice Question:** Tommy is a holder in due course of a promissory note. He learns that there is a dispute between the issuer and original holder regarding the underlying contract and one party has been discharged. He does not have the time and resources to seek payment of the instrument if it is contested. He sells the instrument to Olivia, who is confident that she can enforce the instrument. What are Olivia's rights with regard to enforcing the instrument?
- **Resource Video:** <http://thebusinessprofessor.com/shelter-principle-and-negotiable-instruments/>

28. Can you limit holder in due course status?

In some situations, it is possible for the issuer of a note to limit the ability of anyone to whom the note is transferred to become a holder in due course. The Federal Trade Commission allows such a limitation for notes used in sales of goods. The note must have the proper language in the legend or footnoted that the paper may be subject to applicable defenses and a possessor is not a holder in due course. This action preserves the ability of the maker of the note to assert any defenses to payment (particularly those arising in the underlying agreement) against a later transferee of the note.

- *Note:* This is generally not available for drafts.
- **Discussion:** Why do you think the FTC allows for the limitation of HDC status? Do you think that placing a legend is sufficient to protect the interests of a purchaser of an instrument? Why or why not?
- **Practice Question:** Carrie is the issuer of a note used to pay for commercial goods. She is not certain about the contract and wants to limit the note being negotiated to a holder in due course. What are her options?
- **Resource Video:** <http://thebusinessprofessor.com/limit-holder-in-due-course-status/>

29. Does a payor have any defenses to paying an instrument that is presented for payment by a holder in due course?

A holder in due course (HDC) has greater rights to enforce an instrument against the payor than does a mere holder of the instrument. The HDC is shielded from certain defenses against enforcement of an instrument. Generally, a payor may

assert any number of “personal and real defenses” against enforcement of a note by a holder. The payor, however, can assert only real defenses, not personal defenses, against the holder in due course.

Personal Defenses - Personal defenses are generally defenses applicable to the underlying agreement or between the original parties to the underlying agreement. Common personal defenses are as follows:

- *Breach of Contract* - Any party to a contract who breaches the agreement cannot enforce payment of a negotiable instrument issued as part of that agreement.
- *Failure of a Condition* - Contracts may be subject to conditions precedent and subsequent. The occurrence or non-occurrence of which could discharge an individual from her obligations under a contract.
- *Lack or Failure of Consideration* - If the underlying contract fails for lack of consideration it may constitute a defense to enforcement of an instrument. Further, if a promissory note is given as a gift, it may be a defense against later enforcement. Since a gift promissory note is a promise to make a future payment, the obligation itself is not supported by consideration. The gift is the underlying payment, rather than the promise of payment. As such, it may not be enforceable for lack of consideration.
- *Mistake* - Bilateral and, in some cases, unilateral mistake in entering into a contract can affect enforceability of an agreement. This will serve as a defense against the enforceability of a negotiable instrument used as consideration for the agreement.
- *Waiver* - If a party to the underlying agreement waives the obligation of the other party (the party issuing the negotiable instrument), it can serve as a defense to enforcement of the instrument by the holder.
- *Prior Payment* - A note should be presented for payment, collected by the payor, and paid. If the note is paid, but not collected, it could fall into the hands of a subsequent holder. A subsequent holder of the instrument does not acquire the right of payment unless she qualifies as a holder in due course.
- *Theft of the Instrument* - Someone who steals a negotiable instrument may qualify as holder of the instrument. The payor may assert a defense against payment to a holder.
 - *Note:* A forger does not qualify has a holder.
- *Unauthorized Completion* - In some cases, a holder may be charged with completing or entering information on an instrument. Notably, if a holder receives blank or incomplete instrument and completes it in an unauthorized manner, this is a defense against that holder and any subsequent holder, unless she is a HDC.
 - *Note:* This does not include a forgery, which is a defense against an HDC.
- *Fraud in the Inducement* - Fraud in the inducement is when a party defrauds the other party in order to have her enter into the agreement. This normally means providing information that is untrue or deceptive information, but the information is not the subject matter of the contract.

- **Resource Video:** <http://thebusinessprofessor.com/personal-defenses-to-negotiable-instrument/>

Real Defenses - Real defenses apply against any holder, including a holder in due course. Common real defenses are as follows:

- *Forgery* - The forger of an instrument or a payee's signature on an instrument is not a holder. As such, the non-holder cannot negotiate the instrument to a HDC.
 - *Example:* Agnes steals a check from Ben and forges his signature. She negotiates the check to Clark, who would otherwise qualify as an HDC if Clark were a holder. Agnes does not have to pay this instrument.
- *Bankruptcy* - Bankruptcy of the payor is a defense against holders and HDCs. The obligation to pay a negotiable instrument is considered a debt. This debt may be included in the debtor's bankruptcy estate. The holder or HDC must submit a claim for payment of the instrument to receive anything from the estate. Discharge of the debt discharges the obligation of the debtor to make payment.
 - *Example:* Agnes issues a promissory note. The note is transferred several times to multiple holders in due course. Agnes files for bankruptcy protection and her obligation to pay the instrument is include in the bankruptcy estate. An HDC would have to make an unsecured claim against the bankruptcy estate of Agnes or seek enforcement against a prior transferor or indorser.
- *Alteration* - Alteration is a limited defense against a holder and HDC. It may be a complete defense against a holder, but an HDC can enforce the instrument up to the original or correct amount of the instrument.
 - *Note:* If the instrument was blank and then filled out, the HDC can enforce it for the whole amount. This rule places the risk on the issuer who makes an incomplete instrument.
- *Duress, Mental Incapacity, Illegality* - Any of these typical contract defenses can also work against an HDC.
 - *Example:* Situations amounting to a defense against an HDC include where the issuer is subject to duress, has lost mental capacity due to disease, or the subject-matter of the contract is illegal due to a trade tariff. The underlying obligation must be void. If the underlying obligation remains voidable (rather than void), it is no defense.
- *Fraud in Fact* - Fraud in fact means that the subject matter of the contract involves an intentional deceit. This is different than fraud in the inducement.
 - *Example:* A seller intentionally makes false representations about the nature or quality of a good. This is fraud constituting the subject matter of the contract.

- **Resource Video:** <http://thebusinessprofessor.com/real-defenses-to-payment-of-negotiable-instrument/>

- **Discussion:** Why do you think defenses are separated into real and personal defenses? Are you convinced that

each type of defense is appropriate against a holder or HDC? Should any personal defenses be effective against an HDC? Why or why not?

- **Practice Question:** Taylor is the holder of a promissory note that is order paper. Smith steals the paper and forges Taylor's signature. He then transfers the note to Zora. If Zora presents the instrument for payment, what is the likely result?

30. What is a "claim in recoupment"?

A claim in recoupment is similar to a personal defense. It allows a payor to offset any claim that she has against the claimant or the original issuee.

- *Note:* A claim in recoupment applies against a holder, but not a holder in due course.
- Example: The payee on an instrument owes a debt to the named payor. If a subsequent holder presents the instrument for payment, the payor may offset that claim against payment to the holder. If, however, the payee is a holder in due course, the payor cannot offset that claim.

- **Discussion:** Why do you think a claim in recoupment is enforceable against a holder but not a HDC? Do you agree with this?
- **Practice Question:** Evan enters into a contract with Frank. As part of the contract, Evan issues a promissory note to Frank. Frank fails to fully perform some immaterial aspects of the contract. This entitles Evan to offset of the payment price owed to Frank. If Frank presents the note for payment, what is the result? What if he trades the note to Ernest, who qualifies as an HDC?
- **Resource Video:** <http://thebusinessprofessor.com/claim-in-recoupment-applicable-to-negotiable-instrument/>

31. What are the rights of a holder in due course if the underlying transaction is a consumer transaction?

There is a broad exception to the heightened rights afforded a holder in due course if the instrument is issued pursuant to a consumer transaction. This situation generally arises when a consumer of a good signs a note promising to pay the debt arising from purchase of the good. It may not be fair to force a consumer who writes a note to have to pay a third-party, holder in due course if the underlying contract is breached. As such, the Federal Trade Commission and some states require consumer credit contracts (and sometimes consumer promissory notes) to contain the designation "consumer paper". This designation makes the instrument non-negotiable. As such, no one can be a holder in due course under the UCC.

- *Note:* If the language is omitted, a holder of the note can be an HDC, but the original seller of the note can be subject to fine.
- **Discussion:** Do you agree with granting an exception to negotiability of consumer paper? Do you think the label, "consumer paper" is sufficient notice to a holder that the paper is non-negotiable?

- **Practice Question:** Carter owns a store selling personal lawn equipment. Winston purchases a lawn mower for his personal use. He signs a promissory note as consideration for the mower. Carter wants to liquidate some of his accounts receivable and sell the promissory note from Winston. Can you explain to him the rules that apply in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/holder-in-due-course-consumer-transactions/>

32. What is the result if a negotiable instrument is forged?

A forged negotiable instrument is not enforceable against the party whose name was forged. The forged instrument is, however, enforceable against the forger. Basically, the instrument is treated as though the forger signed her own signature. Also, a forged negotiable instrument puts affirmative duties on parties implicated in the forgery. For example, a drawee bank on a forged check must use ordinary care in inspecting a potentially forged signature when paying check. The owner of the check may be liable if the check is stolen and forged because of her own negligence. The owner has a duty to verify records to identify forged instruments. The drawer is barred from contesting improper payment of the check by a one-year statute of limitations.

- **Discussion:** How do you feel about the ability to enforce a forged instrument against the forger? What do you think about the additional responsibilities placed upon the parties?
- **Practice Question:** Cathy is an employee of ABC Corp. She steals a check from the company, signs her manager's name, and makes the check out to herself. The check is drawn on ABC's account at First Bank. She then indorses the check and transfers it to Doris. Doris presents the check to First Bank for payment. Who is potentially liable on the check?
- **Resource Video:** <http://thebusinessprofessor.com/forged-negotiable-instrument-and-holder-status/>

33. What is the result if a negotiable instrument is stolen?

A negotiable instrument made out to a specific individual is order paper. If the instrument is stolen, the thief can only transfer it by altering or forging the payee's signature. As such, a transferee of stolen, forged order paper is not a holder or holder in due course and therefore does not take free of the payor's defenses. Bearer paper, on the other hand, may be transferred by anyone in possession of the instrument. A thief can negotiate stolen bearer paper to a holder. A holder of the paper would be subject to a payor's personal defenses or a claim by a payee that the instrument was stolen. In contrast, a holder in due course of stolen bearer paper takes the instrument free of the claims of the payor that it was stolen.

- **Note:** Special rules apply when the theft of the negotiable instrument is carried about by an agent (such as an employee) of the payor. If an agent misappropriates an instrument, the principal may be liable on the instrument based upon the authority of the agent. The principal has a claim to the instrument or its proceeds against the agent and subsequent takers unless a subsequent transferee is a holder in due course.

- **Discussion:** How do you feel about the ability of a HDC who receives an instrument from a holder to enforce the

instrument? Why does it matter whether the thief is also a forger? Should the interests of the payor be balanced against the interest of the HDC in this situation? Why or why not?

- **Practice Question:** Eric executes a promissory note payable to “Amanda or order”. Tommy steals the note and endorses Amanda’s name. He then sells the note to Max, who is unaware of the forgery. What is Eric’s obligation to pay the instrument? What rights does Amanda have? What are Max’s rights?
- **Resource Video:** <http://thebusinessprofessor.com/stolen-negotiable-instrument-and-holder-status/>

34. What is the role of a guarantor or surety of a negotiable instrument?

A guarantor (also known as a surety or co-signor) serves to add certainty of payment of a negotiable instrument. A guarantor of a note or draft is an “accommodation party” who signs the instrument as an indorser. There are a couple of forms of guarantor, as follows:

- *Guarantor of Payment* - A co-maker's accommodation indorsement guarantees payment. The holder may demand payment from her without first seeking payment from other co-maker.
- *Guarantor of Collection* - A collection guarantor is an accommodation party who is liable only if a judgment is rendered against a payor and the judgment is uncollectible against the debtor or is returned unsatisfied.
- **Discussion:** Why do you think the UCC provides for a distinction between a guarantor of payment versus a guarantor of collection?
- **Practice Question:** Sara makes a promissory note payable to “Dave or order”. Dave does not want to accept the note from Sara because of her poor credit history. Angela, who has excellent credit, agrees to cosign the note to add certainty. What are the rights of the parties in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/guarantor-or-surety-of-a-negotiable-instrument/>

35. What is an “accord and satisfaction”?

An accord and satisfaction is a resolution of a contested debt. For example, the payor and holder of a negotiable instrument may have a dispute as to the amount and duty of payment of the instrument. Often a payor of the debt will offer a lesser amount than what is claimed by the holder in full satisfaction of the debt owed. This is an offer of settlement of the disputed debt. An instrument that purports to be full payment for an obligation will discharge an obligation if certain requirements are present:

- *Good Faith* - One party, in good faith, tenders an instrument to the claimant as full satisfaction of the claim;
- *Bona Fide Dispute* - The amount of the claim is subject to a *bona fide* dispute;
- *Payment Accepted* - The party receiving the offer of settlement obtains payment of the instrument; and

- *Adequate Notice* - The instrument or accompanying written communication contains a conspicuous statement to the effect that the instrument is tendered as full satisfaction of the claim.

A creditor receiving an offer of accord and satisfaction who inadvertently accepts the payment (not aware of accord language), upon learning of the other party's intent, may make or offer repayment within 90 days of receipt.

- **Discussion:** Why do you think the UCC allows for the “accord and satisfaction” of a disputed payment obligation under a negotiable instrument? Are the prerequisites for a valid accord and satisfaction adequate? Why or why not? Can you think of any other necessary requirements?
- **Practice Question:** Cathy enters into a contract with Bernice. A dispute arises as to each party's performance of the agreement. Cathy sends a check to Bernice with “accord and satisfaction” printed on the check. What is else is required to effect a valid accord and satisfaction of the disputed debt?
- **Resource Video:** <http://thebusinessprofessor.com/negotiable-instrument-accord-and-satisfaction/>

LIABILITY AND WARRANTIES FOR NEGOTIABLE INSTRUMENTS

There are two main types of liability on a negotiable instrument - primary and secondary liability. The maker of a note and drawee of a draft are primarily liable to pay the instrument. Parties who later sign, transfer, or present an instrument may be secondarily liable to pay the instrument. Secondary liability is conditioned upon the note or draft being dishonored upon presented for payment to the primarily liable party. When a payor dishonors an instrument, the holder may seek payment from third parties who previously signed or transferred that instrument. The ability to receive payment from previous signors and transferors is based upon theories of warranty. These individuals, in certain circumstances, warrant to later transferees or holders that the instrument is valid and payable.

- **Discussion:** What do you think about the system of primary and secondary liability on a negotiable instrument? Why do you think the UCC allows for secondary liability? How does the affect the liquidity and value of the instrument?
- **Resource Video:** <http://thebusinessprofessor.com/liability-for-warranties-of-negotiable-instrument/>

36. What is “drawer or maker liability” for a negotiable instrument?

A drawer of a draft orders that at third-party drawee pay a specific amount to a payee who presents the instrument. The drawer, as creator of the instrument, is liable if the drawee dishonors (refused to pay) the draft. Likewise, a maker of a note is liable to a holder who presents the note for payment. If a maker or drawer wrongfully refuses to pay the instrument, any person entitled to enforce the instrument or any indorser who paid the instrument may sue for wrongful dishonor.

- **Example:** Harry writes a check drawn of First Bank to Ira. If First Bank refuses to pay the check, Ira may present it to Harry for payment. If Harry writes a note to Ira, he is liable to pay the note when validly presented by a holder. In either situation, if Harry refuses to pay the draft or note, Ira may sue for performance. If Ira transfers the

instrument to a later holder, the holder would be able to sue if Harry fails to pay. If Ira or a later holder received payment on the instrument from a previous holder or transferor of the instrument, the individual paying the instrument may seek reimbursement or payment from Harry.

- **Discussion:** How do you feel about the ability of any holder or payor of an instrument to seek payment of an instrument from the maker or drawer? What objective does these rules serve?
- **Practice Question:** Ida issues a promissory note to Jim. Jim negotiates the note to Kyle. Kyle presents the note for payment and Ida refuses payment. What are the rights of Ida and Kyle in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/drawer-or-maker-liability-to-pay-negotiable-instrument/>

37. What is “transferor warranty” of a negotiable instrument?

A transferor of a negotiable instrument warrants the following to the recipient of the instrument:

- *Good Title* - The transferor has good title to the instrument;
- *Enforceability* - The transferor is entitled to enforce the instrument;
- *Authorization* - All signatures are authorized and authentic;
- *Alterations* - There have been no alterations to the instrument;
- *Defenses* - There are no defenses to enforcing the instrument; and
- *Solvency* - The transferor does not know the payor to be insolvent.

Transfer warranties apply when the transferor transfers the instrument for consideration. The new holder only receives transfer warranties from an immediate transferor. Thus, a holder cannot enforce the instrument pursuant to transfer warranty against anyone who transferred the instrument without consideration or did not directly transfer the instrument to her.

- **Note:** A payor bank of a draft does not receive transfer warranty, as the instrument is presented to the bank, rather than transferred. Presentment warranty is discussed separately.

- **Discussion:** How do you feel about the warranties provided by the transferor of a negotiable instrument? Are these warranties adequate? Why or why not? Can you think of any other warranties that should be included? Why do you think these warranties are limited to situations where the instrument is transferred for value? Should these warranties apply to prior transferors (as apposed to the immediate transferor)?
- **Practice Question:** Leena is the holder of a note. Leena transfers the note to Kate for \$100. Kate then transfers the note to Jean for \$110. What transfer warranties apply to each of the parties?

- **Resource Video:** <http://thebusinessprofessor.com/transfer-warranty-of-negotiable-instrument/>

38. What is “indorser warranty” of a negotiable instrument?

An indorser of an instrument makes warranties to the maker or drawer of an instrument and to subsequent holders of the instrument. Assurances to the marker or drawer include:

- *Good Title* - She has good title to the instrument,
- *Forgery* - She has no knowledge of forgery, and
- *Materially Altered* - The instrument is not materially altered.

An indorser warrants to a subsequent holder that:

- *Good Title* - She has good title,
- *Signatures* - All signatures are genuine,
- *Alterations* - The instrument is not materially altered,
- *Defenses* - There are no known defenses against payment of the instrument, and
- *Insolvency* - There is no knowledge of the maker or drawer’s bankruptcy.

Liability for a failure of these assurances is known as “indorser liability”. The difference between indorser warranties and transferor warranties is that any good-faith holder of the note may enforce these warranties against any indorser. Recall, transfer warranties are limited to the immediate transferor. Indorser warranties make the indorser (signor) of an instrument secondarily liable to a holder. That is, the indorser is liable to pay an instrument that has been dishonored. An indorser who pays the instrument is left to seek reimbursement from a prior indorser or anyone who transferred the instrument to her.

- *Note:* Indorser liability can be disclaimed by the indorser at the time of indorsement. Generally, the disclaimer must be noted on the instrument. Disclaimer is not available for checks. The maker or drawer of a note or draft does not incur indorser liability or transferor liability. These individuals are primarily liable on the instrument.

- **Discussion:** Why do you think the UCC allows a holder of a dishonored instrument to seek payment from any prior indorser? Is this situation fair to a prior indorser? Why or why not? Why do you think these protections are necessary given the existence of transferor warranties?
- **Practice Question:** Victor is the holder of a note drawn by Russ and payable to “Victor or order”. Victor signs the instrument and negotiates it to “Waylon or order”. Waylon later signs the instrument and negotiates it to Yvonne. Yvonne presents the note to Russ for payment and it is dishonored? Yvonne does not want to sue Russ to enforce the instrument. What are her options for seeking payment of the instrument?

- **Resource Video:** <http://thebusinessprofessor.com/indorser-liability-for-negotiable-instrument/>

39. What is “presentment warranty” of a negotiable instrument?

Presentment warranty applies when a person entitled to payment of an instrument presents it to a maker or drawee for payment. The presenter warrants to a good faith payor the following:

- *Enforceability* - She is entitled to enforce the instrument,
- *No Alterations* - The terms of the instrument are genuine and there have been no alterations, and
- *No Forgeries* - The drawer of the instrument’s signature is genuine.

Presentment warranties generally apply to drafts, as all drafts must be presented for payment. This warranty is broader than the name implies. A payor of an instrument can enforce these warranty provisions against the presenter and all prior transferors of the instrument. The theory is that any transferor of the instrument represents that the instrument may be presented for payment in accordance with the above warranties.

- *Note:* Presentment warranty may be disclaimed in certain drafts, but cannot be disclaimed for checks.

- **Discussion:** Why do you think the UCC allows for presentment warranties? What gap does this fulfill in protection of holders of a draft or note? Are these protections adequate? Why or why not?
- **Practice Question:** Ellen is the holder of a check written by Darla and drawn on First Bank. She received the check from Ed, who received it from Clark, the original issuee. If Ellen presents the check to First Bank, what is she warranting to the bank? If First Bank accepts and pays the check and it turns out that Ellen was not entitled to payment, what are First Bank’s options for recovering the funds paid?
- **Resource Video:** <http://thebusinessprofessor.com/presentment-warranty-of-a-negotiable-instrument/>

40. To what extent is a warrantor liable for damages suffered by a holder of a dishonored note or draft?

An individual presenting a draft or note for payment that is dishonored may recover damages from a prior warrantor of the instrument. That is, a person receiving an instrument in good faith and subject to warranties may recover from the warrantor an amount equal to the loss suffered as a result of the dishonor. The holder may recover the amount payable on the instrument, plus expenses and loss of interest incurred as a result of the dishonor.

- *Note:* The amount of potential recovery from a warrantor is limited if the claimant received partial payment of the instrument. For example, a drawee receiving presentment warranty may recover from a warrantor damages for breach of warranty equal to the amount paid by the drawee, less the amount the drawee received or is entitled to receive from the drawer because of the payment, plus any expenses and loss of interest resulting from the breach.

- **Discussion:** Do you agree with the principle that an individual enforcing an instrument against a warrantor should be able to receive expenses and losses from the dishonor? Should the rights of the warrantor be balanced against the rights of the claimant? Why or why not?
- **Practice Question:** Pam is the holder of a check for \$5,000 that she received from Tom. Pam presents the check to First Bank and it is dishonored. Pam seeks to enforce the instrument against Tom based upon transferor warranty. She incurs \$350 in court fees in an effort to enforce the instrument. What amount may Pam recover from Tom?
- **Resource Video:** <http://thebusinessprofessor.com/warrantor-liability-on-negotiable-instrument-damages/>

41. Is there a time limitation for exercising warranties on negotiable instruments?

The holder of an instrument must make a warranty claim to a warrantor within 30 days of notice of dishonor of the instrument. Failure to give this notice within 30 days may relieve the warrantor from liability for any losses incurred as a result of the failure of the claimant to give timely notice.

- **Example:** Emily is the holder of a draft drawn on ABC Financial. She received the draft from Clayton. Emily transfers the draft to Doug. The draft is subsequently transferred multiple times. Eventually, Easton presents the draft for payment. ABC pays the draft and then learns that Easton was not validly entitled to payment. ABC seeks to recoup the money paid from Easton, the presenter of the draft. When Easton and other transferors cannot be found, ABC attempts to enforce the instrument against Emily. ABC waits longer than 30 days to give Emily notice of its claim. This delay caused Emily to not be able to recover from Clayton, who she recently paid money she owed. She would have been able to offset the amount owed if she had been given timely notice. Her obligation to pay ABC on presentment warranty may be discharged due to her loss caused by ABC's delay in providing notice of its presentment claim.

- **Discussion:** Why do you think the UCC allows for a discharge of liability on a presentment claim for losses incurred because of late notification from a claimant seeking to enforce the instrument based upon warranty? What objectives are being served? Do you agree with this principle? Why or why not?
- **Practice Question:** Tim presents a draft created by Stacy and drawn upon First Credit Union. Tim acquired the draft from Elvis. First Credit Union pays Tim and then learns that Tim was not entitled to payment. First Credit Union is able to recover from Tim on the basis of presentment warranty. Tim seeks to recover from Elvis based upon transferor and presentment warranties. Tim fails to give Elvis notice of his claim within 30 days of learning of the First Credit Union's dishonor. What does this mean for Tim and Elvis' rights?
- **Resource Video:** <http://thebusinessprofessor.com/warranty-liability-negotiable-instrument-time-limitations/>

42. When are the warranties of a negotiable instrument discharged?

Transferor, indorser, and presenter liability is discharged by any manner that would effectively discharge a party's obligation on a contract at common law. These provisions may relieve the obligation of a payor or payee, but could still subject transferors or indorsers to liability.

- *Note:* Indorser and accommodation party liability may be discharged by the same means that a surety's liability is discharged.
 - *Example:* Valid payment discharges the obligations of payor of a negotiable instrument. Other methods include tender of payment and refusal, cancellation or renunciation of the obligations, material and fraudulent alteration of the instrument, certification, acceptance varying a draft, reacquisition, and, in some cases, unexcused delay in giving notice of presentment or dishonor.
- **Discussion:** Why do you think payment of a negotiable instrument relieves that party's warranty liability? Would it be fair to subject a payor to double liability for payment of an instrument? Why or why not?
 - **Practice Question:** Leon receives a promissory note made by Raymond as part of a contract. Leon transfers the note, which is subsequently transferred numerous times before it comes to Linda. Linda submits the instrument to Raymond for payment and it is dishonored. Linda seeks to enforce the instrument against Leon. Leon pays the instrument? What is Leon's remaining responsibility on the instrument? Under what situations would Raymond be relieved from his obligation to pay Raymond on the instrument?
 - **Resource Video:** <http://thebusinessprofessor.com/discharge-warranties-negotiabl-instrument/>

TOPIC 21: BANKRUPTCY LAW

Overview

Bankruptcy is a federal body of law concerning the relationship between a debtor and creditors. Specifically, bankruptcy law provides several methods for a debtor to recover from financial situations that are overwhelming to the individual's continued well-being or existence. The bankruptcy process differs for individuals and businesses. This chapter introduces the bankruptcy system. It introduces the applicable bankruptcy laws and key provisions. It begins by explaining the types of bankruptcy — Chapters 7, 11, and 13. It then explains the method for initiating and processing a bankruptcy filing. It explores the role of the debtor, creditors, bankruptcy court, and trustee and the rights of each during the bankruptcy process. This includes the trustee or debtor in possession's right to stop collection efforts; the right to disaffirm contracts; the right to recover certain prior payments made to creditors, etc. A key concept throughout the bankruptcy process is the priority of secured and unsecured creditors. Lastly, it explains the rights and obligations of the parties at the conclusion of the bankruptcy process.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• Bankruptcy • Bankruptcy Code • Types of Business Bankruptcy - Liquidation - Reorganization - Voluntary & Involuntary • Bankruptcy Participants - Debtor - Creditor - Trustee - Bankruptcy Court	• Key Concepts - Filing for Bankruptcy - Bankruptcy Estate - Automatic Stay - Proof of Claim - Meeting of Creditors - Creditor Priority - Discharge • Authority of Bankruptcy Court • Role of Bankruptcy Trustee	• Chapter 7 Bankruptcy • Chapter 11 Bankruptcy • Debtor in Possession - Accept or Reject Contracts - Avoiding Powers - Automatic Stay - Use Business Assets - Post-Petition Financing • Appoint Trustee or Examiner • Plan of Reorganization • Cramdown
-

TOPIC 21: BANKRUPTCY - QUESTIONS & ANSWERS

1. What is “bankruptcy”?

Bankruptcy is both a status and system of laws aimed at protecting individuals and businesses (collectively, “individual”). An individual is bankrupt when she is insolvent or the value of her debts exceeds the value of her assets. The bankruptcy system is a body of laws that allows for the elimination or restructuring of an individual’s debt. The underlying objective of the system is to rehabilitate and allow for the future prosperity of the individual. The bankruptcy process is the subject of this chapter.

- **Discussion:** How do you feel about the concept of allowing individuals to eliminate or restructure their debt? What affect do you think this ability has on economic activity and productivity in society? What arguments can you provide for and against this system?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-bankruptcy/>

2. What are the types of business bankruptcy?

The primary classifications for bankruptcy are as follows:

- **Liquidation** - Liquidation bankruptcy is the process by which the assets of an individual or business are liquidated or sold in an effort to generate funds to pay creditors. Any debts owed to creditors after the liquidation of assets and payment to creditors is discharged.
 - **Note:** “Discharge” of a debt means that the debt is erased and cannot be collected through legal means in the future. For individual debtors, some assets may be exempt from inclusion in the bankruptcy process.
 - **Example:** ABC Corp is suffering declining sales. The company debts exceed its assets and it cannot service all of its debts from its revenues. ABC Corp decides to file for liquidation bankruptcy, which involves selling off all of its assets and transferring the funds generated to creditors.
- **Reorganization** - A reorganization bankruptcy is a process by which the individual or business establish a plan to pay all secured debts and as much of its unsecured debts as possible during a set period of time (usual 5 years). The terms of the plan, including how much is paid to each creditor are based upon a number of factors, such as the amount of recurring, disposable income of the debtor. The unpaid portion of any unsecured debts are erased after the end of the payment plan period. The business may continue operations throughout this process.
 - **Note:** Creditors are paid based upon their “priority” and the status of their claims as secured or unsecured. Classes of investors receive a pro-rata share of available assets based upon the funds available and size of their claims. Secured creditors must be paid in full or a plan of reorganization fails.
 - **Example:** ABC Corp files for reorganization bankruptcy. All debt collections against the company halt. ABC must now come up with a plan to pay off its debts with income from future operations. It must use

all disposable income to pay debts for the plan period. Secured debtors must be paid in full before unsecured debtors receive any funds.

- *Voluntary vs Involuntary* - The bankruptcy process begins either with a debtor filing a voluntary petition or creditors of the debtor filing an involuntary petition. A debtor who qualifies under the law and wishes to do so may file a voluntary bankruptcy petition. In other situations, a creditor (or creditors) of a business debtor who meets the statutory requirements may force the debtor into involuntary bankruptcy. The process for initiating an involuntary bankruptcy is discussed separately.

While the process for liquidation bankruptcy is similar for individuals and businesses, reorganization bankruptcy for each is distinct. Throughout this chapter, we focus on business bankruptcy; however, many of the concepts applicable to business bankruptcy apply equally to individuals.

- **Discussion:** Why do you think the law allows for both liquidation and reorganization bankruptcy? Are the objectives of each of these types of bankruptcy different? How do you feel about the ability to voluntarily elect bankruptcy or to be forced into bankruptcy by a debtor?
- **Practice Question:** ABC Corp is in financial trouble. It is considering filing for bankruptcy protection. Can you explain the two bankruptcy options available to ABC Corp and the general characteristics of each?
- **Resource Video:** <http://thebusinessprofessor.com/types-of-bankruptcy/>

THE BANKRUPTCY PROCESS

3. Who are the primary participants in the bankruptcy process?

The primary participants in the bankruptcy process are as follows:

- *Debtor* - The debtor is the individual or business entity seeking or filing for bankruptcy protection.
- *Creditor* - A creditor is any individual owed a debt or obligation by the debtor. Creditors may include individuals, businesses (or other entities), or holders of securities (debt or ownership interests) of a business debtor.
 - *Note:* To be included in the bankruptcy process, creditors must receive notice of the bankruptcy filing.
- *Bankruptcy Trustee (or Debtor-in-Possession)* - The bankruptcy trustee is a representative elected (or appointed) to represent the interests of creditors of the bankrupt debtor. The trustee is charged with assembling the assets of the debtor's estate and either selling those assets or administering those assets in accordance with a plan of reorganization. The trustee must meet numerous statutory qualifications, including being independent and disinterested from the debtor or creditors. The role of the trustee varies a bit between personal and business bankruptcies and liquidation and reorganization bankruptcies.
 - *Note:* In Chapter 7 liquidation cases, the creditors may elect the trustee. In Chapter 13 reorganization cases, the US Attorney General may appoint a standing trustee to represent all

creditors in the Chapter 13 case.

- *Personal & Business Liquidation Bankruptcy* - The trustee automatically takes control over the debtor's estate, liquidates the non-exempt assets, and distributes the proceeds to creditors. This process is the same in a personal and business liquidation.
- *Personal Reorganization Bankruptcy* - The trustee accounts for all of the assets of the debtor, assists in the development of a plan of reorganizations, and administers an approved plan for the reorganization of debts and payment of creditors.
- *Business Reorganization Bankruptcy* - Generally, a business debtor remains in possession of the assets of the bankruptcy estate. The debtor is known as a "debtor-in-possession" (DIP). The DIP serves the same function as the trustee but manages its assets and operations in accordance with the rules laid out by bankruptcy law. In this case, a trustee is only appointed when creditors of the estate petition the court to do so in an attempt to protect their interests. This normally happens when the debtor-in-possession fails to act in accordance with bankruptcy law or fails to otherwise adequately protect the interests of creditors.
- *Bankruptcy Court* - The bankruptcy court is a federal court charged with administering the bankruptcy process. Much of the bankruptcy process is handled by the trustee or debtor-in-possession. The court generally steps in to review and approve liquidations and plans of reorganization, grant discharges of indebtedness, and adjudicate disputes between or among debtors and creditors.

The role of each of these participants is discussed separately.

- **Discussion:** Do you think the bankruptcy process protects the rights of debtor and creditors? Why or why not? Why do you think the role of the trustee is varied between business and personal reorganizations?
- **Resource Video:** <http://thebusinessprofessor.com/primary-participants-in-bankruptcy-process/>

4. What key concepts are necessary to understand the bankruptcy process?

Below are some key concepts and definitions to understand prior to continuing with this chapter.

- *Filing for Bankruptcy* - Filing for bankruptcy means submitting a bankruptcy petition along with all supporting documents to the bankruptcy court. For individuals, a bankruptcy filing is voluntary (optional for the individual). A business bankruptcy may be voluntary or involuntary. In a voluntary petition, the bankruptcy court will review the initial filing for completeness. If accepted, the court will initiate the bankruptcy process. If applicable, the court will then forward the case to the office of the trustee. In a business reorganization, the debtor-in-possession will begin exercising the authority granted a trustee under the bankruptcy law. In an involuntary bankruptcy filing, the debtor has the option of agreeing with the petition or contesting the petition before the bankruptcy court.
- *Bankrupt Estate* - Upon filing bankruptcy, the court will issue an "order of relief". This order serves to form the bankruptcy estate. The bankruptcy estate includes all non-exempt assets and debts of the debtor at the time of the bankruptcy filing. Basically, the debts and assets of the debtor are held in trust and managed for the benefit of

creditors. Assets acquired or debts incurred after the filing of bankruptcy may be excluded from the bankruptcy estate, absent a specific bankruptcy law allowing the estate to incur the debt or claim an interest in the asset.

- *Note:* Bankruptcy law incorporates federal and state laws regarding assets that are exempt from the bankruptcy estate. This may include an equity value in a primary residence, a dollar value of specific types of personal property, retirement accounts, etc.
- *Automatic Stay* - The automatic stay is an important protection afforded a debtor and the bankruptcy estate. Once the court issues the order of relief, the law grants the debtor a stay from all collection efforts by creditors or their representatives. The stay of proceeding places penalties on any creditor who seeks to collect a debt incurred prior to the bankruptcy filing. This provision gives the debtor the ability to assemble debts and develop a plan for liquidation or reorganization.
- *Meeting of Creditors* - Once the order of relief is issued, creditors have the opportunity to meet to examine debtor records and discuss claims against the estate. This meeting is more common in business bankruptcies than in individual bankruptcies. In chapter 7 cases, the trustee will orchestrate the vote to elect a permanent trustee.
- *Creditor Priority* - Priority in bankruptcy refers to the order in which creditors of the debtor or bankruptcy estate are paid. Generally, secured creditors must be paid in full from the liquidation or reorganization, or the asset(s) securing the secured creditors' claims must be surrendered to them. Once secured creditors are paid, unsecured creditors are paid in their established order of priority. Unsecured debtors with similar priority are treated as a class. If each unsecured debtor in a class is not paid in full, each member of the class receives payment based upon an equal percentage of her debt. Creditor priority may be established by the nature or type of the debt, the timing or order in which the debt is incurred, or the contractual provisions associated with the debt. Generally, unsecured creditors only receive payment of a fraction of their total claim (if they receive anything at all) due to the scarcity of assets in the bankruptcy estate. For this reason, creditors often argue over their priority.
 - *Note:* The concept of priority is covered in greater detail in the chapter on secured transactions.
- *Discharge* - The debts of the debtor that are included in the bankruptcy estate are generally discharged after the successful completion of the bankruptcy process. This means that the debts are satisfied and the creditors cannot later seek repayment of these debts. Whatever amount the debtor receives as payment on the debt from the bankruptcy estate is final. The type of bankruptcy will determine whether a creditor receives a single payment (in a liquidation) or whether the debtor receives installment payments for a period of time (in a reorganization).
 - *Note:* Certain obligations cannot be discharged in bankruptcy, such as tax, alimony and child support obligations, intentional tort liability, student loan liability, breach of fiduciary duty, drunk driving liability, certain government fines, and debts not submitted to the trustee.

- **Discussion:** Why do you think the debts and assets of the debtor are held in trust during the bankruptcy process? What do you think is the value of the automatic stay? How do you think priority rules affect the conduct of creditors when lending to debtors, if at all?
- **Resource Video:** <http://thebusinessprofessor.com/key-concepts-to-understand-bankruptcy-process/>

5. What rules govern the bankruptcy process?

The rules governing the bankruptcy process are contained in Title 11 of the US Code of Statutes. The relevant sections of the bankruptcy code are organized as follows:

- Chapter 1 – General Provisions – Definitions, Powers of Court
- Chapter 3 – Case Administration
 - Note: Chapters 1, 3, and 5 are generally applicable to all bankruptcy cases
- Chapter 5 – Creditors and Claims
- Chapter 7 – Liquidation
- Chapter 9 – Municipal Bankruptcy
- Chapter 11 – Reorganization
- Chapter 13 – Individual Reorganization

Bankruptcy law is augmented by common law interpretation of statutes and regulations by federal bankruptcy courts. Further, state priority laws and exemptions are integrated into the bankruptcy process.

6. What is the authority of the bankruptcy court?

The bankruptcy court has authority to hear any case arising under the bankruptcy system. Generally, the role of the court is simply to approve a plan of liquidation or reorganization. The court's role expands when there is some level of dispute between debtor and creditor. In a dispute, the bankruptcy court does not allow for a jury trial. A bankruptcy judge, appointed pursuant to Article I of the US Constitution, is charged with hearing the case. Matters arising under the bankruptcy system commonly include administration of the bankruptcy estate, allowance of claims against the estate, counterclaims by the estate against claimants, exemptions of estate property, and matters relating to confirmation of a plan of reorganization. The court may also enter appropriate orders and judgments as provided for under the bankruptcy code.

- **Discussion:** Why do you think the jurisdiction of the bankruptcy court is limited? Hint: Think about the constitutional authority of the bankruptcy court.
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-authority-of-the-bankruptcy-court/>

7. What is the authority of the trustee (debtor in possession) in bankruptcy?

As previously discussed, the trustee in bankruptcy plays an important role in the administration of a bankruptcy case. The general authority of the trustee includes:

- affirming or disaffirm contracts with the debtor which are yet to be performed;
- setting aside fraudulent conveyances from the bankruptcy estate;
- voiding certain preferential transfers of property by the debtor to creditors;
- suing those who owe the debtor an obligation that is not paid; and
- setting aside statutory liens on property taking effect upon the filing of bankruptcy.

Remember, the trustee in bankruptcy plays a primary role in all individual bankruptcies and business liquidation bankruptcies. Trustees are only appointed in business reorganizations in limited circumstances. It is the responsibility of the DIP to administer the bankruptcy estate. The authority of the DIP is discussed separately.

- **Discussion:** What do you think about the authority of the bankruptcy trustee? Why do you think the trustee's authority is so broad?
- **Practice Question:** ABC Corp is in the process of a liquidation bankruptcy. A bankruptcy trustee has been appointed to control ABC's bankruptcy estate. What are the powers of the trustee in settling the debts and obligations of the estate?
- **Resource Video:** <http://thebusinessprofessor.com/role-of-trustee-in-bankruptcy/>

8. What assets of the debtor are included in the bankruptcy estate?

The assets of the bankruptcy estate include all legal and equitable interests of the debtor in property at the commencement of the bankruptcy case. A legal interest means any legal right to the exclusive use and enjoyment of the property. An equitable interest includes any rights or claims to the ownership of property based upon principles of fairness. So, if a debtor has the ability to make a valid demand or claim for ownership rights in property, that property becomes part of the bankruptcy estate. This may include rights to sue or collect debts from others. Property of the estate also includes property that the debtor acquired within 180 days of filing for bankruptcy if acquired with proceeds or profits from property of the estate. Property excluded from the estate includes any income derived from the services of the debtor performed after the filing for bankruptcy protection, equitable powers that the debtor may exercise for others, educational IRA plans, 529 plans, and certain ERISA qualified retirement plans.

Federal bankruptcy law allows for certain exemptions of property from the estate based upon state law. State statutes regarding what constitutes a property interest of an individual is generally determinative of whether property indeed belongs to the debtor. Certain agreements will attempt to thwart the provisions of the bankruptcy code by limiting the transfer of property to debtors or divest debtors of ownership in property upon the filing of bankruptcy. These agreements are generally ineffective to prevent such property from becoming property of the bankruptcy estate.

- **Note:** An important state statute regarding exempt property from a bankruptcy estate regards the value of a homestead (or real property) exemption.

- **Discussion:** How do you feel about the type of assets included in the bankruptcy estate? Why do you think certain assets are excluded from the estate? Why do you think the federal bankruptcy law follows state law with regard to the assets that are exempt from the bankruptcy estate? What effect might this have on a debtor's choices when filing for bankruptcy protection?
- **Practice Question:** Doug is involved in a vehicle accident with Harry. Harry is driving a \$1 million Lamborghini sports car. Harry sues Doug and receives a \$1 million judgment. Doug has no other debts, but he decides to file for a chapter 7 liquidation bankruptcy. Doug's only assets are an educational IRA and his home, which is worth \$500,000 and is not subject to a lien or security interest. How will Doug's bankruptcy filing affect Harry's claim against him? What will determine whether Harry receives any money for his claim against the bankruptcy estate?
- **Resource Video:** <http://thebusinessprofessor.com/what-assets-or-included-in-the-bankruptcy-estate/>

9. What is the automatic stay in bankruptcy?

The automatic stay under Section 362 of the Bankruptcy Code protects debtors from ongoing collection efforts (during the pendency of the bankruptcy case) against property included in the bankruptcy estate. Specifically, creditors are prohibited from the following conduct:

- efforts to collect, assess, setoff, or recover a claim against a debtor arising before the bankruptcy filing;
- commencing or continuing a judicial, administrative, or other action to collect the debt;
- enforcing a judgment against the debtor's property;
- obtaining possession or control over assets included in the bankruptcy estate; or
- creating, recording, or enforcing a lien against the debtor's property.

Some limitations to the protections afforded under section 362 include:

- commencement or continuation of criminal actions and certain actions for domestic support;
- commencement or continuation of actions by governmental units pursuant to its regulatory power (such as tax liability); or
- creation or perfection of a statutory lien for certain types of real property.

The stay of proceeding will continue until the case is closed, dismissed, or discharge is granted. The court may also relieve or modify a stay generally or for a specific creditor for cause, for lack of adequate protection of a secured creditor's interest, or if the debtor has no equity in the subject property and it is not necessary for the reorganization of the debtor's estate. If a debtor violates a stay, any collection action can be undone. Further, if a debtor willfully violates the stay, the debtor may recover any attorney's fees incurred in challenging the collection action, as well as potential punitive damages.

- **Discussion:** Why do you think the bankruptcy code provides the above-referenced protections under section 362? Are these protections adequate? Why or why not? Does the ability of the bankruptcy court to modify the 362 stay provision affect your opinion? Does this provision adequately protect debtor interests?
- **Practice Question:** ABC Corp files for bankruptcy protection. 123 Corp is a debtor of ABC with a security interest filed in several pieces of ABC's equipment. 123 wants to understand its right to seek collection of the debt against ABC, including repossessing the equipment securing the debt. Can you explain the limitations on 123's ability?
- **Resource Video:** <http://thebusinessprofessor.com/section-362-automatic-stay-in-bankruptcy/>

10. What is a claim by creditors of the bankruptcy estate?

A claim is a notice to the trustee of the debtor's estate that the debtor owes a fixed amount to the claimant. Claimants are creditors of the estate. For liquidation bankruptcies and personal reorganization bankruptcies, creditors of the estate must submit a proof of claim within a specific period of receiving notice of the bankruptcy filing. A creditor that fails to file a claim against the estate is barred from later collecting that debt if the bankruptcy filing proceeds to discharge of the debtor. Below are several important aspects about claims against the bankruptcy estate:

- **Proofs of Claim** - At the commencement of a bankruptcy case, the debtor is required to provide a list of all assets and debts to be included in the estate. The debtor must also identify all creditors holding these debts. Creditors are then given notice of the debtor's bankruptcy case with instructions on how to submit a claim. Creditors must then submit a proof of claim attesting to the court the nature and amount of the claim. If a creditor submits a secured claim, she must include evidence of a security interest. Creditors in Chapters 7 and 11 bankruptcies must file the proof of claim within 90 days of learning of the bankruptcy case. In Chapter 11 cases, the court will establish a "bar date" by which creditors may file a proof of claim; but, filing a proof of claim is not necessary to receive a distribution from the debtor's estate. All creditor claims are generally allowed, unless the claim is challenged by the debtor, trustee, debtor-in-possession or by other creditors.
 - **Note:** In some cases, unsecured creditors may request the court appoint a "creditor's committee" to represent their collective interests and communicate with the debtor in possession.
- **Disputing Proofs of Claims** - When a creditor submits a claim against the bankruptcy estate, other parties in interest (such as the debtor, trustee, DIP, or other creditors) can file an objection to the claim. If a third-party opposes the claim, this creates a "contested matter" which is adjudicated in a proceeding before the bankruptcy court. The objecting party must demonstrate that the claim is not valid. If the party presents some evidence against the claim, the claimant will have to introduce evidence to support her claim. A trustee or debtor in possession generally pays based upon the amount of claim "allowed" by court.
- **Secured and Unsecured Claims** - A secured claim is the amount of a debt equal to the "value" of creditor's interest in assets of the estate. The claim is bifurcated and is secured to extent of the value of the collateral. Any amount of the creditor's claim beyond the value of the collateral is classified as an unsecured claim. The amount of a claim is generally the debt owed at the time of filing, including all amounts that accrue pre-petition, interest, late charges and attorney's fees. A debt generally does not receive interest during the pendency of the bankruptcy without special exception. Debts arising after the filing of bankruptcy are not included in the bankruptcy estate. The only

post-petition debts included in the bankruptcy estate are the administrative expenses of managing the estate or instances of post-petition financing. These claims generally receive administrative priority over the unsecured claims. The difference between the allowed claim amount paid to the creditor and the amount of the creditor's claim is the amount of the debt discharged in bankruptcy.

- *Note:* To be included as part of a secured or unsecured claim, attorney's fees must be permitted by contract or state law. If so allowed, attorney's fees are treated the same as interest on the debt.

- **Discussion:** What do you think about the requirement for all creditors of the debtor to submit claims to the bankruptcy estate? Is the requirement to dispute claims adequate? Do you agree with the manner in which secured and unsecured claims are handled?
- **Practice Question:** ABC Corp files for Chapter 11 bankruptcy (reorganization). 123 Corp is a creditor of ABC. ABC sends notice of the bankruptcy filing to all creditors. What are the requirements for 123 to be paid on its claim? What happens if ABC or any other creditor disputes 123's claim against the estate? If the debt owed to 123 is secured by collateral that is only worth one half of the amount of the debt, how will this be handled?
- **Resource Video:** <http://thebusinessprofessor.com/proof-of-claims-in-bankruptcy-case/>

11. What is voluntary and involuntary bankruptcy?

A bankruptcy case begins when either a debtor voluntarily files for bankruptcy or creditors petition to subject a business debtor to bankruptcy.

- **Voluntary Bankruptcy** - Any business may voluntarily file for a liquidation or reorganization bankruptcy at any time. While a liquidation bankruptcy causes a business to dissolve, a reorganization bankruptcy allows a business to continue operating. For an individual to file for reorganization bankruptcy under Chapter 13, she must have regular income and have unsecured debts not exceeding \$307,675 and secured debts of less than \$922,975. The requirements for a business to undertake a reorganization bankruptcy under Chapter 11 are discussed in greater detail below. In a liquidation bankruptcy under Chapter 7, the primary limitation is that an individual (not a business) must meet a "means test". The means test limits the ability of individuals to file for bankruptcy if the individual has recurring revenue (income) above a certain amount. The amount is determined by the state's median income for its citizens. The purpose of this test is to prevent individuals who have sufficient income to pay debts from using a liquidation bankruptcy to wipe away debts and defraud creditors.
 - *Note:* The means test does not apply to business liquidations. A business may file for liquidation bankruptcy at any time.
- **Involuntary Bankruptcy** - An involuntary bankruptcy, as the name implies, is involuntarily imposed upon the debtor. One or more creditors of a business debtor may commence an involuntary bankruptcy action against a debtor by filing a chapter 7 or chapter 11 petition with the bankruptcy court. To commence this action, the following conditions must be present:
 - three or more business creditors must have good faith, non-contingent claims against the debtor totaling

\$15,325 or more (beyond the amount of any secured debt), or

- if the debtor has fewer than 12 creditors, a single creditor holding a good faith, non-contingent claim against the debtor of \$15,325 or more.

These provisions are in place to make certain that no single creditor can undermine a business's operations by petitioning for involuntary bankruptcy without meeting minimum standards. The court may award damages against a creditor for filing an involuntary bankruptcy in bad faith. If the debtor fails to successfully defend a petition for involuntary bankruptcy, the court will order relief against the debtor. If the debtor contests the involuntary filing, the court will only subject the debtor to bankruptcy if:

- The debtor is not paying its debts as they come due, or
- Within 120 days prior to filing the action, the court appoints a custodian over the assets of the debtor with the purpose of enforcing a lien.

It is important to remember that any debts that the debtor fails to pay in a timely manner must be good faith debts that are not subject to dispute or controversy. The danger for a creditor seeking to place the debtor in involuntary bankruptcy is, if the court dismisses the action (other than pursuant to agreement of all parties), the court may award court costs and attorney's fees against the creditor. If the creditor acted in bad faith, she may be subject to actual damages suffered by the debtor, as well as punitive damages.

- **Discussion:** What do you think about the unlimited ability for businesses to file a voluntary bankruptcy? What do you think about the ability of creditors to force a debtor into involuntary bankruptcy? Are the requirements for an involuntary bankruptcy sufficient to protect a debtor? Why or why not? Do they offer a valid option for creditors in enforcing debts against a debtor? Why or why not? Does the ability of the creditor to receive damages for a bad-faith, involuntary filing affect your opinion?
- **Practice Question:** ABC Corp is a large corporation that produces farm chemicals. ABC owes over \$1 million to 123 Corp for services rendered and supplies. ABC has continuously failed to respond to 123's collection efforts. ABC Corp does not seem to have outstanding debts owed to any other businesses. What are 123's options to collect this debt through the bankruptcy process?
- **Resource Video:** <http://thebusinessprofessor.com/voluntary-and-involuntary-bankruptcy-requirements/>

CHAPTER 7 and CHAPTER 11 BANKRUPTCY

12. What is the "Chapter 7" bankruptcy process?

The Chapter 7 bankruptcy process is fairly straightforward. It involves the following steps:

- *Filing* - The debtor files a voluntary petition or is the subject of an involuntary petition.
- *Bankruptcy Estate* - Initiating the bankruptcy process creates the bankruptcy estate containing all of the debtor's

non-exempt assets. Also, the automatic stay halts all collection efforts against the debtor. The trustee in bankruptcy is appointed or elected and charged with identifying and assembling assets of the bankruptcy estate.

- *Proofs of Claim* - At the time of filing, creditors of the debtor are put on notice of their rights to put in a claim against the bankruptcy estate for any debts owed them by the debtor. Secured creditors must be paid in full from the estate or have the property serving as collateral for the debt surrendered to them. Once secured creditors are paid to the extent of the value of their security interest in collateral, unsecured creditors are paid based upon their priority. Higher priority creditors will be paid before lower priority creditors. All creditors in a given class of debtor will be paid an equal percentage of their claims.
- *Liquidation* - The trustee will sell or liquidate all available assets of the bankruptcy estate to generate funds to pay estate debts.
- *Discharge* - Once all assets of the estate are liquidated and creditors paid, the court will enter an order discharging the debtor of all debts identified in the bankruptcy proceeding. Failure to submit a claim after receiving notice will cause a claim to be discharged. If a creditor is not notified of the bankruptcy proceeding, that creditor's claim against the debtor will not be discharged.

This process is fairly linear in nature. It is common for bankruptcy cases to be dismissed at any stage of the proceeding for failing to move forward in accordance with the court's order.

- **Discussion:** What do you think about the process for filing a Chapter 7 Bankruptcy? Can you think of situations where a business liquidation could be very difficult? Do you think the process adequately protects creditor rights?
- **Practice Question:** ABC Corp is in dire straits. It is considering filing for bankruptcy and liquidating the company. Can you explain to ABC the process of liquidating under Chapter 7?
- **Resource Video:** <http://thebusinessprofessor.com/chapter-7-bankruptcy-process/>

13. What is the Chapter 11 bankruptcy process?

Chapter 11 bankruptcy (Chapter 11) seeks to reorganize or restructure the debts of the debtor without liquidating all of the debtor's assets (as under Chapter 7). The objective is to allow the business to continue operations in an attempt to maximize the value of the business to all stakeholders. Chapter 11 follows a similar process to that of Chapter 7, with the following notable differences:

- *Bankruptcy Estate* - Filing for bankruptcy protection creates the bankruptcy estate. At this point, the court does not appoint a bankruptcy trustee to collect and manage the assets of the estate. Rather, the debtor remains in control of the business operations and all business assets. The DIP is vested with the same authority as a trustee in a Chapter 7 bankruptcy. This includes authority to use or even sell assets for the benefit of the estate, accept or reject contracts, and seek post-petition financing for the business. All of this authority is limited, however, by the objective of the DIP to control the estate for the benefit of all creditors.

- *Note:* The debtor in possession's duty to creditors is a change from the board's duty to manage the

corporation for the benefit of creditors.

- *Proof of Claims* - A creditor of the bankruptcy estate is generally not required to submit a proof of claim. Rather, the DIP is required to account for and identify all debts of the estate. The DIP must give all creditors notice of the bankruptcy filing. Secured creditors may be concerned by the DIP's use of the collateral securing their claim in the continued operations of the business. If so, they can challenge DIP actions in the bankruptcy court. Unsecured creditors may organize and request the bankruptcy court recognize the group as a creditors committee. The purpose of the creditors committee is to represent the interests of all creditors in negotiations with the DIP.
- *Plan of Reorganization* - The DIP must put forward a plan of reorganization. This plan must pay off all secured creditors within the term of the plan. Further, the plan must be voted upon and accepted by at least one class of "impaired" unsecured creditors under the plan that is not paid in full. Lastly, the bankruptcy court must approve the plan. If the plan is not reasonable or the DIP cannot possibly achieve these objectives, the plan may fail and the bankruptcy case could be dismissed.
 - *Note:* In many cases, the company will achieve creditor approval of a plan by forcing the plan on certain groups of creditors. This is known as a "cramdown".

Filing for bankruptcy protection under Chapter 11 can be a useful tool for business. As such, businesses have developed special purpose bankruptcies to achieve a specific business objective. For example, a business may use chapter 11 to escape certain types of tort liability. Further, if a company has a single prevailing asset, a company may liquidate the large asset, but otherwise go through the chapter 11 process. This is common when the debtor has a large single real estate asset.

- **Discussion:** Why do you think the Chapter 11 bankruptcy process allows the debtor to remain in control of business assets? Why do you think this is of primary concern to secured creditors? Do you think it protects creditor rights to require that a bankruptcy plan be approved by certain classes of unsecured creditor? Why or why not?
- **Practice Question:** ABC Corp is in dire straits. It is considering filing for bankruptcy to reorganize the company's business operations. Can you explain to ABC the process of liquidating under Chapter 11?
- **Resource Video:** <http://thebusinessprofessor.com/chapter-11-bankruptcy-process/>

14. What is the authority of the debtor in possession?

The authority of the debtor in possession (DIP) is similar to that of a bankruptcy trustee. The objective of the DIP is to guard the interests of creditors by reshaping the bankruptcy estate to allow the business to continue operations. In doing so, the DIP is vested with the following important powers.

- *Accept or Reject Contracts* - The DIP may accept or reject contracts of the debtor that have not yet been performed or are on-going. In this way, the DIP can get rid of contracts that are oppressive or cause losses to the business but can retain contracts that are beneficial and necessary for the reorganization of the business. This rule invalidates provisions in a contract restricting, conditioning, or prohibiting a debtor's rights to assign a contract. To retain or assume a contract, the DIP must provide adequate assurance of continued performance and must cure

any defaults under the contract. The court may impose timelines and restrictions on the termination or any modifications to existing contracts. Further, there may be limitations on the ability of the debtor to later assign an assumed contract (such as a requirement for assurance of future performance). Lastly, any contract that has been terminated pre-petition may not be assumed in bankruptcy.

- **Discussion:** Why do you think the bankruptcy law allows a DIP to accept or reject executory contracts of the debtor? Do you think it is fair to contract parties that the DIP can accept beneficial contracts and reject non-beneficial contracts? Is requiring the DIP to provide adequate assurance of performance sufficient to protect the rights of parties to retained contracts?
- **Practice Question:** ABC Corp is suffering a decline in business and cannot meet its obligations. ABC decides to declare Chapter 11 bankruptcy. As a DIP, ABC seeks to reject several contracts that are causing losses and retain several contracts that are beneficial to the business. What rules apply to ABC's plan?
- **Resource Video:** <http://thebusinessprofessor.com/debtor-in-possession-authority-to-accept-or-reject-contracts/>

- **Avoiding Powers** - The DIP exercises the avoiding powers of a bankruptcy trustee. This is known as the “strong-arm” powers. The strong-arm authority allows the DIP to:
 - **Avoid Preferential Conveyances** - The DIP may seek to undo any preferential conveyances or payments made by the company and certain statutory liens placed on the debtor's assets by creditors. Generally, a payment is considered preferential if it made while the debtor was insolvent and it enables the recipient creditor to receive more than such creditor would receive if the case were a case under Chapter 7. Further, a preferential conveyance must meet the following elements:
 - any transfer of interest in the debtor's property;
 - within 90 days of filing for bankruptcy (or one year if the transfer is to insiders of the business);
 - to or for benefit of a creditor on account of an existing debt.

If these elements are present, the DIP may undo the transaction by making a claim against the preferred creditor for return of the transferred assets. There is an assumption that a debtor is insolvent in the 90-day period prior to the filing of bankruptcy. This period is extended to one year if any payment benefits an insider of the business (such as an owner of the business, officer, director, third-party guarantor, etc.). The longer time period for insiders rests upon the presumption that companies may siphon off funds to insiders upon signs of financial distress. The term “transfer” is broadly defined to include any payment, transfer of property, creation of a lien on property, or recording of a security interest. The requirement that the transfer benefit the creditor is also construed very broadly. Even a payment on a debt that somehow reduces a third-party guarantor's liability for the debt may be considered preferential.

There are several exceptions or defenses that protect conveyances that may otherwise qualify as preferential, including:

- *Contemporaneous Exchanges of Value* - This exception allows a debtor to make payment to a creditor who simultaneously provides value to the debtor. The theory behind this exemption is that a supplier should not worry about creating an “antecedent debt” based upon the timing of the exchange of money (or property) for goods or services.
 - *Example:* A business could purchase goods or hire services and make immediate payment for those goods or services without payment being considered preferential.
- *Payment in the Ordinary Course of Business* - If a payment is recurring or is part of the ordinary course of the employer’s business, it may not be deemed preferential. To determine if such a payment is truly in the ordinary course of business, a court will examine the length of account, relationship history, whether the amount or form was different from past payment, any unusual collection or payment activity, and whether creditor took advantage of debtor’s deteriorating financial condition.
 - *Example:* A recurring financing payment made each month on assets or recurring services would not be considered a preferential payment.
- *Purchase Money for Collateral* - A transaction that creates a security interest in property acquired by the debtor will not be considered preferential if done pursuant to a security agreement that describes the collateral and is given to allow the debtor to purchase the collateral. Generally, the debtor must file the security interest within 20 days of taking receipt of the collateral or the security interest loses priority to other secured creditors.
 - *Example:* The debtor purchases equipment from a dealer who finances the deal. If the dealer takes a security interest in the equipment within 20 days, the security interest is not deemed to be a preferential payment.
- *Enabling Loans* - If a debtor receives an enabling loan to continue operations, payments on that loan may not be considered preferential.
 - *Example:* A debtor receives funds on a new line of credit. Payment on this credit agreement is not considered preferential.
- *Extending New Value* - If a debtor makes payment to a creditor on account or existing debt, but later receives new value in a transaction (such as an extension of credit or purchasing goods on account), that payment or any lien taken on goods or payment made toward those goods or services would not be preferential.
 - *Example:* The debtor owes a seller of inventory who finances the sale to the debtor. If the debtor makes a payment on the debt in order to receive new inventory financing, this would not be considered preferential.
- *Floating Liens* - If a debtor acquires and finances new assets or is subject to a prior lien

specifically covering after-acquired collateral (such as inventory or receivables), the attachment of a floating lien will not be considered preferential. An important limitation with this defense is that the creditor cannot materially improve her position as a result of any payment.

- *Note:* Inventory and receivables financiers are protected when the debtor acquires property, but they are not permitted to enhance their positions during the 90-day period.
- *Example:* Fred makes a loan to ABC Corp. The loan is secured by all of ABC's assets and includes an after-acquired property clause. If ABC acquires new property, it will be subject to Fred's security interest. The attachment of this floating lien to the newly acquired equipment is generally not considered a preferential payment.
- *Avoid Fraudulent Conveyances* - The Bankruptcy Code allows for state fraudulent-transfer laws to remain in effect during a bankruptcy. The bankruptcy code allows the DIP to reclaim any fraudulent conveyances by the debtor. The DIP may look back two years to challenge any fraudulent transfers made with the "intent to hinder, delay or defraud" creditors, or made without "reasonably equivalent value". A failure of reasonably equivalent value may include situations where a debtor transfers corporate assets to a creditor or purchaser for an extremely low value.
 - *Example:* ABC Corp transfers assets to the CEO's brother-in-law for one-tenth of the value of the assets. If ABC files for bankruptcy within two years of this transaction, the DIP would likely be able to recover the assets (or equivalent value) as a fraudulent transfer.

If the DIP successfully challenges and avoids a transfer, she may recover the actual property transferred or the value of the property transferred. There are limits on the ability of the trustee to recover from a transferee who receives the property in exchange for value (such as payment of a preceding debt) and in good faith without knowledge of the voidability of the transfer.

- **Discussion:** Why do you think the bankruptcy law allows a DIP to avoid preferential and fraudulent transfers by the debtor? How do you feel about the default position that a transfer within 90 days of bankruptcy filing is a preferential payment? What do you think about the exemptions of certain types of otherwise preferential payments? Are there any exceptions you would add or exclude? Why? How do you feel about the 2-year look-back period for fraudulent transfers?
- **Practice Question:** Martin is CEO of ABC Corp. ABC is going through financial problems and files for Chapter 11 bankruptcy. Two months before filing for bankruptcy, Martin directed ABC to repay an outstanding debt owed to 123 Corp. 123 Corp is owned by a close friend of Martin. Under what provisions might a DIP challenge this transfer?
- **Resource Video:** <http://thebusinessprofessor.com/avoiding-powers-of-debtor-in-possession/>

- *Stay of Proceedings* - The DIP may enforce or employ the Section 362 stay of proceeding provisions against existing debtors. This broad authority gives the DIP power to continue operations with existing creditors without being subjected to debt-collection practices that may thwart the reorganization of the estate. The DIP's authority

trumps any rights to collection or agreement not to contest a debt that is present in the debt agreement. Upon request of a party in interest and after notice and a hearing, the court may grant relief from the stay. The justifications for relieving the stay are as follows:

- *No Equity in Property* - The debtor does not have any equity in the property and it is not necessary for an effective reorganization; or
 - *Example:* The debtor purchases equipment that is financed by the seller. At the time of filing bankruptcy, the debtor owes more on the loan than the equipment is worth. The equipment is not necessary for the continued operations of business, so the creditor may seek relief from the stay to repossess the equipment and sell it.
- *For Cause* - The court may relieve the stay of proceeding for cause, including the lack of adequate protection of an interest in property.

The primary limitations of the automatic stay are that it does not stop certain criminal actions, paternity suits, collection of domestic support obligations, or actions by a governmental unit exercising its police and regulatory power. The police or regulatory power exception should be narrowly construed when the actions result in financial penalty or forfeiture. Courts generally employ two tests to determine whether the stay should apply in these situations:

- *Pecuniary Purpose Test* - If the primary purpose of the government unit's action looks back and punishes for past conduct, it should not be excepted from the stay as an exercise of police or regulatory power.
- *Public Policy Test* - If the primary purpose of government action relates to stopping a continued threat to public safety or health, it should be excepted from stay as police or regulatory power.

One factor that the court will consider is whether relieving the stay would cause irreparable harm to the bankruptcy rehabilitative process.

- **Discussion:** Why do you think the bankruptcy law allows a DIP to selectively enforce the Section 362 stay of proceedings? Do you think a creditor should be able to petition for the removal of the stay under the above-referenced situations? How do you feel about the application of the stay to certain police or regulatory powers of government agencies? Do the above-referenced tests for making this determination affect your opinion?
- **Practice Question:** ABC Corp files for Chapter 11 Bankruptcy. The DIP issues notice to all debtors of the corporation to halt any collection efforts. Several secured creditors are concerned about their interest. Under what grounds can these creditors seek a lift for stay from the bankruptcy court?
- **Resource Video:** <http://thebusinessprofessor.com/automatic-stay-of-proceedings-in-bankruptcy/>

- *Use of Business Assets* - The DIP may use assets of the business in on-going operations. This includes the use of business cash in the "ordinary course of business". This authority also includes using, selling, or leasing the

business's assets. If an asset will be "permanently impaired" or the use of assets is challenged by a creditor of the estate, the court must specifically approve its use. Special issues arise when the DIP seeks to lease or sell business assets in the course of business. Physical assets of the business generally serve as collateral for one or more classes of secured creditor. In this situation, the secured creditors may demand adequate protection of their interests from the DIP. This means the DIP may have to take measures to ensure that the bankruptcy estate's use of the assets in on-going operations does not prejudice the secured status of the creditors. Adequate protection may be provided by:

- *Payments* - The DIP may make payments to the secured creditor for any decrease in the value of collateral securing the debt.
- *Second Lien* - The DIP may authorize an additional or replacement lien to the extent of any decrease in the value of collateral securing the debt.
- *Other Relief* - The DIP may provide other relief that provides the creditor with assurance of payment of the equivalent value of the collateral.

Also, to the extent of any surplus value in the collateral, the secured creditor is entitled to interest and reimbursement of attorneys' fees and expenses as part of its claim against the bankruptcy estate.

- **Discussion:** Why do you think the bankruptcy law allows a DIP to use assets of the business to fund on-going operations? Do you think the above-listed methods of providing adequate assurance sufficiently protects creditor rights? Why or why not?
- **Practice Question:** ABC Corp files for Chapter 11 Bankruptcy. The DIP continues to use business assets in the on-going operations of the business. Some of the assets are collateral for loans. The secured parties are concerned, as these assets will be used up in business operations. The secured parties do not want to be reduced to unsecured status. What is the DIP required to do in order to continue using these expendable assets in the course of operations?
- **Resource Video:** <http://thebusinessprofessor.com/authority-of-debtor-in-possession-to-use-business-assets/>

- *Post-Petition Financing* - The DIP may establish unsecured credit (incur debts) in the ordinary course of business following the filing of bankruptcy. This practice creates new obligations for the bankruptcy estate that are often superior or have priority over payment of the existing debts. This is known as "administrative expense priority". These debts must be actual, necessary costs and expenses of preserving the estate. This ability is limited by the rule that an equity owner in the business cannot retain any value in a Chapter 11 bankruptcy until all other creditors are paid. The court may, however, grant an exception when a current shareholder extends new credit to the bankruptcy estate. While authority to secure post-petition financing is extremely important in reorganizing the bankruptcy estate, it can have a detrimental impact on existing shareholders who lose priority in favor of the post-petition creditors. If the DIP is unable to obtain credit, even with the promise of administrative expense priority, the court may, after notice and hearing, order:

- *Super-priority Administrative Expense* - This provides the creditor with priority over any or all administrative expenses of the kind.
- *Lien on Unencumbered Property of the Estate* - This provides the creditor with a lien on property of the estate that is not otherwise subject to a lien.
- *Junior Lien on Encumbered Property of the Estate* - This provides the creditor with a junior lien on property of the estate that is subject to a lien.

The court may only authorize a junior lien on encumbered property if the DIP is unable to otherwise obtain such credit and there is adequate protection of the senior lien holder.

- **Discussion:** Why do you think the bankruptcy law allows a DIP to seek post-petition financing? Is it fair that post-petition debt receives administrative expense priority? Why or why not? Are the measures that a court may take to allow the DIP to obtain new financing fair to existing debtors? Why or why not?
- **Practice Question:** ABC Corp files for Chapter 11 Bankruptcy. The DIP continues business operations. She realizes that the business will require new capital. What are her options for obtaining post-petition financing and the benefits she can offer to creditors? If she is unable to obtain financing by this method, what methods may a court employ to provide financing for the business?
- **Resource Video:** <http://thebusinessprofessor.com/authority-of-debtor-in-possession-to-secure-post-petition-financing/>

15. What is appointment of a trustee or examiner?

In certain circumstances, the bankruptcy court will appoint a bankruptcy trustee to supervise the actions or conduct of the debtor in possession (DIP). Generally, however, there is a strong presumption against appointment of a trustee. To overcome this presumption, creditors must show “cause” why the appointment is necessary. Cause includes situations involving fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case. The bankruptcy court will look at the “totality of the circumstances” to determine the need for a trustee. An alternative to appointing a trustee is the appointment of a “corporate examiner”. The examiner serves a role similar to special counsel to the DIP. This action allows management to continue running the business while having activities monitored by the examiner.

- **Discussion:** How do you feel about the DIP remaining in control of the business? Do you think appointment of a trustee should require a showing of “cause”? Why or why not? Do you think the appointment of a corporate examiner is sufficient protection to substitute for appointment of a trustee? Why?
- **Practice Question:** ABC Corp files for Chapter 11 Bankruptcy. The DIP continues business operations. Many creditors become concerned about their interest based upon the DIP’s decision making and apparent incompetence. What are the options available to the creditors in this situation?

- **Resource Video:** <http://thebusinessprofessor.com/appointment-of-trustee-of-examiner-in-chapter-11-bankruptcy/>

16. What is a plan of reorganization?

The DIB has an exclusive 120-day period to file plan of reorganization. The court may enlarge or reduce the exclusivity period “for cause”. The DIB has exclusive control over the case early on and may take a first stab at the terms of the proposed restructuring. The bankruptcy code provides guidelines for the contents of the plan of reorganization as follows:

- *Mandatory Provisions* - The mandatory provisions to include a plan are as follows:
 - *Classes of Claims* - The plan must designate classes of claims.
 - *Equal Treatment* - All members of a class must be treated the same.
 - *Secured Claims* - Secured claims must be classified separately unless the creditors have common rights.
 - *Unimpaired Classes* - The plan must designate any class that is not impaired, any class that is impaired.
 - *Plan of Implementation* - The plan must provide adequate means for a plan’s implementation.
- *Permissive Provisions* - The plan of reorganization may include any of the following provisions:
 - *Impair a Class* - The plan may impair any class.
 - *Executory Contracts* - The plan may provide for assumption or rejection of executory contracts.
 - *Sale of Property* - The plan may provide for sale of estate assets.
 - *Handling Claims* - The plan may provide for settlement or adjustment of claims belonging to the estate, such as turnover of property or avoidance claims.
 - *Other Provisions* - The plan may contain any other provisions that do not conflict with the reorganization of the estate.
- *Notice of the Plan* - Before the plan can be distributed to creditors and interest holders, the court must approve a disclosure statement for distribution. The disclosure statement must contain adequate information about the debtor and the bankruptcy filing. This generally includes:
 - description of debtor’s business,
 - history of debtor’s business,
 - current financial information, including the financial statements,

- description of plan and execution game plan,
- liquidation analysis,
- management retention and compensation,
- pro forma operations projections,
- summary of pending or planned litigation,
- transactions with insiders, and
- tax consequences if plan is confirmed.

Once the disclosure statement is approved by the court, the DIP may solicit acceptances from creditors and interest holders. The DIP must send the plan, disclosure statement, and ballot to all known creditors and parties in interest.

- *Acceptance of the Plan* - To approve the plan, a class of impaired creditor must accept the plan and it must be approved by the court. A class of creditors accepts the plan if approved by at least two-thirds (2/3) of the total claims and one-half (1/2) of the total of allowed claims of the class. “Unimpaired” classes of creditor are not entitled to vote on the plan. An unimpaired creditor will receive full payment of its claim under the plan. It is conclusively presumed that unimpaired creditors accept a proposed plan. If a class receives no dividend under the plan (no payment), it is deemed to have rejected the plan. Once approved by a single class of impaired creditors, the bankruptcy court must hold a hearing to determine whether the plan can be confirmed. The plan must meet the following elements for court approval:
 - *Best Interest* - The plan must be in the best interest of creditors. Dissenting creditors often litigate this element. Each creditor must receive at least as much as it would receive under a Chapter 7 liquidation.
 - *Administrative Priority* - Unless otherwise agreed, holders of administrative expense priority must be paid in cash on the effective date of the plan.
 - *Priority Claims* - Holders of priority claims must be paid by the effective date unless such class has accepted the plan stating otherwise.
 - *Feasible* - The plan must be “feasible”, such that it is not likely to be followed by liquidation or further reorganization unless such course of action is proposed as part of the plan. Factors to determine whether a plan is feasible include:
 - earning power of the business,
 - adequacy of the capital structure,
 - economic and market conditions,

- ability and retention of management, and
- ability to meet obligations as they become due.

- **Discussion:** What do you think about the process for proposing and approving a Chapter 11 bankruptcy plan? Why do you think the plan only requires approval of one class of impaired creditors? Should impaired creditors be given a vote? Why or why not? Do you think the rules required for confirmation of the plan adequately protect creditor interest? Why or why not?
- **Practice Question:** ABC Corp files for Chapter 11 Bankruptcy. The DIP puts forward a plan for reorganization of the company. What is required for the plan to be approved by creditors? What is required for the plan to be approved by the bankruptcy court?
- **Resource Video:** <http://thebusinessprofessor.com/bankruptcy-plan-of-reorganization/>

17. What is “cramdown” of a reorganization plan?

The plan of reorganization must be approved by at least one class of impaired creditor, excluding votes cast by corporate insiders. If any class of impaired creditor has not accepted the plan, the court, on request of the proponent of the plan, shall confirm the plan “if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class . . . [t]hat is impaired under, and has not accepted, the plan”. This is known as “cramdown”, as the plan is being forced upon impaired creditors who voted against plan approval. In the event of a cramdown, the court will determine whether treatment of each class is “fair and equitable”. Even in a cramdown, the following attributes of the plan must be true:

- **Secured Creditors** – Secured creditors must retain a lien on collateral or proceeds and receive deferred cash payments equal to present value of the collateral or receive the indubitable equivalent of its claim.
- **Unsecured Creditors** – Unsecured creditors must be paid in full or no holders of junior claims may receive any payment.
- **Discussion:** How do you feel about the ability of the court to cram down a plan on impaired creditors? What factors should the court use to determine whether the plan is fair and equitable to the impaired creditors?
- **Practice Question:** ABC Corp files for Chapter 11 bankruptcy. The DIP puts forward a plan of reorganization. Under the plan, several classes of creditors will not receive full payment of their claims. That is, these creditors are impaired. If any of the impaired creditors object to the plan, what options are available to the DIP to seek creditor approval of the plan?
- **Resource Video:** <http://thebusinessprofessor.com/cramdown-of-chapter-11-bankruptcy-plan/>

18. To what extent does the bankruptcy process relieve a debtor’s debts?

Unless otherwise stated, confirmation of the debtor in possession's (DIP's) plan of reorganization discharges the debtor from any debt that arose before the date of the plan's final confirmation. The plan will specifically identify any post-petition debts that are not a part of the bankruptcy estate. If a creditor with a pre-petition debt fails to file a proof of claim, its debt will also be discharged as part of the bankruptcy process. Due process rights limit the ability of the court to discharge debts of claimants who did not receive notice of the bankruptcy filing. Unless otherwise indicated in the plan, confirmation vests all of the property of the estate in the debtor free and clear of all liens and encumbrances. Following plan confirmation, the debtor is in complete control of the business and able to continue operations.

- *Note:* In Chapter 11 reorganizations, a debtor is not required to submit a proof of claim. As such, failure to file the proof of claim will not result in discharge of the claim against the debtor.
- **Discussion:** How do you feel about the ability of bankruptcy court to discharge debts of the debtor that were not presented as claims to the trustee? Is it fair to require the creditors to file a proof of claim in order to preserve their creditor status? Why do you think this rule does not apply in Chapter 11 reorganizations?
 - **Practice Question:** ABC Corp files for bankruptcy. It initially puts in a petition for Chapter 11, but later converts the filing to a Chapter 7 liquidation. ABC notified all creditors of the Chapter 11 filing, but failed to notify 123 Corp of the Chapter 7 filing. If 123 Corp fails to submit a proof of claim to the bankruptcy trustee, how will this affect 123's rights?
 - **Resource Video:** <http://thebusinessprofessor.com/discharge-of-debtor-in-bankruptcy/>

TOPIC 22: ENVIRONMENTAL LAW

Overview

Environmental laws include federal and state statutes and regulations that govern the conduct of individuals and businesses that have an impact on the natural habitat or resources. This chapter introduces the concept and purpose of environmental law. It introduces the major federal environmental laws and the agencies primarily charged with enforcing these laws. It then explains the available enforcement mechanisms. For each of these laws, it explains the primary government obligations in enforcing the law and the obligations of individuals in complying.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• Environmental Law • Structure of Environmental Law • Environmental Protection Agency (EPA) • Enforcement Mechanisms • The National Environmental Policy Act (NEPA) - Environmental Impact Statement	• The Clean Air Act (CAA) - State Implementation Plan - New Source Performance Standards & New Source Review - Prevention of Significant Deterioration - Non-Attainment Areas - Interstate Pollution - Enforcement	• The Clean Water Act (CWA) - Variances & Exceptions • The Endangered Species Act (ESA) • Federal Pesticide Laws • The Solid Waste Disposal Act (SWDA) • The Toxic Substance Control Act (TSCA) • Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)

TOPIC 22: ENVIRONMENTAL LAW - QUESTIONS & ANSWERS

1. What are “environmental laws”?

Environmental law is a combination of state and federal laws aimed at protecting individuals from the negative consequences of environmental degradation. More specifically, environment law addresses pollution, natural resource management (including forests, minerals, and wildlife), and the environmental impact of human activity.

- **Discussion:** How do you feel about the role of the federal and state governments in protecting the environment? Are the environmental laws adequate? How should the burden of these laws be balanced against individual rights?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-environmental-laws/>

2. What is the structure of environmental protection law?

The Federal Government has promulgated numerous laws that provide a national framework for environmental protection and management. Under these frameworks, states have the ability (and sometimes requirement) to pass state standards for environmental protection. These regulations govern public and private conduct that has an effect or impact on the environment. The federal system is set up to allow multiple levels of enforcement. Federal and state administrative agencies are charged with implementing and enforcing the various environmental laws through administrative, civil, and criminal actions. Further, individuals can bring private civil causes of action against violators of environmental laws (including actions against the federal or state government for failing to adequately enforce the environmental laws). These actions may be pursuant to a particular federal or state environmental statute or pursuant to common-law tort actions.

- **Discussion:** What do you think about the system of environmental law? Why do you think federal law allows for state regulation? Is the multi-layer system of federal, state, and private actions sufficient to achieve the objectives of environmental law?
- **Practice Question:** William plans on opening a factory that will potentially discharge matter into the air and water. He is curious about what laws may affect his operations. Can you explain to William the structure of the environmental protection laws?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-structure-of-environmental-protection-laws/>

3. What is the Environmental Protection Agency?

The Environmental Protection Agency (EPA) is a federal agency created to protect the environment by policing activities that have a negative impact upon the environment. Specifically, the EPA is charged with enforcement of the various federal environmental statutes, writing regulations, conducting environmental assessments, conducting environmental research, and educating the public on environmental standards. In carrying out its functions, the EPA works closely with state and local governments, as the environmental regulatory regimes are closely integrated. Particularly, much of the

responsibility for enforcing environmental laws rests with the states. As part of its enforcement function, the EPA has administrative authority to levy fines, sanctions, and other punitive measures for failure to adhere to environmental law.

- **Discussion:** How do you feel about the role of the EPA? Is the role overly broad? Does the integration with state and local regulatory agencies and regime affect your opinion? Why or why not?
- **Resource Video:** <http://thebusinessprofessor.com/environmental-protection-agency/>

4. How are the environmental laws enforced?

The EPA is charged with enforcement of federal environmental law, while state administrative agencies are similarly charged with enforcing violations of state environmental law. These agencies may cross-enforce the other's law in conjunction with enforcing their own provisions. Enforcement actions may be administrative, civil, or criminal.

- *Administrative Actions* - The EPA may pursue administrative remedies against violators of environmental law. This involves subjecting alleged violators to trial by judge in an administrative court. The remedies available to the administrative court include penalties, negotiated settlements, and supplemental environmental projects (such as public works projects). Administrative settlements may include monetary penalties and orders to clean up the contamination or pay for the contamination cleanup. An important administrative function for the EPA is determining liability for contamination and cleanup enforcement. Administrative enforcement actions must generally follow the procedures outlined under the Administrative Procedures Act.
- *Government Civil and Criminal Actions* - The EPA or state environmental agencies may also initiate civil or criminal actions against violators of environmental law. Civil actions may be federal lawsuits filed by the EPA in federal court or lawsuits by state agencies filed in state or federal court. The EPA or state environmental agencies, in conjunction with the US Department of Justice or a state attorney general's office, may also initiate criminal actions against violators of environmental law. Criminal actions are generally reserved for particularly egregious violations that are intentional, knowing, or reckless. Generally, the US Justice Department files federal civil and criminal actions on behalf of the EPA. Likewise, state attorneys general generally file civil and criminal enforcement actions at the state level.
- *Private Actions* - Individuals may also bring private civil actions in state or federal court against violators of environmental law. Generally, these actions are based upon tort theory. The following are common types of private civil action for violations of environmental law:
 - *Public Nuisance* - A public nuisance is any activity that causes damage or harm to the general public or environment rather than to a specific individual's person or property. Generally, only a public official appropriately charged with protecting the public may bring an action for public nuisance.
 - *Private Nuisance* - Nuisance generally entails the use of one's property that unreasonably interferes with the use or enjoyment of another person's property. Private nuisance is an action by an individual or group of individuals against a defendant or group of defendants. A court must determine what is an "unreasonable" use of one's property.

- *Other Tort Doctrines* - Other private causes of action against violators of environmental laws include:
 - *Trespass* - Trespass is when a person intentionally enters or causes something (e.g., trash, smoke, water, noise, fumes, etc.) to intentionally enter another person's land without permission.
 - *Negligence* - This tort is based on the defendant's failure to use ordinary and reasonable care in its actions affecting the plaintiff.
 - *Strict Liability* - Some activity by a defendant may be subject to strict liability for any injury resulting from the conduct. This is the case when undertaking any activity deemed to be ultrahazardous in nature.

In some cases, individuals may file actions against representatives of state or federal agencies for failure to adequately enforce the federal or state environmental laws. In a civil action, the defendant has failed to comply with environmental statutes, regulations, or administrative orders.

- **Discussion:** How do you feel about the enforcement mechanisms available for violation of environmental laws? Why do you think the law allows for agency and private civil actions?
- **Practice Question:** ABC Corp is a large manufacturer of textiles. ABC pulls water from the river to cool the large company boilers. This water, once cooled, is re-deposited in the river. If ABC violates federal and state environmental laws by also dumping chemical wastes in the river, what are the potential actions available against ABC?
- **Resource Video:** <http://thebusinessprofessor.com/enforcement-of-environmental-protection-law/>

MAJOR ENVIRONMENTAL PROTECTION LAWS

The following are the major environmental protection laws in the United States.

5. What is the National Environmental Policy Act of 1970?

The National Environmental Policy Act of 1970 (NEPA) was first major federal environmental statute. It lays out broad goals and steps for federal agencies to incorporate environmental considerations into decision-making. NEPA has been held to not be a substantive act; rather, it is made up of procedural statutes requiring federal agencies to consider the environmental impact of proposed projects before taking action. NEPA applies to all federal agencies. It does not apply to states or private parties, unless there is sufficient federal involvement to bring the actions within the "federal nexus" (i.e. federal financing or federal permitting). Most notably, NEPA requires that the federal government undertake an "environmental assessment" and prepare an "environmental impact statement" before undertaking certain projects. The agency is not required to prepare an impact statement if the initial assessment deems that the project will have no significant adverse impact on the environment. If the agency moves forward with the impact statement, it must include the statement in every procedural reporting aspect of the project.

- *Note:* Before the environmental statement is completed, NEPA requires that agencies designate significant

environmental issues associated with a contemplated action.

- **Resource Video:** <http://thebusinessprofessor.com/national-environmental-protection-act/>

An environmental impact statement is a detailed document that estimates the environmental impact of the proposed action. NEPA requires that an impact statement include the following:

- environmental impact (direct and indirect; beneficial and detrimental),
- any adverse environmental effects unavoidable if implemented,
- alternatives to the proposed action,
- short versus long-term use or productivity of the proposed project, and
- any irreversible or irretrievable commitment of resources involved in implementation.

The impact statement is often critiqued as a compliance rather than a decision-making tool, as federal agencies are not mandated to comply with any findings or recommendations in the statement. NEPA contains numerous provisions about litigating impact statement adequacy on procedural grounds. The process for developing an impact statement is as follows:

- *Identify Issues* - The agency should follow public process to determine the scope or key issues to be included;
- *Public Comment on Draft of Statement* - The agency should develop a draft impact statement, file it with the EPA, and allow time for public comments;
- *Final Draft* - The final impact statement is filed with the EPA, and a supplemental statement is prepared as required.

There is no private right of action under NEPA; instead, plaintiffs must sue under the Administrative Procedures Act for violations. The APA requires final action by the EPA before undertaking judicial review. Fifteen states and the District of Columbia have environmental policy acts modeled on NEPA. States may generally only be sued under their own NEPA statute, except when a sufficient federal nexus is created with the state project (such as through federal funding).

- **Resource Video:** <http://thebusinessprofessor.com/environmental-impact-statement-nepa/>

- **Discussion:** How do you feel about the procedural requirements of NEPA? Do you believe the environmental assessment and environmental impact statements are necessary procedures for administering the environmental laws? Does it affect your opinion to know that agencies are not required to follow the impact statement recommendations? Should these requirements be measured against the burden imposed upon the agency by these requirements?

- **Practice Question:** The Department of Agriculture is pursuing a plan to construct a large water distillation facility in New Mexico. What environmental law procedures must the agency follow before undertaking this project?

6. What is the Clean Air Act?

Clean Air Act (CAA), along with numerous amendments, was passed with the purpose of developing and achieving air quality standards throughout the US. It gave rise to the National Ambient Air Quality Standards (NAAQS), which limit the amount of certain air pollutants discharged into the air based upon air quality standards averaged over specific intervals of time. The EPA issues primary and secondary quality standards.

- *Primary Air Quality Standards* - These standards relate to levels of air particulates that pose a risk to public health; and
- *Secondary Air Quality Standards* - These standards relate to the negative consequences of the pollution on the environment or property (but generally outside of the threat to human health).

- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-clean-air-act/>

The primary components of the CAA are as follows:

- *State Implementation Plans (SIPs)* - States bear the burden of implementing a plan to comply with national air quality standards (NAAQS). The NAAQS provide a maximum concentration level for certain pollutants in the air. A state has a great deal of latitude in developing a plan to implement these standards, or “state implementation plan” (SIP). Under this structure, each state must submit a SIP to the EPA that provides for implementation, maintenance, and enforcement in each air-quality control region. The EPA Administrator must approve SIPs as complete and meeting all requirements. If EPA finds a SIP inadequate to attain or maintain NAAQS, it can require revision of the plan. If the EPA finds a SIP incomplete, a state fails to make the required submissions, or if it disapproves a SIP in whole or part, it will promulgate a federal implementation plan (FIP). The EPA must promulgate the FIP within 2 years of disapproval of the SIP unless the state corrects the deficiency and the Administrator approves it.

- **Resource Video:** <http://thebusinessprofessor.com/state-implementation-plan-clean-air-act/>

- *New Source Performance Standards (NSPS) and New Source Review (NSR)* - This is a federal set of uniform technology-based standards for new and modified sources of air pollution. These rules envision a best available technology (BAT) for categories of stationary air pollution sources. Standards can vary within each category according to class, type, and size of source. The NSPS establishes emission limitations achievable through application of adequately-demonstrated BAT, taking into account cost, non-air quality health or environmental impacts, and energy requirements. There is often controversy over what constitutes BAT, whether the EPA took into account the cost and other factors associated with compliance, and whether technology has been adequately

demonstrated. NSR is one of the key programs designed to achieve compliance with the NAAQS through a pre-construction review process for new and modified stationary sources.

- *Note:* Existing sources of air pollution must meet NAAQS but are exempt from many of the NSPS requirements.

- **Resource Video:** <http://thebusinessprofessor.com/clean-air-act-new-source-performance-standards-and-new-source-review/>

- *Prevention of Significant Deterioration (PSD)* - Amendments to the CAA in 1997 established a PSD structure which requires permits for areas that have achieved better air quality standards than required under NAAQS. These areas are known as “attainment areas”. The state administers this permitting process with EPA approval. This system includes ambient (increment & NAAQS compliance) and Best Available Control Technology (BACT) components. The BACT standards tend to be more stringent than NSPS. As with the BAT standards, BACT standards do not require a particular technology; rather, they provide a process for choosing what control technology to employ.

- **Resource Video:** <http://thebusinessprofessor.com/clean-air-act-prevention-of-significant-deterioration/>

- *Non-Attainment* - Congress amended CAA in 1977 to add Part D for “non-attainment” areas. Under these new provisions, states unable to achieve NAAQS must comply with Part D. Part D imposes construction and operating permit requirements on new and modified sources of pollution in these areas. Before issuing permits to create new or modified sources, the EPA must find:
 - *Comply with Lowest Achievable Emission Rate (LAER)* - This is a category-wide determination of whether the new or modified source would meet the most stringent emission limitations contained in a SIP or achieved in general practice (whichever is more stringent).
 - *Note:* The source can demonstrate that an emission limitation is not achievable, but it can never emit above the NSPS level.
 - *Reasonable Further Progress (RFP)* - The source must demonstrate a decrease in total allowable emissions in the region or annual incremental reductions in emissions of applicable air pollutants sufficient to provide for attainment of NAAQS by the specified deadline. A new source can demonstrate RFP by obtaining offsets (decreases in emissions) from existing sources. Basically, the source can employ under-pollution credits from other sources and apply it to the current source to meet overall standards. The offset policy intends to strike a balance between economic and environmental protection interests.
 - *Note:* This provision enables non-attainment areas to continue to develop economically while moving toward NAAQS attainment.
 - *Compliance Schedule* - The new or modified source must provide a schedule for compliance of all

sources owned by this source's owner.

In 1990, Congress created levels of non-attainment for individual pollutants, with different target dates for compliance with NAAQS. States are also required to demonstrate RFP in their SIPs. This amendment also added two more requirements before issuing a permit (in addition to RFP, LAER, compliance of owner):

- Administrator must not have found a SIP was inadequately implemented by the state, and
- An alternative analysis must demonstrate that the benefits of the proposed new source outweigh the environmental costs.

- **Resource Video:** <http://thebusinessprofessor.com/clean-air-act-non-attainment-areas/>

- *Interstate Pollution* - The CAA statutes are poorly designed to address interstate externalities, as no programs require consideration of the effects in other states of the placement or number of new pollution sources. The EPA addresses this concern by conditioning SIP approval on a states' plan not contributing significantly to non-attainment in, or interfere with maintenance by, any other state of a primary or secondary NAAQS. Also, the SIP cannot interfere with measures required in another state's SIP.

- *Note:* This allows a downwind state to sue the EPA Administrator for approving a SIP (or revision) that interferes with downwind attainment. The 1977 Amendments authorized states or political subdivisions to petition the EPA (at any time) for a finding that a major source or group of sources in another state are causing them to violate NAAQS. It also requires a state to provide notice to nearby states when it proposes to build a new or modified PSD source or one that might contribute significantly to compliance with downwind NAAQS.

- **Resource Video:** <http://thebusinessprofessor.com/clean-air-act-interstate-pollution/>

- *Enforcement* - The EPA can initiate or take part in enforcement actions for violations of the CAA. This includes seeking administrative orders, civil sanctions, or participating in criminal actions through the Justice Department. The CAA authorizes fines of up to \$25,000 per day for emissions violations. Criminal sanctions include fines of individuals up to \$250,000 and up to 15 years in prison. Corporations can be fined up to \$1 million per incident for knowingly endangering people with emissions and up to \$500,000 per incident for negligent emissions.

- *Note:* The EPA has approved numerous state plans to allow polluters to save or "bank" any amount that the company falls below its maximum pollution threshold. This allows the company to use this amount as a sort of credit and pollute more at a later period. Companies are also allowed to sell or trade in these banked pollution rights. This allows cleaner companies to sell their benefits to heavier polluters.

- **Resource Video:** <http://thebusinessprofessor.com/clean-air-act-enforcement-provisions/>

- **Discussion:** How do you feel about the Clean Air Acts combination of state and federal enforcement regime? Do you believe the regulatory measures are sufficient to achieve the Act's objectives? Should the individual requirements on polluters be balanced against the economic needs of a region?
- **Practice Question:** ABC Corp plans on building a new factory in New Mexico and very close to the border of Arizona. Under the Clean Air Act, what procedures might ABC have to follow in order to receive the necessary permissions to build and operate this facility?

7. What is The Clean Water Act?

The Clean Water Act (CWA) is made up of several water pollution control acts including, the Federal Water Pollution Control Act, the Clean Water Act, and the Water Quality Act. The CWA protects society from the harmful effects of discharge of pollutants into navigable waterways by municipal and industrial dischargers. It regulates discharges from what are known as “point sources” and “non-point sources”.

- *Point Sources* - These include direct discharges from an immediate point, such as a pipe or drainage culvert. The CWA requires point source polluters to install or implement best practicable technology (BPT) and best available technology (BAT), based upon new or existing points sources. The CWA further prohibits discharges from a point source without a permit, which requires that the discharge meet defined effluent limitations. This is a similar approach to CAA's new source limitations.
- *Non-point Sources* - These include indirect discharge such drainage and run-off from spraying. While this type of discharge is not directly regulated by the CWA, the EPA is authorized under the CWA to require polluters to adopt limitations necessary to meet state water-quality (WQ) standards. The CWA also requires that a state implement any of the following plans to regulate non-point discharges:
 - *Area-wide Waste Management Plans* - This may include broad-scale waste treatment plans for areas with substantial water quality problems.
 - *State Management Plans* - A management plan must include best management practices for non-point sources such as agricultural operations.
 - *Permit Program* - A state can use a marketable permit scheme approach to regulate non-point discharge of pollutants.

The EPA requires that states designate uses of intrastate waters with the goal of fishable or swimmable quality and set standards for the total “maximum daily load” of pollutants in a body of water. States must determine the water quality criteria necessary to support the designated use. Either numerical concentrations or narrative criteria may be considered. States must then meet the non-degradation policy limiting any degradation from prior water quality. The EPA also has a means for controlling interstate pollution such that a downstream state can enforce its water-quality standards against upstream pollution sources.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-clean-water-act/>

The CWA allows for variances from its requirements when circumstances justify exemption. There are two main exemptions available to existing sources:

- *Economic Justification* - If a party cannot afford the BAT requirements, it must show that the technology employed to prevent discharge of pollution is all that the company can afford and that it will be effective in reducing pollution to within allowable levels. This variance effectively modifies the BAT for this party.
- *Process Justification* - A Fundamentally Different Factor (FDF) variance allows certain exemptions from the BPT permitting requirements. The EPA will consider the cost of implementation (such as facility or manufacturing costs), but the ability of the party requesting the variance to pay the cost is not considered.

- **Resource Video:** <http://thebusinessprofessor.com/clean-water-act-exceptions-or-variances/>

Other relevant Clean Water laws include the Marine Protection, Research, and Sanctuaries Act of 1972 (MPRSA) and Safe Drinking Water Act of 1974 (SDWA). The MPRSA requires a polluter to receive a permit system before discharging potential pollutants into the ocean. The SDWA requires the EPA to set maximum acceptable levels for certain contaminants in drinking water.

- **Discussion:** How do you feel about the protective requirements of the Clean Water Act? Why do you think the CWA focus on point, rather than non-point, polluters? Do you have confidence that the best practical and best available technology standards, along with the permit system, are sufficient protections? Do you believe that the standards applicable to non-point polluters are appropriate? Why do you think the CWA allows for exemptions from its provisions based upon economic impact or process issues?
- **Practice Question:** ABC Corp is a manufacturer of textiles. For the last 30 years, ABC has runs a factory located on a river that emits some level of point-source pollution in the local river. What Clean Water Act standards must ABC meet in order to continue its operations?

8. What is the Endangered Species Act of 1973?

The Endangered Species Act (ESA) protects animals and plants that the Secretary of Interior or marine species that the Secretary of Commerce lists as “threatened” or “endangered”. The Fish and Wildlife Services (FWS) and National Marine Fisheries Services administer (NMFS) administer the ESA. The determination of whether a species is endangered or threatened is made “solely on basis of best scientific and commercial data available” without consideration of cost of protection. A species is “endangered” if “in danger of extinction throughout all or a significant portion of its range”. A species is “threatened” if likely to become endangered in the “foreseeable future”. The Secretary must also designate a “critical habitat” for the endangered or threatened species. The secretary will take the “economic impact” and “other relevant impact” into consideration in making this designation.

Protections - The ESA provides the following protections for endangered or threatened wildlife:

- *Federal Agency Action* - The ESA prohibits any federal action that jeopardizes endangered or threatened species or results in destruction or adverse modification of their critical habitat. Under these rules, no federal agency can authorize, fund or carry out any action that jeopardizes an endangered species. The ESA states that all federal agencies shall carry out programs for conservation of endangered or threatened species. “Conserve” is defined as “use of all methods and procedures necessary to bring any endangered or threatened species to the point” where they do not need saving. A federal agency can only take actions that are “not likely to jeopardize a protected species”. The Endangered Species Committee is authorized to exempt certain agency actions from the “no jeopardy” requirements. Exemption requires a supermajority vote, finding that there are “no reasonable and prudent alternatives to the agency action”, and that benefits of the action “clearly outweigh” benefits of non-jeopardizing alternative courses of action. The ESA requires consultation between agency contemplating a project and the ESA administering agency to determine if the no jeopardy regime would be violated.
 - *Note:* The law authorizes civil actions against the Secretary for failure to perform non-discretionary duty.
- *Private Actions* - The ESA makes it unlawful for any person to “take” any listed species. “Taking” means to “harass, harm, pursue, hunt, shoot, wound, kill, trap, capture, or collect, or attempt to engage in any such conduct.” This is a slightly more lenient than the “no jeopardy” requirements since it only applies to endangered species (not threatened species). Also, private parties may apply for permits for actions that otherwise constitute violations of the law. The Secretary may issue permits for otherwise proscribed takings that are “incidental to the carrying out of otherwise lawful activity or exemptions for scientific purposes”. As a condition of the incidental taking permit, the holder must submit a conservation plan to “minimize and mitigate” the impact of the taking. Usually this involves a commitment to acquire and conserve some land to provide a suitable habitat for the species.
 - *Note:* Section 9 of the ESA prohibits any person from transporting or trading in any endangered species of fish or wildlife or from taking any such species with in the United States.

The ESA strictly prohibits considering the financial or economic impacts of implementation the act’s provisions. A review board can grant exemptions to the ESA for certain important federal projects, but not for private activities. The ESA requires recovery plans for species it protects.

- **Discussion:** How do you feel about the protections afforded under the Endangered Species Act? Do you feel like the restrictions are sufficient to achieve the results of the law? What do you think about the exemption from prohibitions on federal actions and private takings? Why do you think the private taking restrictions do not apply to threatened species? How do you feel about the granting of permits for private takings?
- **Practice Question:** ABC Corp is thinking of expanding its manufacturing footprint. It intends to clear cut about 200 acres of land beside its current plant to construct a new facility. ABC is aware that the forest is full of animals. What limitations might ABC face when attempting to clear the land?
- **Resource Video:** <http://thebusinessprofessor.com/endangered-species-act/>

9. What federal laws control pesticides?

There are two primary federal pesticide acts:

- the Federal Insecticide, Fungicide, and Rodenticide Act of 1947, and
- the Federal Environmental Pesticide Control Act of 1972.

Both of these acts require registration and labeling of agricultural pesticides. The EPA is directed to register those pesticides and certify that they are properly labeled, that they meet the claims made as to their effectiveness, and that they will not have unreasonable adverse effects on the environment. Further, manufacturers must label them as “general” or “restricted use” and place training requirements on applicators. The EPA can deny or suspend registration or it can halt manufacture of the product. The EPA defines what the pesticides can and cannot be used for and may seek penalties against violators.

- **Discussion:** Why do you think pesticides are regulated by federal law? Do you think the requirement to register pesticide products is sufficient to protect the public and environment from adverse effects? Should the need for the pesticides be weighed against its environmental impact?
- **Practice Question:** ABC Corp manufactures chemicals. It seeks to introduce a new chemical used to rid crops of specific bugs. What requirements must ABC meet before introducing the pesticide?
- **Resource Video:** <http://thebusinessprofessor.com/primary-federal-laws-governing-pesticides/>

10. What laws govern solid waste disposal?

The Solid Waste Disposal Act (SWDA) was the first major federal law directed at waste disposal. It recognizes the potentially negative health and environmental consequences associated with certain waste disposal practices. The SWDA provides waste management standards for municipal and industrial waste, promotes waste management technology, and charges municipalities with responsibility for disposal of solid waste. The SWDA is subject to numerous amendments expanding its coverage as follows:

- *The Resource Recover Act of 1970 (RRA)* - This act added to the SWDA by introducing waste reduction provisions (such as recycling) and laid out criteria for disposal of hazardous waste.
- *The Resource Conservation and Recovery Act of 1976 (RCRA)* - This act added again to the SDWA by expanding its coverage and focus to include the development of new waste disposal technology. Notably, the RCRA banned the use of open-land dumping and placed additional liabilities on creators of waste (even after entry into a waste disposal system). It made creators of hazardous waste ultimately responsible for waste generated at any point in its existence. This is known as “cradle-to-grave” responsibility. It established a system for tracking hazardous waste throughout its life.
- *The Hazardous and Solid Waste Amendments* - These amendments to the SDWA were passed in 1984 to place more stringent requirements on the management and disposal of hazardous waste and established underground waste storage standards.

- *The Federal Facilities Compliance Act of 1992* - This act amended the SDWA yet again to make federal facilities accountable and subject to the provisions of the SWDA.

The EPA is primarily charged with enforcing the provisions of the SWDA through administrative, civil, and criminal actions. The regulations developed by the EPA to administer the provisions of the SWDA are a primary compliance concern for businesses.

- *Note:* The SWDA prohibits retaliation against employees for providing information about environmental infractions to the EPA. Retaliation may be any form of negative action against an employee motivated by the employee's disclosure of information.

- **Discussion:** Why do you think waste disposal is a concern of the Federal Government? Do you think the breadth of coverage of waste disposal laws is adequate?
- **Practice Question:** ABC Corp is accused by an employee of failing to comply with federal standards in the disposal of solid waste. What are the methods for the employee to enforce the laws against ABC? What are the risks to the employee of doing so?
- **Resource Video:** <http://thebusinessprofessor.com/solid-waste-disposal-act/>

11. What is the Toxic Substance Control Act of 1976?

The Toxic Substance Control Act (TSCA) regulates the introduction of new and existing chemical substances into the market. The TSCA defines a chemical substance as "any organic or inorganic substance of a particular molecular identity, including any combination of these substances occurring in whole or in part as a result of a chemical reaction or occurring in nature, and any element or uncombined radical". Many of the provisions of the TSCA focus on chemicals that pose an unreasonable risk of harm to health and the environment. The TSCA specifically prohibits the manufacture or importation of chemicals not previously registered with the TSA without notifying the EPA beforehand. Following notification, the EPA reviews the chemical to determine if it poses an unreasonable risk to human health or the environment. The EPA may ban production and importation or impose lesser limitations on its production and use.

- *Note:* Exceptions to the TSCA notification requirement include small quantities of chemicals used in research and development and items regulated under other acts, such as food, cosmetics, pesticides, alcohol, tobacco, explosives, and radioactive material.

- **Discussion:** Why do you think controlling the importation of toxic substances is of concern to the Federal Government? Do you think the definition of chemical substance is sufficiently broad? Do you agree that the EPA should be charged with determining whether chemicals should be admitted for importation?
- **Practice Question:** ABC Corp has subsidiaries in other countries that develop new products. ABC develops a new chemical used to remove paint from cement surfaces. The chemical is very caustic. What steps must ABC Corp take before importing the substance?
- **Resource Video:** <http://thebusinessprofessor.com/toxic-substance-control-act-of-1976/>

12. What is the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)?

In 1980, Congress passed the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) to address cleanup cost of unsafe hazardous waste dumps or spills. CERCLA allocates billions of dollars under a congressional authorization for environmental cleanup of dangerous hazardous wastes. This is known as the “Superfund”. The continued funding of the superfund is through civil actions against polluters and three separate taxes levied on chemicals, petroleum products, and general corporate profits. The superfund pays for cleanups where private parties are insolvent or the responsible party is unknown. It advances money to the EPA for cleanups pending recovery of costs, which often leads to suits for reimbursement from the responsible parties.

- *Note:* Funds allocated to the superfund are largely depleted and the long-term sustainability of the program is consistently in question.

Liability - CERCLA imposes strict liability on those responsible for unauthorized discharges of hazardous waste. Federal and state agencies charged with managing natural resources may sue a responsible party to force clean up of hazardous substances and to recover any damages to the natural resources. Liability also includes the cost of remediation of the waste itself. Responsible parties include:

- *Owner Operators* - Those who currently (or previously) operate or own waste disposal sites during the time that the pollution occurred. An “operator” is someone who directs the workings of, manages, or conducts operations specifically related to pollution. Responsible parties also include owners or operators who learned of the pollution and did not disclose that information prior to transferring the land.
 - *Note:* CERCLA exempts people who hold indicia of ownership to protect a security interest without participating in management of a facility. This provision generally protects banks holding a security interest in contaminate property.
- *Arranger Liability* - Those who arrange for disposal of wastes may be responsible parties. Most courts hold that an intent to dispose of the waste is necessary for liability. The intent inquiry is only relevant for determining if an individual is a responsible party. After that step, the responsible party is strictly liable and intent to have disposed of the waste in a different manner is irrelevant.
- *Transporters* - Transporters of hazardous wastes are only liable if they actively and substantially participate in the decision-making process that ultimately identifies a facility for disposal. It does not need to be an independent decision to select the particular site, but the transporter must have a significant influence in the selection process for liability.

The responsible party may be able to seek contribution from former owners of the polluted land for any damages paid. A finding that harm is divisible lets responsible parties divide liability. Responsible parties have the burden of showing their waste and cleanup costs are divisible from other parties. This avoids the unfair consequences and prevents a party from escaping liability when other parties are insolvent or cannot be found.

Defenses to Liability - The purchaser of contaminated property may escape liability through a number of defenses, as follows:

- *Good Faith* - The owner had no knowledge of the waste at the time of purchase and used due diligence in checking the land for toxic hazards.
- *Force Majeure* - The pollution was caused by an act of God (natural occurrence) or was caused during war.
- *Third Party Liable* - The pollution was the result of an act or omission of an identifiable third party. A responsible party may avoid liability if it can show that someone else was the sole cause of the harm, it was not the responsible party's employee or agent, and the acts or omission causing the pollution did not occur in connection with a contractual relationship with the responsible party. Finally, the potentially responsible party must also show that she exercised due care with respect to the discharge of a hazardous substance and took precautions against foreseeable acts or omissions of the polluter.

Individuals can purchase CERCLA insurance for potential liability.

- **Discussion:** What do you think about the CERCLA protections? Do you think the superfund program is adequate to provide for hazardous waste cleanup? Do you think the liability provisions are fair and serve the intended purpose? How do you feel about the available defenses to personal liability under CERCLA?
- **Practice Question:** ABC Corp purchases land from 123 Corp. ABC continues using the land in the same manner as used by 123 Corp. Several years later, ABC becomes aware that the land is contaminated? What potential liability does ABC face? What are their options for deferring or sharing liability with 123 Corp?
- **Resource Video:** <http://thebusinessprofessor.com/comprehensive-environmental-response-compensation-and-liability-act-cercla/>

TOPIC 23: INTELLECTUAL PROPERTY

Overview

Intellectual property, as the name implies, is an intangible form of property right. It establishes rights that extend beyond the possession of a physical item and protects an individual's ideas, plans, procedures, information, creations (function and design), etc. This chapter introduces the concept of intellectual property, its economic importance, and the four major types - trade secrets, patents, trademarks, and copyrights. It then proceeds to explain the nature of each form of intellectual property right and the process for securing those rights. It also provides the extent of protection afforded the holder of intellectual property rights and the method or manner of enforcing those rights against infringers.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

• <u>Intellectual Property</u> - <u>Purpose</u> - <u>Capturing</u> • <u>Trade Secret</u> • <u>Patents</u> - <u>Types</u> - <u>Novel, Non-Obvious & Useful</u> - <u>Patentable Subject Matter</u> - <u>Filing a Patent</u> - <u>Provisional Patent</u> - <u>Enforcement</u>	• <u>Trademark</u> - <u>Types</u> - <u>Securing Trademark Protection</u> - <u>Distinctiveness</u> - <u>Assessing Distinctiveness</u> - <u>Registering a Trademark</u> - <u>Filing Process</u> - <u>State-law Protections</u> - <u>Denying Trademark Protection</u> - <u>Enforcement</u> - <u>Determining Infringement</u>	• <u>Copyrights</u> - <u>Protections</u> - <u>Requirements</u> - <u>Duration</u> - <u>Registering</u> - <u>Holders</u> - <u>Enforcement</u> - <u>Defenses</u> - <u>Fair Use</u>
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TOPIC 23: INTELLECTUAL PROPERTY - QUESTIONS & ANSWERS

1. What is intellectual property?

Intellectual property is an intangible (not touchable) form of property or right. The types of legally recognized intellectual property right include:

- *Trade Secrets* - Intra-firm information that has economic value, is not commonly known, and is subject to internal measures to protect the information from disclosure.
- *Copyrights* - An original, creative work of authorship that is affixed to a tangible medium (printed, recorded, etc.)
- *Trademarks* - A distinctive word, symbol, logo, or other mark that is used in commerce to represent a business, its products, or services.
- *Patents* - Discoveries, designs, or inventions constituting patentable subject matter that is novel, non-obvious, and useful.

Generally, intellectual property rights afford the owner or a holder the right to exclude others from selling, importing, or otherwise commercializing the subject property.

- *Note:* The owner or holder of intellectual property may have the right to exclude others from infringing upon her rights but not have the right to use or possess a manifestation of its intellectual property.
- *Example:* Dan designs a machine that can simultaneously fire hundreds of projectiles (bullets) per second. While he may be able to patent this creation and exclude others from developing and selling his invention, it may be illegal for him to actually possess this type of weapon.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-intellectual-property/>

2. What is the purpose behind granting ownership rights in intellectual property?

Like other forms of tangible property, the rights associated with intellectual property incentivize individual productivity. The exclusive right to use or control property also incentivizes creativity. This belief is captured in Article 1, Section 8 of the US Constitution, which grants Congress the power “to promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.” In furtherance of this purpose, the Federal Government created an extensive statutory and regulatory framework for the recognition and enforcement of intellectual property rights.

- *Note:* Generally, intellectual property rights (particularly patents) grant a limited monopoly to the holder in exchange for full disclosure of the intellectual property rights to the public. This is not true for trade secrets, which require secrecy.

- **Discussion:** How do you feel about the concept of intellectual property? Should individuals be able to establish rights in a form of creation that limits the ability of others to employ that creation in a commercial manner? Why or why not? How is this different from a monopoly, which is generally illegal under antitrust law?
- **Practice Question:** Payton and Eric are having a discussion over the usefulness and necessity of a government allowing for intellectual rights. They ask your opinion as to why the government allows for such rights. What can you tell them about the origin and purpose of intellectual property rights in the United States?
- **Resource Video:** <http://thebusinessprofessor.com/justification-for-intellectual-property-rights/>

3. What does an individual have to do to capture intellectual property rights?

The requirements for securing intellectual property rights vary depending upon the type. For example, some types of intellectual property may require filing with a government agency. Failure to file or meet a filing deadline could forfeit one's rights to the "public domain". Once intellectual property is in the public domain, an individual's rights in the property are forfeited and cannot be recaptured. This is just one simple example of many separate requirements that may apply when attempting to secure rights in a particular item of intellectual property. The requirements for securing rights in intellectual property are discussed separately.

- **Discussion:** Why do you think Congress provides for varying methods of securing intellectual property rights based upon the type of intellectual property? Is there an argument that the procedures should be more uniform?
- **Resource Video:** <http://thebusinessprofessor.com/capturing-or-securing-intellectual-property-rights/>

TRADE SECRETS

4. What are trade secrets?

A trade secret is a form of intellectual property specific to individuals or businesses involved in a trade or industry. More specifically, it is any form of knowledge or information that:

- has economic value from not being generally known to, or readily ascertainable by proper means by, others; and
- has been the subject of reasonable efforts by the owner to maintain secrecy.

Trade secrets may include a broad range of company information, such as project or strategic plans, operational methods, customer lists, designs, and research and development.

Trade secrets are protected under common law and many states have adopted forms of the Uniform Trademark Secrets Act (UTSA). Both provide causes of action against individuals who misappropriate the information kept as a trade secret. The theory behind liability is that an individual who misappropriates the information breaches a duty of loyalty owed to the owner. Trade secret rights never expire, unless the information loses economic value or is no longer kept secret by the

company.

- *Note:* Competitors may legally assemble, reverse-engineer, or otherwise uncover information subject to a trade secret. The sole limitation is that a competitor cannot misappropriate the information from the holder of the trade secret.
 - *Example:* A trade secret could be a recipe, customer list, or strategy for carrying out a process. If Cheap-Cola reverse-engineers the Coca-Cola formula, it is free to use the trade secret in commerce without violating Coca-Cola's rights. If, however, Cheap-Cola pays a Coca-Cola employee for the secret recipe, it would violate Coca-Cola's rights to sell a product employing that recipe.
- **Discussion:** How do you feel about the idea that a company's private information cannot be taken and used by others? How do you think these types of protections affect industry competition? Can you think of any companies that successfully use trade secret rights in selling a product?
 - **Practice Question:** Jim works for Sweet Melissa's Barbecue Sauce Company as a taste engineer. He works with combinations of spices to make the Sweet Melissa sauce line tasty. He is considering leaving the company to start his own sauce line. He developed several sauces for Sweet Melissa that he knows are not patented. He believes that he can take these recipes and develop a successful product line. Does Jim potentially face liability if he uses the recipes he developed when working for Sweet Melissa's?
 - **Resource Videos:** <http://thebusinessprofessor.com/what-are-trade-secrets/>

PATENT RIGHTS

5. What are patents or patent rights?

A patent is a form of intellectual property protection that covers products, processes, designs, and other creations (collectively "invention"). A patent conveys a right to exclude others from making, using, selling, or importing the covered invention. Patent rights are basically rights to exclude others. They protect against copies or unauthorized reproductions of the patented item. Patent rights are the subject of federal law, and states may not grant or otherwise regulate patents. The US Patent and Trademark Office (USPTO) is a federal agency that administers the patent system. It reviews and grants petitions to secure patent rights.

- *Note:* Registering a patent with the US Customs and Border Protection Agency may help prevent infringement, such as bringing counterfeit goods into the US.

Consistent with other forms of intellectual property, the purpose or objectives of the patent system is to record and disclose patents to the public. The trade off for public disclosure of the invention process is protection of limited rights in the property. The effect is to promote or provide an incentive for creation and innovation. The belief is that innovation is a benefit to society. Providing an individual the right to exclude others from reproducing her creation for commercial purposes allows her to capitalize on her creation without competition. Patent rights last for a statutory period of time (14 or 20 years). Contrary to popular belief, patent rights do not confer the right to make, use, or sell a patented creation. These rights are subject to any laws, regulations, ordinances, etc., that pertain to and may limit rights to use this type of creation (such as environmental regulations, licensing, antitrust rules, consumer regulations, private contracts, etc.).

Further, the patent holder may not use her patent in a manner that infringes on the rights of others.

- *Note:* Patent protection does not stop a valid purchaser of the item from using the item. Further, it does not stop that individual from reselling the item. It does, however, stop the individual from manufacturing the item, selling the copied item, or (in some instances) using the unauthorized copy. Patent rights provide a specific period of protection that varies depending upon the type of patent. After the expiration of that time, anyone can use, produce, or sell the patented subject-matter (i.e., it enters the “public domain”).
- *Example:* BigPharm Corp buys the patent rights to a new drug. It spends over \$1 Billion on research and development. Once the clinical trials are complete and the drug is FDA approved, BigPharm releases the drug to the public. Other drug companies are prevented from reproducing the drug and selling it for a 20-year period. In many industries (such as pharmaceuticals) it is imperative to allow creators the ability to recuperate their costs before allowing competitors to capitalize by copying their creation.

- **Discussion:** How do you feel about the government granting individuals the exclusive right to make, use, or sell their invention? Why do you think patent rights only allow the ability to exclude others?
- **Practice Question:** Mandy is a metal worker. She builds a new machine for bending metal. If Mandy is considering starting a business manufacturing and selling the machine, what are the advantages of pursuing patent protection?
- **Resource Videos:** <http://thebusinessprofessor.com/overview-of-patents/>

6. What are the primary types of patents?

There are three categories of patent, as follows:

- *Utility Patents* - This generally covers the creation of a new composition of matter, function, or process. This includes machines, procedures, and chemical compounds. These creations must be a novel (new), non-obvious, and useful. The term of protection is 20 years from the date of filing.
- *Design Patents* - This covers the pattern, design, or overall appearance (including ornamentation) of a product. It generally includes new, original, and ornamental or aesthetic design for an article of manufacture. It concerns appearance and is not related to function. The term of protection is 14 years from date of issue.
- *Plant Patents* - This covers the development of a new plant species through genetic engineering. This may include hybrid species of crops or a new variety of plant that can be reproduced asexually. The term of protection is 20 years from date of filing.

Utility patents are commonly employed by firms with the objective of creating innovative products or processes. Design patents, on the other hand, are the focus of aesthetic differentiation for new or existing products. Plant patents serve an important role in the development of greater food production methods and genetically modified strains of plant that produce more and better withstand environmental pressures.

- **Discussion:** Why do you think these three types of creation are granted specific categories of patent protection? Why do you think the period of protection differs among these types of patents?
- **Practice Questions:** Patrick developed a native, smartphone application with supporting software capability. He believes that he will be able to commercialize his invention. He is curious as to what type of intellectual property protection he should pursue?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-the-types-of-patent/>

7. What are the general requirements for an invention or discovery to be capable of patent protection?

The subject of a claimed patent must be eligible for patent protection. Eligible subject matter varies slightly depending upon the type of patent. That is, a design patent must attach to some physical item, while a utility patent has a broader range of potential subject matter. Once determined to be patentable, a specific subject matter must be “novel” and “non-obvious”. These two requirements apply to all types of patents. Utility patents have an additional requirement and must also be “useful”.

Novelty - To qualify for patent protection, a creation must be novel. Novelty, in this context, goes beyond the requirement for newness. The subject matter cannot have previously been used, sold, or the subject of patent by another inventor within a year of the patent filing. In summary, this means that the patented item does not currently exist in the claimed form. There are two standards for novelty: 1) the time that the item is disclosed to the public and 2) the time of filing.

- *Time of Disclosure:* The subject of the patent cannot be known, used, or printed in a publication in this country prior to its creation in the US. The creation may be known or used in a foreign country, but it cannot be in a printed publication in a foreign country before it is created in the US. This generally means that if the item was previously known or in use by the public prior to the date of disclosure by the patent filer, it cannot be patented by someone other than the original discloser.
- *Time of Filing Application:* The creation cannot have been previously disclosed to the US public more than one year prior to the filing of the patent application. This means that the item cannot be advertised or in use by the general public. It cannot have been the subject of a patent application in the US or any other country. Further, it cannot be used or described in any publication prior to the application for patent.
 - *Note:* This generally means that once the item is disclosed to the public, the discloser has one year to complete the patent filing process.

Non-Obviousness - The non-obviousness requirement means that someone having ordinary skill in the field would not have a ready knowledge or understanding of the invention. That is, it cannot be readily or commonly understood to the average person in that field or industry. The average person in the field or industry is known as a Person Having Ordinary Skill in The Art (PHOSITA). Basically, if a creation is a logical embodiment of existing knowledge (items of creation already exposed to the world) it will not be eligible for patent protection. As such, the USPTO will examine all prior creations (prior art) in that field to see whether the PHOSITA would deem the proposed creation to be non-obvious.

- *Note:* Simply changing the basic design, size, or arrangement of an existing invention may be an obvious modification to the existing creation. As such, it would lack the element of non-obviousness. External factors,

such as commercial success of the invention, may indicate that there is a novel aspect of the product in the marketplace.

Usefulness - Lastly, a utility patent (but not a design or plant patent) must be “useful”. This means that there must be some benefit or operational purpose to the invention. The petitioner must demonstrate that the creation serves an intended purpose. Even if the item is not currently in use and serving a purpose, it must address some theoretical need that could arise in the future.

- *Note:* In the commercial context, a product or process that does not address any identifiable need or want of any potential end user is likely not useful.
- **Discussion:** Why do you think the USPTO requires these elements (novelty, non-obviousness, and usefulness) when granting patent protection? Do you think each of these elements are necessary or should be required? Why or why not? What do you think about the PHOSITA standard for determining non-obviousness? Can you think of other efforts or showings that should be present?
 - **Practice Question:** Patrick developed a native, smartphone application with supporting software capability. He believes that he will be able to commercialize his invention. He is curious about what he will have to demonstrate about his application in order to receive utility patent protection?
 - **Resource Video:** <http://thebusinessprofessor.com/requirements-of-a-valid-patent/>

8. What are the specific requirements for a creation to receive design patent protection?

Design patents apply to "the visual ornamental characteristics embodied in, or applied to, an article of manufacture." So, the subject matter of a design patent application must be the ornamental characteristics applied to a physical item. More specifically, the design patent protects non-functional, purely form (shape or configuration) and aesthetic aspects of a patentable subject matter. The item must still meet the subject-matter requirements for a patent, as the design must be inseparable from the item to which it is attached. The design of the creation must also meet “novelty” and “non-obviousness” requirements. The design does not have to have “utility” (usefulness), as the protected creation is ornamental rather than functional in nature.

- **Discussion:** How do you feel about the ability to protect an ornamental design through patent? How are designs unique in nature from creations with function or utility? Are the objectives behind protecting these rights similar? How are they different?
 - **Practice Question:** Leni is a seamstress. She has been brainstorming some unique dresses for infants and young girls. She is scared to let anyone see her designs for fear that they will be copied. If Leni wants to commercialize her designs, what type of intellectual property protections should she pursue and what will she have to demonstrate to achieve that protection?
 - **Resource Video:** <http://thebusinessprofessor.com/requirements-for-a-design-patent/>

9. What are the specific requirements for a creation to receive utility patent protection?

A utility patent protects how something functions or the method in which it is employed. The subject matter of a utility patent is any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof. It may also include improvements on any of these inventions or discoveries that meet the previously-discussed requirements for patentability. The types of patentable subject matter are as follows:

- *Process* - This involves a method of carrying out an activity. It may also involve the effort exerted to effectuate a change in a physical material that alters its character. This includes methods of communicating information, processes or methods (unique sequences of steps) in addressing a business objective.
 - *Example:* A patentable processes could include computer software, a method of engineering a product, a method of valuing stocks, etc.
- *Machine* - This is a device or combination of devices that has some function or utility.
 - *Example:* A machine is a functional device (mechanical or electronic), such as a jackhammer or robotic device.
- *Manufacture* - An article of manufacture is a finished creation that has utility but may not be mechanical or have moving parts.
 - *Example:* Tupperware is an article of manufacture that has utility but is not a machine. Other examples may include a double-walled thermos, spiral notebook, folded corrugated box.
- *Composition of Matter* - Any mixture of ingredients or materials to form a new chemical compound or matter.
 - *Example:* A composition of matter may include special forms of rubber, plastic, glue or cement, and pharmaceutical drugs. It may also include genetically altered (or isolated) aspects of plants or organisms.

While novel inventions or discoveries may be susceptible of patent protection, there are several categories that are not capable of being patented:

- *Naturally Occurring Substances* - Examples would include naturally occurring minerals or elements.
- *Laws of Nature* - Examples include gravity, inertia, or atrophy.
- *Physical Phenomena* - Examples may include the northern lights, earthquakes, tornadoes, hurricanes, and plant or animal growth.
- *Abstract ideas* - Examples may include scientific hypotheses, such as the big bang theory or human evolution.
- *Fundamental Truths* - Examples may include religious or political beliefs innate to a system of belief or governance, such as the ideas that all individuals are created equal.
- *Calculation Methods* - Examples of methods of calculating things include Celsius, Fahrenheit, or Jules.

- *Mathematical Formulas* - Examples include mathematical formula that demonstrate or explain activity, such as $E=MC^2$.

These categories include practically everything made by humans and the processes for making those things. Remember, once the utility patent meets the subject-matter requirement, the application must demonstrate that it is “novel”, “nonobvious”, and “useful”.

- **Discussion:** How do you feel about these categories of patentable subject matter? Why do you think the above-listed items are excluded from patent protection? Can you think of other classes of item that should be patentable or excluded from patent protection?
- **Practice Question:** Ernie is a psychologist. He devised an effective question and answer examination used to determine the compatibility of a new employee within the current workforce. The actual questions he uses are less relevant than the pattern and consistency of applicant answers. He is wondering if his evaluation method is the type of creation that is capable of patent protection. What do you think?
- **Resource Video:** <http://thebusinessprofessor.com/patentable-subject-matter-for-a-utility-patent/>

10. What is the process and information necessary for securing patent rights?

Obtaining a patent requires submitting a patent application and filing fee to the USPTO. There are no common law or state patent protections. A patent attorney at the USPTO will review the application to make certain that the intended patent meets all requirements. Notably, the applicant must file the patent application within one year of publicly disclosing the invention (including presenting or selling it) to meet the novelty requirement.

The various elements required in a patent application include the following:

- *Preamble* - The preamble contains the Name of Applicant, Title of the Invention/Design, and Description of the Creation. A utility patent may require background information about the invention or creation process. This section contains what is commonly referred to as the specification(s), which describes how the underlying invention or design will be used. In a utility patent, the applicant will give a detailed description of the invention. It should describe the utility of the invention and how it is differentiated with regard to other art in the field. The applicant will also describe the “best mode” of production of the invention. This section may also include references to or elaborate upon the description of the individual portions of the drawings.
 - *Note:* The detailed description should provide sufficient information to allow a person skilled in this type of invention (PHOSITA) to use or employ the invention. The PHOSITA should not have to undertake much work or further study to employ the creation.
- *Cross-References* - Often a patent builds upon existing art or patented designs. If this is the case, the application should include a citation to any Cross-Referenced Patents.
- *Figure Descriptions* - These are descriptions of referenced sections of drawings of the claimed invention or

design.

- *Claims* - The claim is the claimed aspects of the creation or design that is the subject of the patent application. Utility patents will generally contain multiple claims targeting specific aspects of the invention. In a design patent application, because the entire design (including all individual components) is considered in the design application, only one claim is allowed.
- *Drawings and Images* - A patent application should include detailed drawings of the claimed invention or design. This is very important for the patent examiner to determine whether the claimed invention or design is patentable, as this is what makes it patentable subject matter. The applicant should include as many views (perspective, section, cut away, detail, etc.) of the item as is needed to thoroughly describe each portion of a claim, number each portion of the invention, provide its source (prior patent reference), and provide a brief description of it.
- *Oath or Declaration* - Lastly, the application must contain a statement certifying that the petitioner is the claimed inventor or designer, as these are the only individuals who can secure patent protections.

The patent application generally requires a filing, search, and examination fee. Once the application and fees are received, the USPTO patent examiner will conduct a search for previously filed patents or applications. The purpose of this search is to determine whether the particular creation exists or has been previously disclosed to the public, as the previous creation or disclosure of the invention may disrupt the ability to secure patent rights. If all conditions are met and the search does not return conflicting patent claims, the USPTO will grant the patent and the patent will be recorded in the federal database. The patent owner must make annual maintenance filings and fees to maintain the patent.

- **Discussion:** What do you think about the elements required of a patent application? Why do you think these elements are specifically required? Can you think of other aspects about the invention that could be relevant to determining whether patent rights should be awarded.
- **Practice Question:** Garth is considering filing a patent application to protect his new invention. Can you explain to him the elements of the patent application?
- **Resource Video:** <http://thebusinessprofessor.com/process-for-filing-for-patent-protection/>

11. What is a provisional patent application?

Overview

A provisional patent is a utility patent filing that does not necessarily include any claims. Pursuant to patent law, the filer can file a complete provisional patent within one year of the first public use or offer for sale of the invention. This then allows the filer one year from the date of disclosure to file for a non-provisional, utility patent. Basically, the provisional patent allows inventors to file and disclose the invention to the rest of the world. If the non-provisional patent is filed within the year, the date of filing of the non-provisional patent is retroactive back to the date of filing of the provisional patent. This allows an inventor one year of protection while she is still developing the attributes of the invention that will later be claimed for patent protection.

- *Note:* The non-provisional patent application must reference the provisional patent filing. Failing to file a non-

provisional patent application results in any protections offered by the provisional patent being lost and the creation cannot be subsequently patented.

Benefits

The benefits of completing a provisional patent filing are as follows:

- *Public Disclosure* - This disclosure starts the one-year period to file a non-provisional patent. Filing the provisional patent provides for an initial year of protection, as the non-provisional patent application will back date to the filing of the provisional patent;
- *Continued Research & Development* - The non-provisional patent provides protection while continuing to develop the product and research the market. The inventor can spend the time developing the claimed elements of the invention to incorporate into the non-provisional application;
- *Pre-marketing* - Filing the provisional application allows the inventor to market the product with a degree of protection while the non-provisional patent application is in the works;
- *Public Notice* - The filing provides notice to the world that the creation (to the extent disclosed) is or will be subject to intellectual property rights (i.e., “patent pending”) and should not be copied for commercial purposes;
- *Confidentiality* - Leaving off the claimed attributes keeps elements of the patent confidential (as it is not yet fully disclosed to the public); and
- *Multiple Filings* - The filer can file multiple provisional patents and later incorporate them all into a single, non-provisional patent application.

- **Discussion:** How do you feel about the concept of allowing individuals to file a provisional patent? Are you convinced the benefits of this type of patent filing are necessary or deserved? Why or why not? Can you think of any downsides to making a provision patent filing?
- **Practice Question:** Bernard is working on computer software that allows businesses to automate a great deal of its marketing functions. He is considering filing a provisional patent application. What are the benefits to Bernard of making such a filing?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-provisional-patent/>

12. What is the process for enforcing one’s patent rights?

If anyone infringes upon a patent holder’s valid patent, the holder may bring a federal lawsuit to prevent further use and to seek recovery of damages suffered as a result of the infringement. The patent holder must file a legal action in the federal district court with jurisdiction over the defendant. At the time of filing, the patent holder will state the grounds for the action and request a preliminary injunction against infringement during the pendency of the hearing. The court will review the circumstances to determine whether an injunction is warranted. The grounds for the action must demonstrate one of the following types of infringement:

- *Direct Infringement* - This means the direct production and sale of a product protected by patent.
- *Indirect Infringement* - This means inducing or encouraging an infringer.
- *Contributory Infringement* - This means assisting in the infringement process - such as producing parts or elements of an invention that are known will be assembled into a patent-infringing product.
- *Literal Infringement* - This means that the infringing product or process directly infringes some of the stated terms in the patent filing.
- *Doctrine of Equivalents* - A creation that does not literally infringe upon an invention as written in the patent may still be an infringement if it functions the same manner to achieve the same function. This doctrine is commonly employed in mechanical devices and computer software.

- **Discussion:** How do you feel about the different methods of infringing upon someone's patent? Why do you think the law allows for these different methods of infringement? Do you agree or disagree with any or all of these methods? Can you think of any other uses of a patented creation that should constitute infringement?
- **Practice Question:** Franz invents a coffee maker that injects hot water under high pressure into disposable cups by piercing the top of the cup. The machine filters the coffee before it flows into the consumer's cup. He files and receives utility patent protection of his invention. Gretchen likes the idea and designs a very similar machine that makes coffee by injecting hot water under high pressure into disposable cups by piercing the side of the cup. The machine filters the coffee in a different method. If Franz believes Gretchen has infringed upon his patent, what are his options for demonstrating patent infringement?
- **Resource Video:** <http://thebusinessprofessor.com/process-for-enforcing-patent-rights/>

TRADEMARK LAW

13. What is a Trademark?

A trademark is a form of intellectual property right dedicated to any word, phrase, sign, symbol, logo, color, sound, design, shape, decor, or other distinctive element (collectively known as a "mark") that represents a business, brand, or commercial activity (sale of the product or services). The trademark allows a consumer to identify the business or commercial activity associated with the mark. That is, trademark rights come about from use of the mark in association with goods or services. Trademark law has two objectives:

- *Business Protection* - It allows the owner of the trademark to prevent others from infringing upon that business's identity, and
- *Consumer Confusion* - It protects consumers from confusion regarding the business or commercial activity represented by the mark.

Businesses seek to secure trademark rights to protect their company, brand, or image. They do not want other companies

to benefit from their branding efforts by creating customer confusion as to the source of a given good or service. Even if a customer is not confused, very similar marks can destroy the distinctiveness of a company's mark, thereby making it less recognizable by customers. As such, enforcing trademark rights is an important tool in securing and expanding a business's brand. Without trademark protection, competitors could easily detriment a competing brand by mimicking that brand's mark.

- **Discussion:** How do you feel about the objectives behind granting trademark protection? How does this compare to the objective of granting patent protection? Can you think of any other benefits that a trademark provides for a business?
- **Practice Question:** Holly is launching a clothing line. She is weighing the advantages and disadvantages of seeking trademark protection for her company brand. Can you explain to Holly the purpose of the trademark and the benefits to the business and public?
- **Resource Video:** <http://thebusinessprofessor.com/overview-of-trademarks/>

14. What are the types of trademarks?

The term trademark is commonly used to refer to a broad range of protected marks, including:

- *Trademark* – Any mark, word, picture, or design that attaches to goods to indicate their source.
- *Service Mark* – A mark associated with a service.
- *Certification Mark* – A mark used by someone other than the owner to certify the quality, point of origin, or other characteristics of goods or services.
- *Collective Mark* – A mark representing membership in a certain organization or association.
- *Trade Dress* - Trade dress is broader than a single mark. It protects the overall appearance of a business, product, or service. It may include colors or shapes, architectural design, distinctive store decorating motifs or package shapes and colors. It encompasses the “total image and overall appearance” of a business.
 - *Example:* Think about the shape and color of a Pizza Hut or Taco Bell. These brands are identifying by the overall distinctive appearance of its buildings.

Business names or trade names may be the subject of trademark protection. The name must represent the business, product, or brand.

- **Discussion:** Why do you think the USPTO recognizes multiple classes of mark? Had you previously ever heard of these specific classes of mark? Which one in the group of trademarks is dramatically different than the rest?
- **Practice Question:** Ellen wants to file for trademark protection of the mark that she uses to represent her business.

What are the types of trademark and what do you need to know to determine what type of trademark she will be filing?

- **Resource Video:** <http://thebusinessprofessor.com/types-of-trademark/>

15. What is required to secure trademark protection?

Trademark law requires that a mark be “used in commerce” and “distinctive” from other marks. If a mark is used in commerce and sufficiently distinctive, there are two primary methods of securing trademark protection. The first method is “state-law protection”. State-law protection may include both statutory protection and common-law protection of the trademark rights within a particular state’s borders. The trademark is subject to protection if it meets all of the qualifications for protection and is used to identify a good or service sold within the state. The second method is “federal protection” resulting from registering the mark with the US Patent and Trademark Office and using the mark in interstate commerce. Each of these requirements and methods of establishing trademark rights is discussed separately.

- **Discussion:** Why do you think state law and federal law provide for trademark protections? Can you think of any initial benefits from securing trademark protection under state and federal law?
- **Practice Question:** What are the two types of trademark protection that may exist at the state or federal level? What are the common elements between these methods of protection?
- **Resource Video:** <http://thebusinessprofessor.com/capturing-trademark-rights/>

16. What is the “distinctiveness” requirement for trademark rights?

A proposed trademark must be “distinctive”. This means that the mark cannot be so similar to another mark that it causes consumers to confuse the brand or entity associated with that mark. If it is confusing to the consumer, the USPTO will reject the application for registration. So, the likelihood of confusion is partially based upon the mark and partially related to the nature of the product or service that it represents. To determine if a similar mark is being used in commerce, the USPTO trademark attorney will search for registered marks and unregistered marks with common law protection. The attorney will then examine whether the commercial activity represented by any similar marks is related to the commercial activity to be represented by the proposed trademark. If there is a high degree of similarity for both of these factors, it is more likely that the mark will be confusing to consumers. If the mark conflicts with a mark that was registered prior to the proposed mark, the USPTO will reject the registration. If the mark conflicts with another proposed mark that was filed before it, the USPTO will suspend its review and notify the applicant of the conflict.

Classification of Distinctiveness

A proposed mark may have varying degrees of distinctiveness. The higher the degree of distinction, the less likely it is to confuse customers about the brand or entity that it represents. If a mark is less distinctive, it may require an applicant to demonstrate public perception or recognition of the mark in order for it to be capable of trademark protection. The following are degrees of trademark distinctiveness:

- *Arbitrary and Fanciful terms* - A “fanciful mark” has no other meaning. It is created to represent the commercial

activity claiming trademark rights. An “arbitrary mark” is the association of an existing word or symbol with a commercial activity that has no relation or logical connection to that mark. If a proposed trademark falls under either of these categories and is not already used by another business, it is automatically recognized as inherently distinctive.

- *Example:* Yahoo, Bing, Google, Starbucks, Verizon, and Exxon are all examples of fanciful terms. Many of the logos, sounds, or non-sensical expressions associated with companies would also be fanciful. Apple computers, Camel cigarettes, Colt pistols, Amazon web services, Subway restaurants would all constitute arbitrary words. Further, the images or logos used in connection with these brands would be arbitrary, such as Ronald McDonald or the GEICO lizard.
- *Suggestive Marks* - A suggestive mark somehow suggests the underlying business or entity represented by the mark. It does not describe the entity, or its product or service, but something about the mark somehow relates to or helps the consumer understand the brand or entity that the mark represents. It generally requires a certain level of cognition, creativity, or imagination in how the product is perceived.
 - *Example:* Citibank, Inc., Playboy, Inc., Microsoft, Coppertone, are all words used as suggestive marks to represent a brand or commercial activity. While less common, the symbols used by a company may also suggest the commercial activity, such as the Zappos shoe symbol or Yankee’s baseball logo.
- *Descriptive Marks* - A descriptive mark, as the name implies, describes in some way the product or service represented. This can include information about or allude to the nature, characteristics, geography, or qualities of the product or service. To qualify as a mark, the owner must demonstrate that the mark has achieved “secondary meaning” beyond the literal definition of the mark. Secondary meaning is when consumers associate the mark directly with the brand or business rather than simply a general description of the brand or company’s primary commercial activity. This requirement ensures that there is no confusion between the literal meaning and the brand or commercial activity.
 - *Example:* Chick-Fil-A, Home Depot, American Apparel, First Bank, Pizza Hut are all examples of descriptive marks. All of these companies have names that describe their business; but, the business names are now commonly understood by customers to represent the particular business rather than a general commercial activity. It is far less common that a image or logo will be descriptive unless the symbol incorporates a descriptive word, phrase, or slogan.
- *Generic Marks* - A generic mark is not capable of trademark protection. Generally, the mark is not distinctive because it represents a type or class of commercial activity (product, service, etc.). A valid mark may become generic if the mark begins to describe every product or service of that type. That is, it no longer makes the specific product or service distinctive.
 - *Note:* A business mark that is becoming generic will fight to restore its distinctiveness for that business’ product or service. This is the case with Xerox, Chapstick, and Google.
 - *Example:* A generic mark may include aspirin, laundromat, car, band-aid, kleenex. All of these were once brands that later became synonymous with the product or service.

- **Discussion:** How do you feel about the USPTO distinctiveness requirement? Should a company be able to register a mark that is already being used? Why or why not? Should it matter if the mark is being used to represent an unrelated commercial activity? Why or why not? Should descriptive marks be allowed to be trademarked? Why or why not? Should arbitrary, fanciful, and suggestive marks be required to achieve secondary meaning? Why or why not? Do you think the law should allow a trademark to become generic because of popular use and generic association by consumers? Why or why not?
- **Practice Question:** Darla is launching her new pet product line. She has is going back and forth between Perfect Pet Products and Octep, which is Pet Co spelled backwards, as her business name. If Darla plans to trademark the business name, what analysis of each name will the USPTO undertake in determine whether the name is sufficiently distinctive?
- **Resource Video:** <http://thebusinessprofessor.com/distinctiveness-requirement-for-trademark/>

17. What is the process for determining whether a descriptive mark is sufficiently distinctive?

A descriptive mark must acquire a secondary meaning in order to be sufficiently distinctive to be protected by trademark law. Arbitrary, fanciful, and suggestive terms do not require that the mark have a secondary meaning, as they are sufficiently distinctive by their nature. The first step in the analysis is to determine whether the mark is indeed descriptive of the product or service. The trademark office or a court will use several tests to determine whether a mark is descriptive (as apposed to arbitrary and fanciful, suggestive, or generic).

- *Dictionary Test* – This test seeks to determine the ordinary significance and meaning of the word as demonstrated by a dictionary. This provides evidence of how the general public would encounter the mark.
- *Imagination Test* – This examines whether the meaning of the mark is obvious, or whether it requires some level of imagination or thought to determine the represented good or service. If a high degree of cognition is required, the mark is likely suggestive rather than descriptive.
- *Competitor Need or Use* – Do competitors need to actively use the claimed mark for their customers to recognize or understand what their product or service does. If so, this is evidence of descriptiveness of the term, and the strong presence of secondary meaning for the specific business can make it an enforceable mark. This can also indicate that the mark is generic in nature and not capable of protection.

The next step is to determine whether the trademark has achieved secondary meaning that is separate from its descriptive nature. Secondary meaning requires that the mark draw reference to the business, rather than the product or service itself. Specifically, secondary meaning is present when, “in the minds of the public, the primary significance of the symbol is to identify the source of the product rather than identifying the product itself.” A court may use various forms of evidence to determine whether secondary meaning exists:

- *Direct Evidence* - Direct input from customers, such as through testimony or surveys.
- *Indirect Evidence* - Indirect evidence may include:
 - *Exclusivity* - Whether the business exclusively uses the mark, or how it is used in the market and for how

long;

- *Advertisement* - To what extent does or has the business advertised the mark as a representation of the business;
- *Market Presence* - What presence does the mark have in the market (market percentage or market awareness of the brand as a result of the mark); and
- *Competitor Use* - Proof that other businesses intentionally copy the mark to achieve market awareness of their business.

- **Discussion:** Why do you think the USPTO requires a descriptive mark to achieve secondary meaning for the mark to be protectable under trademark law? How do you feel about the above-referenced tests for determine descriptiveness and secondary meaning? Can you think of any other methods of demonstrating descriptiveness? Can you think of any other factors to review when determining whether a mark has achieved secondary meaning in the market?
- **Practice Question:** Dominique runs a small sewing shop. She uses the name, The Sewing Shop to represent her business. She now seeks to trademark the name federally by filing with the USPTO. What analysis will the USPT undertake to determine whether the mark is capable of trademark protection?
- **Resource Video:** <http://thebusinessprofessor.com/secondary-meaning-for-descriptive-marks/>

18. What is Federal Registration of a Trademark (Lanham Act)?

Federal registration of a trademark is the process for filing for federal protection of a mark representing a business or commercial activity. The federal statutes governing the registration of trademarks are found in 15 USC, sections 1051-1127. This group of laws is known as the “Lanham Act”. The registration process is managed by the US Patent and Trademark Office, a federal administrative agency. The USPTO issues regulations and rules that govern the trademark registration and maintenance process. Federal courts addressing trademark law create law (“common law”) that also guides or controls the body of trademark law. The common law generally applies to disputes as to ownership and enforceability of trademark rights.

Federal Registration - Federal registration requires that a trademark application meet the aforementioned requirements and be used in “interstate commerce”. This generally means that the mark is used in a manner that is not solely limited to in-state activity. If a business is not currently using the mark in commerce, it may file an “intent-to-use” application along with a filing fee. This allows an 18-month period to begin using the mark in commerce. The filing requirement arises every 10 years following the initial filing. The holder will have to file an “affidavit of use” five years after the date of filing to certify that the mark is still in use. Unless a mark was previously used and abandoned, only the original user of a mark in interstate commerce may register the mark with the USPTO.

Benefits of Federal Registration - Federal registration affords the trademark user additional protections beyond the statutory and common law protections afforded under state law. Some of the major advantages of federal registration of a trademark are as follows:

- Protection in every jurisdiction across the United States;
- Creates a presumption that the registration is valid in the event of a dispute over trademark rights;
- Provides notice to third-parties that the mark is in use;
- Allows for a federal cause of action against an infringer (and there is a presumption of willful infringement);
- Aids in the process of international registration; and
- Allows for the mark to be registered with the US Border and Customs Administration to prevent the importation of counterfeit goods.

The benefits of federal registration are not exclusive. An individual with federal trademark rights may also secure state-law protections.

- **Discussion:** How do you feel about the ability of a business to secure trademark rights all across the US? Should it matter that the business does not conduct business in all states? Why or why not? Are you convinced of the need for federal registration by the above-referenced benefits?
- **Practice Question:** Karl is a small business owner with dreams of expanding his business across the country. He is seeking trademark rights for his business name. Can you explain in a memo the benefits of pursuing federal trademark registration?
- **Resource Video:** <http://thebusinessprofessor.com/federal-registration-of-a-trademark/>

19. What is trademark protection under state law?

Overview

States often pass statutes or provide administrative procedures allowing the public to file or register trademarks that are used in commerce within the state. These states will also provide statutory protections and causes of action against those who infringe upon an individual's state-recognized, trademark rights. In addition to the statutory protections provided by some states, every state provides for common-law protection of trademark rights. That is, an individual has the ability to legally enforce her rights in a trademark *via* state, common-law remedies. State common-law protection of trademark rights arises when an individual or business is the first to use a particular mark in business or commerce within the state and no other business has federal trademark protection.

- **Example:** An individual or firm employs a mark in an attempt to sell a product or service to the public. The mark is not used by another firm within the state and is not subject to federal trademark protection. The individual or firm using the mark is automatically protected under common law in the state where the mark is used in commerce.

Limits on State Trademark Protection

State trademark protections have significant limitations. First, the mark is not protected in areas outside of the state. As such, a business may acquire statutory or common law protection only in the states in which it carries on commercial activity. If someone infringes upon the mark by employing a confusingly similar mark within the trademark holders area of commercial activity, the trademark owner may bring an action to halt use. If, however, someone uses a confusingly similar mark in an area where the firm has not registered or does not carry on commercial activity, no remedy is available. As such, the individual using the infringing mark in another state may effectively lock out the original user of the mark from employing the mark within that jurisdiction. It comes down to a system of first to register or first to use the trademark in commerce in that jurisdiction.

- **Discussion:** Why do you think states offer statutory and common-law protection of trademark rights? How does state, common-law protection of trademarks relate to the concept of property rights? How do you feel about the ability of a business to claim trademark rights under state law by being the first to use that mark in the state?
- **Practice Question:** Billy has a small consulting business named Peak Perform Consulting that is organized in the state of Alabama. He provides consulting services throughout the states of Georgia, Alabama, Florida, Louisiana, and Tennessee. He is looking into opening an office in South Carolina when he learns that a professional services firm named Peak Performance Consulting already exists. Will Billy be able to use his company name in the state of South Carolina? What other information do you need to know about this situation to fully answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/state-protection-for-trademarks/>

20. What are the primary reasons for denying claims of trademark rights?

Whether pursuant to common law, state or federal registration, there are several common reasons for denying trademark protection of a prospective mark. Some of the more common reasons are as follows:

- the mark is the same or similar to a mark currently used on similar related goods;
- the mark merely describes a product or service;
- the mark is generic and represents a product or service; or
- the mark contains certain prohibited or reserved names or designs.

Pursuant to the USPTO examination guide, there are certain characteristics of marks that cannot be registered. The following is a non-exclusive list of several major types of these marks:

- contains the US Flag;
- coats of arm;
- insignia of the United States, any state or municipality, foreign nation, or any simulation thereof;
- are in some way immoral, deceptive, or scandalous;
- trade names (that are not used to identify the goods or services);
- trade dress that has functionality or lacks distinctiveness;
- purely ornamental or decorative marks;

- color marks that are not distinctive;
- universal symbols used incorrectly;
- immoral or scandalous matter;
- deceptive matter;
- matter that may disparage;
- matter that may falsely suggest a connection (with persons, institutions, beliefs, or national symbols);
- matter that may bring someone into contempt or disrepute;
- contain the name, likeness or signature of living persons without their consent; and
- are too similar to existing trademarks registered with the USPTO

- **Discussion:** How do you feel about the reasons for denying trademark protection? Why do you think the above-listed types of trademark are not capable of protection? Are there any types of trademark that you believe should be included on or excluded from the list?
- **Practice Question:** Eric decides to start a sporting goods company. He designs an emblem to represent the business. When he applies to the USPTO for federal protection, the application is denied. What are some of the potential reasons the emblem was denied trademark protection?
- **Resource Videos:** <http://thebusinessprofessor.com/reasons-for-rejecting-a-trademark/>

21. What are common trademark designations used to indicate a claim of trademark rights in a mark?

The traditional trademark designation is (“TM”) or TM. Anyone who uses a distinctive mark may employ this symbol to put others on notice of the trademark claim. If a trademark is registered with the USPTO, the trademark owner can use the symbol ®.

- **Discussion:** What do you think are the primary benefits of including a symbol to demonstrate claimed or registered trademark rights? Can you think of any disadvantages?
- **Practice Question:** Eliot wants to put the world on notice that he claims trademark protection of the symbol representing his business. He has filed for federal protection with the USPTO but no trademark rights have yet been awarded. What are Eliot’s options for including a trademark designation beside his company’s symbol?

22. What is the process for filing a federal trademark protection?

The application for federal trademark protection follows a standard process. The following information is required for every trademark application:

- *Petitioner Information* - Name of applicant; address for correspondence (may be name and address of agent).
- *Mark* - The petition must provide a demonstration of the mark, such as a rendering, photo, or computer image. This will include an indication of whether the mark is made up of standard characters or whether it is dependent upon a particular design of the characters.

- *Nature of Business* - The petition must designate of class of or actual product(s) or service(s) represented by the mark.
- *Filing Fee* - The application must accompany the corresponding filing fee.

Upon receipt of a completed application, the USPTO will assign a serial number to the application and return a receipt of filing to the filer. The trademark attorneys at the USPTO may have additional questions or require additional information of the filer. The proposed mark does not receive federal trademark protection until it is approved by the USPTO. The mark holder may use the trademark symbol ("TM"), but may not use the registered trademark symbol ("®") until the filing process is complete.

- **Discussion:** What do you think about the process for applying for federal trademark protection? Do you think this has the effect of incentivizing individuals to rely solely upon state rights? Why or why not?
- **Practice Question:** Mark is considering filing for trademark protection of the logo representing his business. Can you explain to him what is required to file a federal trademark application?
- **Resource Video:** <http://thebusinessprofessor.com/process-for-filing-a-federal-trademark/>

23. What is trademark infringement?

Trademark infringement involves the unauthorized use of the protected mark or a similar mark to represent a business, brand, goods, or services, other than those of the trademark holder. The use of the mark must create a strong likelihood of confusion for consumers as to the origin of the goods or services. This generally means that the mark must be used to represent competitor business, brands, goods or services. The most common form of trademark infringement is through the production and sale of counterfeit goods.

- *Note:* It is a crime to traffic in counterfeit goods under the Stop Counterfeiting in Manufactured Goods Act (SCMGA). Penalties include imprisonment of up to 10 years and a fine of up to \$2 million.
- *Example:* ABC Corp produces a generic brand of sunglasses that looks like a common model of Oakley sunglasses. ABC affixes a symbol that looks very similar to the Oakley trademarked symbol. This would be infringement through use of a similar mark on competing goods that is likely to cause consumer confusion as to the origin of the product.

Dilution

Another form of infringement is known as “dilution”. Dilution concerns the harm to a famous mark caused by unauthorized use with non-similar goods in a manner that is not likely to cause confusion. That is, the law prevents use of certain trademarks (well-known or famous marks) by anyone other than the holder, even if there is no risk of consumer confusion. The idea is that use of the trademark may dilute the brand value of the federal trademark holder. Using a derivation of a company’s logo for a non-related product may reduce the notoriety or public recognition of the logo with the brand of the trademark holder. Dilution can occur through use of the protected mark or a confusingly similar mark. Pursuant to the Federal Trademark Dilution Act of 1995 and Trademark Dilution Revision Act, dilution of a trademark

occurs when:

- A trademark becomes so commonly known by the public that it is considered “famous”;
 - *Note:* This goes to the distinctiveness of the mark.
- A third party (alleged infringer) is using a mark in commerce that causes the trademark to lose its distinctiveness in the market;
 - *Note:* The third-party’s use of a similar mark with a non-related product causes the mark to no longer be associated with just the holder’s business, brand, product, or service.
- The similarity between the defendant’s mark and the famous mark gives rise to association between the marks; and
 - *Note:* The market does not have to be confused as to the origin of the third-party’s product, but it begins to associate a mark with this third-party’s product.
 - *Example:* I have a trademark on the word ziiiizle, which represents the product I sell. A third party begins selling a non-similar product and calls it a zooozle. The use of a similar mark with a non-similar good starts to cause an association in the market between the marks.
- The association between the marks is likely to impair the distinctiveness of the famous mark or harm its reputation.
 - *Note:* This may include associating it with a brand that makes inferior quality products.

In an infringement action, a party will generally request an injunction against further infringement along with recovery of any damages suffered as a result of the infringement. The Lanham Act allows for the recovery of any profits generated by the infringer as a result of the infringement.

- **Discussion:** How do you feel about the requirement that a mark cause consumer confusion to be infringement? Do you think this should be based upon the similarity of the mark as well as the business, brand, product, or service that it represents? Why do you think courts recognize dilution of a mark when an alleged infringing mark does not create customer confusion? How should a court evaluate whether a mark is famous and whether its reputation in the market is being harmed?
- **Practice Question:** Garth has a pet product business that concentrates on making the highest quality doggy chew toys on the market. The price of the toys reflects its high quality. He trademarks the name Tuff Toys for the product line. Harriet’s business makes outdoor play toys for kids to take to the beach. They are very cheap and low quality. Parents buy them because they expect them to be lost or destroyed after a couple of days of play on the beach. She calls the product lines Tough Toys. Is there any argument that Harriet is infringing upon Garth’s trademark?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-trademark-infringement/>

24. How does an individual enforce Trademark Rights?

If a claimed trademark (that is in commercial use) conflicts with another, the method or ability to enforce the trademark will vary depending on the rights associated with the mark.

- *State Law Rights* - States that allow for trademark registration often establish procedures and causes of action for enforcing trademark rights against infringers. In the absence of a state statute, common law rights in a mark can be enforced within the jurisdictions in which it is actively used. If the businesses are geographically separated, it may provide a buffer of protection against infringement. Recall, a business may use a mark in a jurisdiction where the similar mark is not used in commerce. In the event of an conflict in the same jurisdiction, the cause of action may be pursuant to a state conversion or equitable remedy. A court may award damages or an injunction against further infringement. To recover damages, a plaintiff must demonstrate actual damages. These actions are filed in state trial courts and are entitled to the same procedural rights as other state-law actions.
 - *Note:* This can be difficult for businesses that provide services over the Internet, as the reach is likely to be national.
 - *Federal Registration* - A federally registered mark can be enforced throughout the United States. Enforcement of a trademark generally begins with a “cease and desist” letter. This letter is a communication sent by the owner of a mark to the user of an allegedly conflicting mark demanding the user stop using that conflicting mark or stop using it in the current manner. If the user of the infringing mark fails to comply with the demand, the next option is to either file a state or federal court action seeking to enjoin the infringement. The complaint will allege a violation of federal law. The plaintiff may request any damages she has suffered as a result of the infringement. Federal infringement actions involving a registered mark allow for the recovery of attorney’s fees incurred in enforcing the trademark.
- **Discussion:** What do you think about the methods of enforcing trademark rights under state and federal law? Are there advantages and disadvantages of each method?
 - **Practice Question:** Raymond uses a mark to represent his business in Tennessee and Virginia. He previously filed for federal protection with the US Patent and Trademark Office. He recently learned that another business in Tennessee is using a confusingly similar mark to represent its business. Raymond believes that this third party is infringing upon his trademark. What are Raymond’s options for bringing a state or federal lawsuit against the alleged infringer?
 - **Resource Video:** <http://thebusinessprofessor.com/enforcing-trademark-rights-2/>

25. How does a trademark holder demonstrate infringement of its trademark?

Proving trademark infringement requires a showing that the plaintiff has valid trademark rights and that someone is using another mark that is confusingly similar to the public. That is, the business claiming infringement must show that the other business’s use of the mark causes a high “likelihood of confusion” for the general public regard to the business, product,

or service represented by the mark. In determining whether a mark is confusingly similar, the court will review several aspects of the protected and infringing mark. Some of the primary considerations are as follows:

- *Mark* - How similar in appearance or language are the marks? The court may also look to how the mark sounds when spoken aloud.
 - *Business* - How similar are the goods or services represented by the mark? What are the differences? Is the mark used on several types of product or service?
 - *Market or Industry* - Are the businesses competitors? Same target markets? Same geography? Same stores? Same type of customer? What are the competitive differences (any differentiation or cost differences)? How are they advertised (similar marketing practices)? What is the economic significance of the mark to each party?
 - *Notoriety* - How well known is each mark? How long has each mark been in use? What do customer surveys say about mark and brand association?
 - *Intent or Purpose* - Was the alleged infringer aware of the mark before employing her mark? This goes to determining whether the infringement is intentional or inadvertent.
 - *Public* - What is the extent of potential confusion to the customer? Will a customer mistake the company or brand behind a product as a result of the mark? Will the customer believe that the placement of the conflicting mark is an endorsement by the owner of the valid trademark?
-
- **Discussion:** What do you think about the factors a court would employ in determining whether trademark infringement exists? Do any of these factors seem particularly important in a determination? Can you think of any other factors the court should consider?
 - **Practice Question:** Mark is the owner of Bait Shop Restaurant. For several months, he has been in a trademark rights battle with another business using the name Bait Shop Restaurant. Mark's business was the first restaurant to use this name. Mark is considering bringing a legal action against the alleged infringer. What will Mark have to demonstrate to the court in order to prevail over the alleged infringer?
 - **Resource Video:** <http://thebusinessprofessor.com/infringing-upon-a-protected-trademark/>

COPYRIGHT LAW

26. What is a “copyright”?

Copyright is a form of intellectual property protection applicable to original expressions by the creator. The primary federal law governing copyrights is the Copyright Act of 1976. An “original expression”, for purposes of copyright law, is a very broad term. Section 102 of the Copyright Act identifies several categories of protectable subject matter, as follows: literary, musical, dramatic, pictorial, graphic, sculptural, audiovisual, and architectural works.

Section 102 also excludes several categories: facts, page numbers, mathematical equations, ideas, procedures, processes, systems, methods of operation, concepts, principle, or discovery.

While ideas and facts are not protectable, copyright protects the unique method of expressing ideas or facts. Section 103 specifically identifies compilations of fact that constitute original works as protectable. The facts must be arranged or presented in an original way.

- *Note:* Any work that has entered the “public domain” is not capable of protection.
 - *Example:* Common forms of copyrighted expressions include: literature, music, musical performance, choreography, art, photography, graphic images, sculpture, architectural designs, computer programs, movies or other dramatic works, etc.
- **Discussion:** How do copyrights relate to the intellectual property rights protect by patents or trademarks? Are the objectives for these rights similar?
 - **Practice Question:** Mike is compiling a list of individuals who work in an office building and recording their contact information. He wants to print it as a guide and sell it to individuals in the building. Can he copyright his work?
 - **Resource Video:** <http://thebusinessprofessor.com/overview-of-copyrights/>

27. What are the rights of the holder of a copyright?

Copyrights, as do other forms of intellectual property, allow the holder to exclude others from using or copying the protected work. A copyright holder has exclusive rights to the following:

- *Reproduce* - The holder of a copyright has the ability reproduce and distribute the protected work. For example, the holder of the copyright may distribute copies of the work or license the work for reproduction in any format.
 - *Example:* The holder of a copyright on lyrics to a song may license the rights to perform the song to a recording artist.
- *Derivative Works* - The holder may prepare derivative works based on the original work. For example, the holder may employ images, characters, words, or notes from the original work or adopting your work in other formats.
 - *Example:* The holder of copyrights in an image may incorporate that image in a separate work. Similarly, the holder of copyrights in a song may use any portions of a song (lyrics or notes) in a separate song.
- *Distribution* - The holder may distribute copies or reproductions of the work by sale, lease or other transfer of ownership. This generally includes the right to commercially publish the protected work and distribute it through any medium or method of commerce.
 - *Example:* Jay-Z has the exclusive right to sell and distribute any of the songs or albums to which he holds the master rights.

- *Performance* - The holder may publicly perform the work. For example the holder of a copyright in a song may perform the song in public.
 - *Example:* Michael writes a song. He is the only individual who can perform that song without violating his copyright. Other example may include showings of movies, performances of plays, recitations of literary works or skits, etc.
- *Public Display* - The holder may publicly display the work.
 - *Example:* An example would include displaying art, such as paintings or photography, in galleries or exhibits.

In summary, the owner of the copyright may sell, assign, or otherwise transfer her copyright. She may also license any of these rights to third parties. A license is any transfer of rights that are less than complete ownership of the copyright.

- *Note:* A transfer of rights in the copyright must be done in writing and signed by the copyright holder.

- **Discussion:** How do the rights of the copyright holder compare to those of patent and trademark holders? Do you believe these rights are adequate? Why or why not?
- **Practice Question:** Frank is a musician. He regularly composes new musical arrangements. As such, he is the copyright holder of these original creative works. Can you explain to Frank the rights associated with his copyrights?
- **Resource Video:** <http://thebusinessprofessor.com/rights-of-holder-of-a-copyright/>

28. What are the requirements for establishing copyrights?

Federal law governs the creation of copyrights. Unlike some other forms of intellectual property, there is no need to file or register the copyright. Copyright protection arises when an expression meets the following requirements:

- *Original Work* - The expression must be the original work or creation of the author. That is, it must be sufficiently distinct from existing works so as to demonstrate some level of uniqueness in the content or organization of the content. This means that the work must be created and not copied.
 - *Note:* Facts are not original works; rather, they are recitations of certain truths. Expressions containing facts can, however, be protected by copyright depending upon the selection and arrangement of those facts.
- *Affixed to a Tangible Medium* - The creative expression must be affixed to a tangible medium. This means that the copyrighted work must be recorded in a tangible format. A tangible format may include recording the work on paper, canvas, hard surface, digital device (such as a camera, hard drive, or video recorder), etc. If a expression is made without recording it to any form of tangible medium, it does not receive copyright protection. In fact, if the expression is communicated to the public prior to being recorded, it may find itself in the public domain and incapable of copyright protection.

- *Creative Expression* - The expression must show some aspects of creativity. The expression cannot be entirely obvious or commonly understood. Logical arrangements of facts lack the required creativity. Forms that simply record information are generally not considered to be creative expressions.
 - *Example:* The alphabetical arrangement of a telephone book is not a creative expression.

As stated above, pursuant to the Copyright Act of 1976, an expression that meets the requirements for copyright receive automatic protection. Federal registration of the copyright is available and does offer unique advantages to the holder of the copyright. Registration puts the world on notice of the copyright. Whether registered or not, the owner of a copyrighted work may use the symbol “© ” to indicate her claimed rights in the work. No form of public notice, such as use of the copyright symbol, is required for protection.

- **Discussion:** How is the process for establishing copyrights different from other forms of intellectual property? Why do you think this is the case? Is there any argument for requiring a copyright holder to provide notice to the public of the claimed copyrights?
- **Practice Question:** Dora is writing a screenplay. She is worried about individuals copying her work and claiming it as their own. Can you explain to her the requirements for securing copyrights in her work?
- **Resource Videos:** <http://thebusinessprofessor.com/elements-of-a-copyright/>

29. How long does a copyright last?

The length of time of copyright protection depends upon three factors:

- When the copyright was created,
- The length of the author’s life, and
- Whether the creator was an individual or a firm.

Generally, a work created after January 1, 1978 is automatically protected for a period of 70 years past the life of the last living creator. Works created by entities (by employees or works for hire) are protected for the lesser of 95 years from the date of publication or 120 years from the date of creation. A complicated set of rules applies for calculating the length of protection of a copyrighted work created prior to 1978. In summary, if a work was created, but not published or subject to copyright, similar rules apply as for a work created after 1977. The difference is that a copyright is only guaranteed a minimum of 25 years of protection based the date of creation - until 2002. If the copyright is subsequently published during this 25-year window, the 25-year period is extended to 70 years. If the pre-1978 copyright was subject to copyright protection, the 1909 Act applies to the work. In this case, the work receives 28 years of protection from the date of creation. The protections can be extended for an additional 28 years upon application during the 28th year.

- **Discussion:** How do you feel about the divergent methods of determining copyright protections for works before

and after January 1, 1978? What are the justifications for maintaining this system?

- **Practice Question:** Mark wrote two songs. One he wrote in 1977 and the other he wrote in 1978. He has never made any filings for copyright protection. What are Mark's protective rights in these two songs?
- **Resource Video:** <http://thebusinessprofessor.com/time-period-for-copyright-protection/>

30. What is the process for registering a copyright?

Copyright registration is done through the US Copyright Office (USCO). It can be completed either electronically or through the mail. The process requires the completion of the specific forms applicable to the type or category of copyrightable work. These forms lay out the required material for each type of copyright. Once all required material is delivered, the USCO will review it and, if acceptable, issue a certificate of copyright.

- **Note:** The holder of a copyright can also file the copyright registration with the US Customs Service in an effort to prevent the importation of infringing work.
- **Discussion:** Can you think of any benefits associated with filing a copyright? (Hint: Think about the benefits of registering other types of intellectual property.)
- **Resource Video:** <http://thebusinessprofessor.com/process-for-registering-a-copyright/>

31. Who can claim copyright protection?

Only the creator of the work (or individual contracting for the creation of the work) may secure copyright protection. The copyright may later be licensed or assigned, but the original creator must originally secure those rights. Companies can be authors under copyright law. The following rules apply to creation of the work:

- **Co-Creators of a Work** - When more than one creator takes part in the creation of the work, there is a presumption that each party owns the work (and attached copyright) equally. Of course, the parties can enter into a contract establishing ownership rights in the creation.
- **Jointly Owned Copyrights** - Co-creation or co-ownership of a copyright entitles each owner to full use and enjoyment of the copyrighted work. Absent a contract stating otherwise, however, any income derived from the copyright is split equally among copyright owners.
- **Employees and Work for Hire** - An individual or firm may own a copyright created by a third party if the third party is an employee or independent contractor hired for the purpose of creating such a work. Work made for an employer by an employee generally belongs to the employer if it was created within the scope of employment. Likewise, works created by an independent contractor generally belong to the contracting party if the work is in the scope of the contracted work.
- **Work Agreements and Default Rules** - The employment agreement or work-for-hire agreement (independent contractor agreement) will generally specifically address the issue of intellectual property created by the worker.

Absent an agreement, default rules regarding the status of an individual as employee or independent contractor may vest ownership of any creation in the employer or contracting party. The work created must be within the scope of the copyrighted material. Examples of creation within the scope of a contracted relationship include:

- a new creation that is the subject of the work relationship;
 - any addition to or modification of an existing work product (except for entries to magazines, blogs, encyclopedias, or other collaborative works with open entry);
 - any material constituting a part of a larger contracted work;
 - translations of an existing work;
 - compilations of multiple parts of a work product; and
 - designs or planning material giving rise to the work product.
- *Transfer and Licensing* - The owner of a copyright may transfer the copyright or license its use to any third-party individual or firm. These are common methods of monetizing copyrights beyond personal production and distribution of the copyrighted work. Copyrights exist independently of the original work itself in tangible form. Owning an original of the copyrighted work does not equate to ownership of the copyright.

- **Discussion:** How do you feel about who is considered to be the owner of a copyright? Can you think of any situations where the above-listed rules could result in unfair outcomes?
- **Practice Question:** Harriet is an employee of ABC Corp. She primarily works on the graphic design team where she creates logos and other creative pieces for the company. During her lunch breaks she has been working on a new design concept for a cartoon corporate mascot. She is thinking of attempting to sell or license this creation to some corporations. Does Harriet own her creative work? What other information do you need to make this determination?
- **Resource Video:** <http://thebusinessprofessor.com/who-may-secure-copyright-protection/>

32. What is infringement and how does one enforce a copyright against infringement?

Copyright infringement occurs when a copyrighted work or some portion of the work is reproduced, distributed, performed, or displayed without authority. Authority must be obtained from the copyright holder. A copyright is enforceable through a federal court action. That is, the copyright holder can bring a federal lawsuit against someone infringing upon the copyright. While copyrights attach without registration, the copyright holder must register her copyright prior to bringing a federal court action. Aside from allowing for litigation, a registered copyright provides a public record for the copyrighted work at the time of filing. Once in court, the copyright holder will seek an injunction from further infringement and any monetary damages suffered as a result of the infringement. The registered copyright is presumed valid if the registration occurs within 5 years of creation. This means that any infringing party has to overcome this presumption in court. The federal statute providing for copyrights allows for statutory damages (up to \$150,000) and attorney's fees (if the registration took place within 3 months of publication of the work).

- *Note:* Copyright infringements are routinely resolved through negotiation of the parties.

- **Discussion:** Why do you think the copyright enforcement process requires registration? Are you convinced by the benefits of copyright registration? Can you think of any disadvantages?
- **Practice Question:** Mary wrote a funny poem with great lyrics. One day, when listening to the radio, she hears a couple of lines from her poem in a popular song. If Mary decides to bring a legal action against the performer, what process will she have to follow?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-process-for-enforcing-a-copyright/>

33. What defenses are available to a copyright infringement action?

The following doctrines or laws provide a defense for an alleged copyright infringer:

- *Invalidity* - The defendant may show that the owner's copyright is invalid.
 - *Note:* This generally arises in the context of the validity or scope of copyright licenses.
- *License* - The defendant may demonstrate that she has a valid license.
 - *Note:* This generally arises in the context of the validity or scope of copyright licenses.
- *Public Domain* - The defendant may successfully argue that the work is in the public domain.
 - *Note:* This includes works that are not subject to copyright and can longer be made subject to copyright. Since copyrights attach naturally, it generally means that the duration of the copyright has lapsed. A creator may also undertake steps to affirmatively place the copyright in the public domain.
- *Statute of Limitations* - The defendant may argue that the statute of limitations for enforcement of an infringement action has run.
 - *Note:* This includes situations where a party learns of an infringing use and does nothing to enforce the copyright against infringement within the statute of limitations. It would generally not apply to on-going infringement.
- *Accident* - The defendant may claim unknowing or innocent infringement. This is not generally an available defense for commercial use of a copyrighted work.
 - *Note:* This generally includes any incidental use for a non-commercial purpose.
- *Fair Use Doctrine* - The fair use doctrine claims that there is a valid an legal use of the copyrighted work that does not infringe upon the holder's rights. Examples of fair use may include the following uses:
 - review of the material (such as critique or criticism);
 - academic use (such as teaching the material or research);
 - satire or other parody of the work; and

- news or public commentary.

- **Discussion:** Do you agree that the above-listed scenarios should constitute a defense to a copyright infringement action? Why or why not? Can you think of any other situations that should be a defense or constitute fair use?
- **Practice Question:** SuperBand is being sued by GreatBand for copyright infringement. GreatBand claims that SuperBand used the rhythm and some lyrics from its copyrighted song. What are some of the potential defenses that may be available to SuperBand?
- **Resource Video:** <http://thebusinessprofessor.com/defenses-to-a-claim-of-copyright-infringement/>

34. How does a court determine if use of a copyright constitutes “Fair Use”?

The most disputed affirmative defense to copyright infringement is likely the “fair use” of the copyrighted work. To constitute fair use, the use of the work generally must not be extensive and not cause a negative impact on the copyright holder. The doctrine does not protect activity that is used to diminish the value of the copyright to the rightful holder. In determining whether use of a copyright constitutes fair use, a court will employ several factors in examining the nature and extent of the use. These factors include:

- *Purpose of the Use* - If the purpose of the use was for a non-profit purpose, it is more likely to be protected as a fair use than a commercial activity.
- *Nature of the Work* - What type of copyright is claimed. If the work was created for a commercial purpose, it may demand higher protection. Likewise, a work made for entertainment or a fictional work, may afford greater protection than a fact-based work.
- *Extent of the Use* - If the use was incidental or a very small portion of the work was used, it is more likely to be a fair use. Also, if the work was used as collaboration or as part of a larger project, it may be transformative in nature. A work that sufficiently transforms the original work may be fair use.
- *Economic or Market Impact* - If the use of the copyrighted work causes a negative market or economic impact on the use or value of the original work, it is less likely to be fair use.

- **Discussion:** What do you think about the fair use doctrine? Can you think of any other factors that should be considered in determining fair use?
- **Practice Question:** Tracy is a professor at a large state college. In her class of 300 students, she uses excerpts from a popular business book. The author, who is struggling to repay debt from his unsuccessful run for Congress, decides to sue her and the university for copyright infringement. Tracy claims that her use of excerpts from the book is fair use. What factors will the court consider in determining whether the Tracy’s use constitutes fair use of the copyrighted work?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-fair-use-of-a-copyright/>

35. What is the “First Sale Doctrine”?

Section 109 of the Copyright Act provides a purchaser of a copyrighted item the ability to sell or otherwise dispose of the item without the permission of the copyright holder. This is known as the “first-sale doctrine”. It stands for the proposition that a copyright holder cannot control a copyrighted item after it has been sold or transferred.

- *Note:* The purchase of copyrighted item only establishes rights in that item. It does not authorize an individual to copy or otherwise reproduce that copyrighted item.
- **Discussion:** Why do you think the law allows initial purchasers of a copyrighted item the ability to sell or transfer that item? Is there an argument for limiting a purchaser’s authority? Is there an argument for allowing a purchaser to copy or reproduce the item?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-first-sale-doctrine/>

36. What international protections exist for intellectual property rights?

International intellectual property law is the subject of treaties between nations throughout the world. The United States is a signatory to numerous international agreements respecting intellectual property rights. Some of the primary agreements are as follows:

- *Trade-Related Aspects of Intellectual Property Rights (TRIPS)* - TRIPS is the most recognized agreement among nations concerning the recognition and protection of intellectual property rights. TRIPS is a model agreement promulgated and administered with the World Trade Organization (WTO). Most nation members of the WTO are signatories to the agreement. It provides standards for how intellectual property should be regulated within a country. This includes standards for recognition and protection of intellectual property rights. Forms of intellectual property recognized under TRIPS include copyrights, trademarks, trade dress, geographical identification, designs, patents, new plant varieties, and confidential trade information.
 - *Note:* The scope of protections under TRIPS was further defined under the Doha declaration, a WTO statement issued in 2001.
- *World Intellectual Property Organization (WIPO)* - WIPO is an agency of the United Nations charged specifically with promoting economic development through the facilitation of intellectual property recognition and protection among member countries. The WIPO was formed as part of a multilateral treaty between 188 UN members. WIPO is charged with administering numerous intellectual property agreements between member nations.
- *Paris Convention for the Protection of Industrial Property of 1883 (Paris Convention)* - The Paris Convention was one of the first treaties focusing on the recognition and protection of intellectual property rights. It is administered by the WTO.
- *Berne Convention for the Protection of Literary and Artistic Works (Berne Convention)* - The Berne Convention is an intergovernmental treaty administered by WTO that focuses on protecting copyrights among signatory

nations. Notably, this convention introduced the concept of affording copyright protection to works that are not filed with a governmental office.

- *WIPO Copyright Treaty (WCT)* - The WCT is a WIPO administered treaty focusing on copyright protection among signatory nations. Currently, 94 nations are signatories to the agreement. The WCT focuses on the copyright protection of information technology, computer software, and program design. It offers protections in addition to the Berne Convention.
 - *Madrid Protocol* - The Madrid Protocol is an amendment to the Madrid system for International Registration of Marks. WIPO administers the protocol, which provides the primary international rules for the recognition of trademark rights. Notably, it allows for the multi-jurisdictional registration of trademarks throughout signatory countries.
 - *Patent Copyright Treaty (PCT)* - The PCT is a treaty among WTO countries concerning the recognition and protection of patent rights. It provides a uniform system for filing for patent protections within signatory countries, known as the “international Patent Cooperation Union”. Notably, it allows for a central filing of an “international application” and preliminary investigation of the filing. The results of the application may then be uniformly presented for protection among signatory nations.
 - *The Patent Law Treaty of 2000 (PLT)* - The PLT is a treaty among 59 countries establishing uniform procedures in the patent filing process. It seeks to resolve issues unresolved under the PCT.
 - *Budapest Treaty on the International Recognition of the Deposit of Microorganisms for the Purpose of Patent Procedure (Budapest Treaty)* - The Budapest Treaty is a WIPO administered international treaty and for states that are a party to the Paris Convention. It provides an international patent procedure for microorganisms. Deposit of microorganisms at a central location allows for the adequate disclosure required under most patent procedures.
 - *Anti-Counterfeiting Trade Agreement (ACTA)* - ACTA is an international treaty focusing on intellectual property protection and enforcement by preventing counterfeit goods and copyright infringement. Approximately 30 countries are signatories to ACTA.
-
- **Discussion:** Why do you think the law allows initial purchasers of a copyrighted item the ability to sell or transfer that item? Is there an argument for limiting a purchaser’s authority? Is there an argument for allowing a purchaser to copy or reproduce the item?
 - **Resource Video:** <http://thebusinessprofessor.com/international-protection-of-intellectual-property/>

TOPIC 24: INSURANCE LAW

Overview

Insurance is a method of mitigating the risk associated with a particular situation or transaction. This chapter introduces the concept of insurance and its importance to individuals and businesses. It explains the mechanics for establishing insurance coverage for specific occurrences. It outlines the rights and obligations of the insurer and insured. It then introduces the most common types of insurance coverage and relevant terms of such coverage.

VIDEO LESSON - INTRODUCTION**VOCABULARY & CONCEPTS**

• Insurance • Insurance Contract • Insurable Interest • Insurance Categories • Automobile Insurance	• Health Insurance • Disability Insurance • Life Insurance • Insurance on Real Property • Business Insurance	• Insurer Obligations • Insured Obligations • Structure of Insurance Contract • Insurance Contract - Common Disputes • Termination of Coverage
-

TOPIC 24: INSURANCE LAW - QUESTIONS & ANSWERS

1. What is “insurance”?

Insurance is a risk management and mitigation relationship between an insurer and the insured party. The primary participants and characteristics of the relationship are as follows:

- *Insured* - The insured allocates the contingent risk of loss in a particular situation to an insurer.
- *Insurer* - The insurer is a business entity that agrees to bear the burden of potential losses and to indemnify the insured from a degree of personal loss. “Indemnify” generally means to hold a person harmless by paying any costs or expenses incurred.
- *Premiums* - The insurer receives some form of compensation for assuming the insured party’s risk, known as a “premium”. The insurer assesses the extent or severity of the contingent risk through a process or system known as “actuarial science”. The premium that the insurer charges to the insured is documented through a contract known as an “insurance policy”.
- *Coverage & Policy Limits* - An insurance policy contract is the legal document evidencing each party’s right and obligations in the insurance relationship. It will cover or establish terms of indemnification of an insured for losses suffered as a result of a specific occurrence. It will identify specific limits on the amount of indemnification payable upon the occurrence of a specific risk.

Insurance policies are a specific type of contract with unique attributes.

- **Discussion:** Can you identify a difference between an insurance policy and a typical contract for services? Hint: Think about the elements of a valid contract as compared with the attributes of an insurance policy.
- **Practice Question:** Jed owns a home and car that are both subject to an insurance policy. What must Jed do to maintain this insurance relationship? If Jed’s home or car suffers damage that is covered under the insurance policy, what is the role of the insurer?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-insurance/>

2. What is an “insurance contract”?

An insurance contract, or “insurance policy”, establishes the legal relationship between the insurer and the insured. A potential insured makes an offer to the insurer to purchase the insurer’s services. In the application, the insurer will reveal all information relevant to the insurance relationship. The insurance relationship begins when the insurer accepts the insured’s offer to purchase coverage, which is the “effective date” of the insurance policy. The insurance contract lays out the extent to which the parties allocate or transfer the contingent risk of loss to the insurer. It will detail the rights and obligations of the parties, as well as the types of situation giving rise to loss and the limits of the insurer’s responsibility to pay for losses incurred.

- *Note:* Failure to disclose all material information may later lead to the contract being rescinded by the insurer.

- **Discussion:** Why do you think the disclosure of factual circumstances is important in the formation of an insurance contract? Why do you think the effective date is an important concept for insurance contracts?
- **Practice Question:** ABC Corp identifies a risk of customer injury on its premises. ABC approaches 123 Insurance, Inc., about purchasing a policy to cover this risk. What is the process for establishing an insurance contract?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-an-insurance-contract-or-policy/>

3. What is an “insurable interest”?

For a party to seek insurance against a potential loss, the insured must have some form of interest in the insured property or be subject to a particular loss from an occurrence or event affecting the insured property or individual. This is known as having an “insurable interest”. An insurable interest may be any form of legal or equitable interest in the property, including security interests in the property as collateral. Individuals may have an insurable interest in the life of other persons, but the individual whose life is subject to the policy must agree to such coverage. In some situations, contractual rights or the potential to suffer damages from non-performance of a contract may give rise to an insurable interest. This is the case for professional liability coverage.

- *Note:* An exception exists to the insurable interest requirement for certain types of financial instruments. These instruments effectively insure against an occurrence in which the holder of the instrument has little or no financial interest.
- *Example:* One person cannot take out a life insurance policy on a complete stranger without that person’s permission. There must be some special relationship between the individuals to justify the policy. This could be a family or business relationship. In any event, the insured individual must generally agree for the insurer to issue a life insurance policy to a third party. In health and life insurance policies, the individual applying for the policy must have an insurable interest in the insured’s life at the time that the policy takes effect. In property insurance contracts, the individual applying for insurance must have an insurable interest in the property at the time of loss to the covered property.

- **Discussion:** Why do you think insurance contracts require that an individual have an insurable interest? Can you think of contracts that are similar to insurance policies that do not require a party to have an insurable interest? Hint: Think of the 2007 economic recession.
- **Practice Question:** Amy is a huge fan of a popular singer, Justin. Though she has never met him, she would be distraught if anything were to happen to him. In the event of his untimely demise, she wants to make certain that she would be able to create a shrine and pay homage to the singer. Can Amy take out an insurance policy covering Justin’s life?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-an-insurable-interest/>

4. What are the common categorizations of insurance?

An insurance policy may have any of the following characteristics:

- *Individual vs Group* - Insurance policies may cover individuals or groups of individuals for identified risk(s).
 - *Example:* Ralph purchases a life insurance policy to cover him individually. Sam purchases a group health policy to cover his entire family.
- *Personal vs Commercial* - Insurance policies may cover personal or commercial activity or property.
 - *Example:* ABC Corp purchases a property insurance policy to cover its business location and equipment. Quentin purchases a homeowner's policy to cover damages caused to his home by wind, fire, etc.
- *Liability Insurance* - Liability insurance policies may indemnify the insured or categories of third parties from potential liability for losses incurred in a specific instance or situation. It is commonly associated with losses suffered as a result of negligent conduct, but also may cover property damages.
 - *Example:* Doug is a medical doctor. He purchases liability insurance to cover damages to a patient from negligent performance of his services.
- *Property & Casualty Insurance* - Property and casualty insurance generally insures against damage to the subject property.
 - *Example:* Dough purchases a policy that insures his home against damage from all natural elements, such as wind, fire, or ice.

A policy may cover any or all of the above types of contingent risk.

- **Discussion:** Can you think of other categories or characteristics of insurance contracts?
- **Practice Question:** Bernard owns a small, home-based business. He has two employees who work at his home and these employees regularly meet with clients at this location. He is looking for an insurance policy to cover the risk of individuals coming onto his property and getting injured? Also, he wants to cover his property against potential theft or damage by clients. What types of coverage does he need?
- **Resource Video:** <http://thebusinessprofessor.com/common-characterizations-of-insurance/>

5. What are the common types of insurance coverage?

Individuals may purchase insurance coverage for nearly any foreseeable risk. The following are common types of insurance policies:

- *Automobile Insurance* - Vehicle insurance covers damages suffered by either the individual or automobile pursuant to any number of risks. Common risks covered in vehicle insurance policies include the following:
 - *Liability Coverage* - This type of policy covers, up to the policy amount, the costs and damages suffered by third parties as a result of operating the insured vehicle.
 - *Note:* This type of vehicle insurance coverage is mandatory in every state.
 - *Collision Coverage* - This is a form of property insurance that will pay the value of the damages suffered to a vehicle in a crash, up to a stated amount or up to the total value of the vehicle.
 - *Note:* This type of insurance is generally required by a lender when purchase of a vehicle is financed?
 - *Comprehensive Coverage* - This type of insurance coverage insures the vehicle against forms of damage other than collision, such as vandalism, theft, hazardous weather, etc.
 - *Uninsured (& Underinsured) Motorist Coverage* - This type of insurance coverage provides indemnification for injuries suffered by the driver and passengers of the covered automobile when another party without insurance causes personal injury in a crash.
 - *Note:* It also covers situations where a third party causing the damage or harm is unidentifiable. This type of coverage is mandated in many states.
 - *Other Coverage* - Other insurance coverage in a vehicle policy may include towing and rental car expenses, additional medical payment coverage, and accidental death coverage.
- **Discussion:** Why do you think there are so many special types of coverage applicable to ownership and operation of a vehicle? How does the cost-benefit vary with each type of vehicle insurance?
 - **Practice Question:** Donald is purchasing a new car. He is financing the car through his bank. What types of insurance will Donald likely have to purchase?
 - **Resource Video:** <http://thebusinessprofessor.com/what-is-automobile-insurance/>
- *Health Insurance* - Health insurance pays the medical expenses incurred by an individual pursuant to treatment of covered health risks. Health plans may include medical, pharmaceutical, dental, and vision services by health providers. A health insurer will often disclaim or limit coverage for known conditions of the insured present within a stated period of time prior to purchasing insurance. This is known as excluding “preexisting conditions”. Most health insurers are limited in the ability to exclude preexisting conditions for more than two years following issuance of the policy. The Affordable Care Act of 2010 (ACA) limits the ability for insurers to exclude preexisting conditions, while placing additional tax burdens on those who do not purchase a qualified health insurance plan. It also authorizes the establishment of state and federal insurance exchanges where individuals can

purchase an insurance plan. This system allows individuals to purchase insurance plans at rates comparable to those of large, employer-sponsored, insurance plans. As part of an insurance plan, an insured may be responsible for:

- *Premiums* - Payments for insurance coverage.
 - *Deductibles* - This is a minimum amount that an insured must pay towards the cost of services addressing a contingent risk or occurrence before the insured will begin to pay.
 - *Co-Insurance* - This is an amount or percentage for which the insured is responsible for any costs incurred pursuant to the occurrence of a covered event.
 - *Co-pay* - This is a fixed amount that an insured must pay toward costs incurred as part of a contingent event.
- Common types of health insurance include:
 - *Preferred Provider Organizations (PPO)* - These policies provide a rate of expense coverage for medical treatment received within a specific network of physicians, hospitals, and clinics. The PPO will generally provide a lower rate of expense coverage when the insured receives treatment outside of the established network.
 - *Health Maintenance Organization (HMO)* - These policies provide a rate of coverage for medical treatment received within a specific network of physicians, hospitals, and clinics. The key characteristic is that the insured is assigned to a primary care physician who must refer the insured for treatment at any of the network participants. The insurer provides a rate of coverage for these in-network providers. The insurer provides no coverage for treatment received outside of the network, except in the case of emergency treatment.
 - *Exclusive Provider Organization (EPO)* - EPO plans cover specific types of medical treatment within a specific provider network. These plans are more limited in their coverage than HMO plans, but the costs for the plan are generally lower. Any treatment received outside of the EPO is not covered.
 - *Point of Service (POS)* - A POS plan is similar to a PPO plan in that it provides a rate of expense coverage for in-network healthcare providers. The insured is assigned to a primary care physician or network for certain types of services. The insured has flexibility, however, to visit out-of-network healthcare providers, but the expense coverage is lower than in-network.
 - *High Deductible Health Plan (HDHP)* - A HDHP is a plan that provides a stated rate of health expense coverage after a high annual deductible amount is paid by the insured. Once the insured covers her medical expenses up to the deductible amount, the insurer will pay a stated percentage of costs. HDHP plans are generally grouped with a Health Savings Account (HSA). A HSA allows an individual to make tax-free contributions to a qualified trust account to cover the costs of medical expenses. These contributions allow the insured to pay for much of the deductible costs of HDHPs with pre-tax funds.
 - *Note:* HSA funds must generally be used in the years of contribution or they are lost.

- *Flexible Spending Account (FSA)* - This is a form of self-insurance that is similar to an HSA. An FSA is an employer-sponsored account that allows the employee to make pre-tax contributions to a healthcare (or childcare) spending account. While an HSA is only available with a HDHP, the FSA is available along with any healthcare plan. An employer must sponsor the FSA for its employees.

- **Discussion:** Why do you think the government has an interest in citizens obtaining health insurance? Why do you think health insurance plans are linked to employers? Why do insurance companies seek to exclude preexisting conditions of a covered insured? Why do you think insurers divide disability coverage into long-term and short-term? What types of professions are most likely to need disability insurance?
- **Practice Question:** Doug is an employee of a small business that does not sponsor a health insurance plan. Doug is seeking to purchase an individual plan. What are his options for purchasing insurance? What are some of his options for types of plan to purchase?
- **Resource Video:** <http://thebusinessprofessor.com/common-health-insurance-plan-characteristics/>

- *Disability Insurance* - Disability insurance provides financial benefits to someone who becomes disabled and is unable to continue working in a given profession or function. Disability insurance coverage is generally divided into short-term and long-term disability.
 - *Note:* Long-term disability insurance is generally in addition to any benefits provided by social security for permanent disability status.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-disability-insurance/>

- *Life Insurance* - Life insurance provides financial benefits in the event a covered individual passes away. The beneficiaries of the policy are generally third parties rather than the insured or the insured's estate. An insured must provide permission or consent for a third-party to purchase a policy covering her. The following are common categories of life insurance:
 - *Whole-Life Plan* - A whole-life policy provides a benefit to a named beneficiary upon the insured's death. Coverage lasts for the remainder of the insured's life. Because of the certainty of payout of the policy, the policy has a cumulated cash value that can be cashed out or used to secure a loan during the insured's life. The owner of the policy pays regular premiums (that are generally locked in at a fixed rate) until the time of the insured's death.
 - *Limited-Payment Life* - This is a variation upon the whole-life policy. All things are similar under these plans, except that the policy becomes fully funded after a certain number of payments. Once these payments are met, the owner of the policy no longer pays a recurring premium.
 - *Term-Life Policy* - Term life insurance provides benefits to a named beneficiary for a specific term from

the initiation of the policy. The owner of the policy pays premiums until the end of the term. At the end of the term, if the insured is alive, the policy ends and no longer offers benefits.

- *Endowment Insurance* - This is a less common form of life insurance in which the owner of the policy pays premiums for the term of the insurance. At the end of the term, a fixed amount is paid to the beneficiary on a certain date.
- *Life Annuity Policy* - This form of policy requires the owner of the policy to make a single lump-sum payment or a series of premium payments to the insurer. The insurer agrees to begin making recurring payments to the beneficiary after a certain date. The payments will last until a specific date or (more commonly) until the end of the insured's life. The lump sum is paid at one time and recurring payments to the beneficiary generally terminate upon the death of the insured.
- *Universal Life Policy* - This type of policy combines term and life insurance into a combination policy.

These policies often exclude specific causes of death, such as suicide, war, criminal death sentence, or murder of the insured by the beneficiary.

- **Discussion:** Why do you think people seek to purchase life insurance? Why do you think an insured's consent is required for a third party to insure her life?
- **Practice Question:** John is considering purchasing life assurance. He has specific plans to leave funds for individuals after he passes away. What are some of John's options of life insurance policies?
- **Resource Video:** <http://thebusinessprofessor.com/characteristics-of-life-insurance-policies/>

- *Homeowner's & Renter's Insurance* - Homeowner and renter's insurance are combination policies that protect property as well as individuals present on the property. The primary characteristics of a homeowner and renter's policies are as follows:
 - *Property Coverage* - The homeowner or renter's policy will generally insure the subject property against damages from specific types of occurrence, such as fire, theft, flood, etc. It will generally cover the physical residence as well as private buildings located on the real estate.
 - *Liability Coverage* - The homeowner or renter's policy generally provides protection (or indemnification to the property owner) against losses resulting from personal injuries suffered on the insured property.
- *Fire Insurance* - Fire insurance insures specific property for a specific amount against damages from fire and fire-related damages (such as smoke, water, etc.) These policies exclude coverage for certain types of fires, such as certain fireplace fires or arson. These policies often place other conditions on coverage, such as the policy owner living at the location where the insured property is located.

- **Discussion:** Why do you think these are common forms of property coverage? Can you think of a reason

why mortgage holders would require a homeowner to purchase such a policy? How do you feel about the ability of an insurer to select specific instances of damage or causes of damage to exclude from coverage?

- **Resource Video:** <http://thebusinessprofessor.com/insurance-policies-relevant-to-real-property-land/>

- **Business Liability Insurance:** Business liability insurance can have any number of property and liability protections. The most common form of business liability insurance is a “comprehensive general liability” (CGL) policy. These policies will insure any number of risks commonly faced by businesses, such as premises liability, product liability, professional malpractice, negligence, environmental liability, etc.
 - **Note:** It is common for insurers to require separate policies for product liability and professional malpractice liability coverage.
- **Professional Liability Insurance** - Professional liability insurance, often called “malpractice insurance”, protects the insured from losses incurred as a result of a specific type of negligent professional practice. A specific type of professional liability insurance is “director & officer liability” insurance, which is purchased by a business to indemnify its officers and directors from losses suffered in the performance of their business duties.
- **Others** - Other common types of insurance include: crime, flood, pollution, mortgage insurance, title insurance, worker’s compensation, unemployment, cyber privacy, etc.

An individual or business may purchase any of the above-referenced types of insurance, as well as many other common types of insurance. Some of the types of insurance may be required by law or by professional trade industry in a given jurisdiction.

- **Discussion:** What types of professional practitioners do or are generally required to purchase these types of policy? Why do you think companies purchase D&O insurance to cover its officers and directors? Why do you think many businesses purchase these types of policies? Can you think of a situation where a business would not benefit from such a policy?
- **Resource Video:** <http://thebusinessprofessor.com/common-types-of-business-insurance/>

6. What are the primary obligations of the insurer?

The primary duties of an insurer in an insurance contract are as follows:

- **Payment for Losses** - An insured is responsible for indemnifying the policyholder or paying for the losses suffered by the insured or a third party as a result of a covered risk.
 - **Example:** Lynn gets into an automobile accident that is his fault. The insurance carrier may be obligated to pay the cost of Lynn’s injuries, the injuries to the other driver, and the cost of damages to both Lynn and the other driver’s car.

- *Duty to Defend* - An insurer generally has the duty to defend or pay the legal expenses of an insured who is subject to a legal action for the covered risk.
 - *Example:* Hank has professional liability insurance for his accounting practice, the insurer will be obligated to defend Hank if a client brings a civil action against Hank alleging negligence in his accounting services.
- *Subrogation* - An insured inherits the identified interest of the insured based upon the occurrence of the covered risk. The insurer may then seek recovery or contribution for harm suffered (funds paid to the insured or third parties) based upon the harm to the insured's interest.

The majority of all civil litigation in the United States involves insurance coverage. Failure of an insurer to comply with its duties under an insurance policy is a common subject of litigation, known as "bad-faith refusal".

- **Discussion:** How do you feel about the duties of an insurer? What should be the rights of an insured if an insurer fails to perform its duties, such as pay the insured's losses or defend the insured in a legal action? Should an insured have the option of paying a claim or defending a legal action? Why or why not?
- **Practice Question:** Eric has an automobile liability coverage policy with ABC insurance. Eric gets into a wreck with another car, which the police deem to be Eric's fault. The other driver sues Eric. Generally, what are ABC's obligations in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/duties-of-an-insurer/>

7. What are the primary obligations of the insured?

The primary duties of an insured in an insurance contract are as follows:

- *Duty to Disclose Information* - The insured must inform the insurer of any events relevant to the contingent risk transferred to the insurer. This includes disclosing information in the application for policy coverage and disclosing incidences of damage to the insured person or property or harms resulting from the insured's conduct. A failure to disclose such information may lead to the loss of insurance coverage.
- *Duty to Cooperate* - An insured has a duty to cooperate with the insurer in the identification, investigation, and resolution of any event or circumstance giving rise to losses born by the insurer.

- **Discussion:** What do you think about the insured's duties? Why do you think they are necessary?
- **Practice Question:** ABC Corp has a policy with 123 Insurance covering any damage to ABC's facilities or equipment. ABC suffers a huge loss when a fire engulfs the facility. What would ABC's obligations as an insured be in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/primary-obligations-of-an-insured/>

8. What is the general structure of an insurance contract?

- *Declarations* - The declarations section of an insurance contract identifies the parties to the contract and dictates that the following provisions constitute an insurance contract. It will generally state the intentions of the parties with regard to the subject-matter of the insurance, the term of the policy, the risks covered by the policy, the limits on payment in the event an insured risk occurs, and the financial obligations of the insured (premiums, deductibles, co-payments, etc.).
- *Definitions* - Most insurance contracts contain a defined terms section that provides the common understanding of certain terms or phrases used throughout the insurance agreement. This section can be very important for avoiding ambiguities in the agreement.
- *Terms of Insurance* - This section, often called the “insuring agreement”, lays out the promises of the insurance company to indemnify the insured against certain risks of loss. Specifically, it will describe the type of risks insured against and the person, property or subject matter covered under the policy. There are two basic forms of an insuring agreement:
 - *Named Perils Coverage* - This form of agreement insures perils specifically listed in the policy. If the peril is not listed, it is not covered.
 - *All-Risk Coverage* - This form of agreement insures all losses suffered to a person or specific property except those losses specifically excluded. If the loss is not excluded, it is covered.
- *Exclusions* - Exclusions are types of contingent risk that are not covered or insured under a policy. There are three major types of exclusions:
 - *Excluded Perils or Causes of Loss* - For example, homeowner’s insurance may exclude damages caused by flooding.
 - *Excluded Losses* - For example, an automobile policy may exclude normal wear and tear from everyday use.
 - *Excluded property* - For example, a homeowner’s policy may not include certain personal property located within the home.
- *Conditions* - Conditions are contractual provisions that require a certain fact or circumstance come about before duties or obligations arise under the contract. If policy conditions are not met, the insurer is not obligated to insure against the loss that is subject to that condition. That is, the insurer will deny a claim for losses if an applicable condition in the policy is not satisfied. For example, the insurer may make filing a claim and providing proof of loss a condition to coverage.
- *Endorsements* - These are forms attached to the main insurance policy used to modify the duties or obligations under the policy. Often endorsements will place some condition on the insurer’s duty to indemnify the insured or cover a particular type of loss. They may also modify or delete express clauses present within the core of the

insurance policy. This is the primary method by which underwriters tailor a specific policy to cover a particular insured.

- *Policy riders* - Policy riders are amendments to an existing policy. The rider contains the amended terms and becomes part of the original insurance contract. An insurer will use a rider any time that the terms of coverage change under an insured's policy.
- *Policy Jackets or Binders* - Insurers often issue a policy within a policy jacket. The jacket is a cover, binder, envelope, or folder containing the policy. The binder will often contain boilerplate provisions of the insurance policy. Some insurers now append material to the insurance policy that contains the standard boilerplate provisions, instead of including those provisions on the jacket.

- **Discussion:** You will notice that an insurance contract follows a similar format to most contracts, but it contains several insurance-specific provisions. Why do you think that insurance contracts employ endorsements and riders to modify the terms of the existing agreement and the duties of the parties? How do you feel about the use of exclusions and conditions in the insurance policy? How do you balance the insured's need for these policies against the potential abuse of insured parties?
- **Practice Question:** ABC Corp has a general liability policy with 123 Insurance. What terms are likely covered in the policy? ABC wants to modify the policy by increasing the coverage limits. What will ABC need to complete to modify the policy?
- **Resource Video:** <http://thebusinessprofessor.com/general-structure-of-an-insurance-contract/>

9. What are the common provisions in an insurance contract subject to legal dispute?

State law requires that insurance contracts contain certain provisions protecting the rights of the insured against the insurer. These provisions are commonly the subjects of litigation. An insurer that fails to pay an insurance claim for which it is legally obligated may be subject to a “wrongful dishonor” action by the insured. Some of these common provisions in many types of insurance policy include:

- *Incontestability Clauses* - An “incontestability clause” protects the insured by preventing an insurer from denying coverage based upon certain misrepresentations by the insured when applying for the policy. These clauses generally do not protect against fraudulent statements made with the specific purpose of deceiving the insured into granting a policy. Incontestability clauses are effective after a stated period of time, the “contestability period”. The theory is that a misrepresentation that does not give rise to an issue in coverage within the stated period was not material at the time of the application for coverage.
- *Anti-Lapse Clauses* - An “anti-lapse clause” prevents an insurer from automatically canceling an insurance policy at the end of a specific policy term. In addition, state statutes require that the insurer give the insured sufficient notice of the policy's termination date and inform the insured of what is required to continue coverage for a future coverage period. If the insurer fails to meet the notice and information requirements, the insured may be able to claim coverage or renew the policy beyond the posted termination date.
- *Appraisal Clause* - Appraisal clauses seek to avoid litigation of disputes as to the replacement or repair value of

covered items. Specifically, these provisions require that the insured and insurer submit any disputes as to valuation to qualified third-party appraisers. These appraisers arrive at a value that binds both parties. The parties split the cost of hiring appraisers to determine the dispute.

- *Duty to Preserve Clause and Notice of Claims* - Nearly all insurance contracts require that the insured seek to preserve evidence surrounding a particular claim and provide notice to the insurer as soon as the insured has a reasonable belief that a claim has arisen. This is particularly true in an indemnification situation where the insurer is responsible for defending and paying any losses awarded through civil litigation.
 - *Preserve Evidence* - The insured must preserve any evidence relevant to the situation once the insured reasonably anticipates litigation on the matter.
 - *Notice of Claims*- These provisions require an insured to provide notice to its insurer of any circumstance that may give rise to a claim under the existing policy. Failure to provide a notice of claim prior to the end of the policy may diminish the ability of the insured to make a claim for injuries or losses incurred.
- *Co-Insurance Clause* - These provisions require that an insured purchase separate insurance on insured property up to a specific percentage of the insured property value. An insured who fails to purchase insurance to meet the required percentage of the property value may forfeit any or all of the coverage under a particular policy.
- *Multiple Coverage Clause* - These clauses limit the insurer's responsibility to pay for losses when multiple insurance policies cover the same property or loss. Generally, these clauses provide that an insurer will be a secondary insurer to any existing insurance. Alternatively, these policies state that the insurer will pay only a *pro rata* share of losses along with the other insurer.
- *Dispute Clause* - Dispute clauses are provisions aimed at curbing insurance litigation. These provisions require the insured and insurer to submit any dispute to binding arbitration, rather than initiating a civil action. Many states will not enforce these provisions and allow parties to initiate litigation.

- **Discussion:** Why do you think the above-listed clauses are frequently the subject of litigation?
- **Practice Question:** ABC Corp has an insurance policy with 123 Corp. It also has a policy with XYZ Corp. If ABC suffers an insured loss, what are some of the issues it may encounter when submitting a claim to ABC or 123 Corp?
- **Resource Video:** <http://thebusinessprofessor.com/common-legal-disputes-over-insurance-agreement/>

10. What is required for termination of an insurance contract?

An insured may terminate an insurance policy at any time. Generally, it requires that the insured express intent to cancel the policy. This may include notifying the insurer in writing or discontinuing payment of premiums. If the insured stops paying the insurance premiums, the insurer must provide the insured with notice of its intention to cancel the policy. If the insurer fails to provide notice within the statutory period, the insured may be able to resume her insurance contract by resuming payments. An insurer is generally limited by statute in its ability to cancel a policy. Below are the common

situations in which an insurer may cancel a policy.

- *Void by Insurer* - An insurer may void a contract if the insured supplies false or misleading information to the insurer to obtain insurance. To void the contract, the insurer must demonstrate that the insured made a fraudulent or material misrepresentation. Further, the insurer must demonstrate that it would not have entered into the insurance relationship with the insured if it had known of the misrepresented facts.
 - *Note:* This right is limited by the incontestability period or clauses in the contract.
- *Conditions in Policy* - An insurance policy may contain any number of conditions that can cause cancellation of the insurance policy. These are normally limited by state law and rules of equity.
 - *Example:* A professional liability or malpractice policy may contain a clause terminating a policy if a person loses a professional licensure.
- *End of Policy Term* - An insurer may be able to terminate an insurance policy at the end of a stated insurance term. State law may limit the ability of the insurer to deny an insured the ability to renew a policy that has not lapsed. This is particularly true with health and life insurance policies.
 - *Example:* A term life insurance policy has a stated period during which the insurance provisions are effective.

- **Discussion:** How do you feel about the requirements for terminating an insurance policy? Why do you think the law places these limitations? Do you have an opinion regarding the above-listed situations allowing an insurer to cancel a policy?
- **Practice Question:** ABC Corp holds an insurance policy with 123 Corp. ABC has made lots of claims in the past years and 123 is considering canceling the policy. What will 123 have to do procedurally to cancel the policy? What conditions provide 123 the ability to cancel the policy?
- **Resource Video:** <http://thebusinessprofessor.com/requirements-for-cancelling-and-insurance-contract/>

TOPIC 25: INTERNATIONAL LAW

Overview

International law concerns the laws agreed to and observed by nations and its citizens. More specifically, international law may include the rules applicable to dealings between two countries. It may also include the laws applicable to a transaction between individuals from separate countries. This chapter introduces the concept of international law and the categories of public and private international law before providing context for its application. This includes international relations and private international transactions. It identifies the primary international organizations charged with promulgating international legal standards. It then identifies the body primarily charged with resolving disputes that arise pursuant to those standards. It reviews the primary methods for transacting business in foreign markets and the legal risks inherent in each. It then reviews the primary US laws that affect international business practice, such as the import and export of goods. Lastly, it reviews the primary methods for resolving disputes in private international transactions.

VIDEO LESSON - INTRODUCTION



VOCABULARY & CONCEPTS

- [International Law](#)
- [Public & Private Int'l Law](#)
- [Int'l Gov. Organizations](#)
 - [NATO](#)
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TOPIC 25: INTERNATIONAL LAW - QUESTIONS & ANSWERS

1. What is “international law”?

International law includes all of the generally accepted rules that govern the relations between nations or countries and their citizens. The concept of international law is much broader than domestic law, which is generally attributed to statutory authority vested by a federal, state, or local governmental body. In many ways, international law is an agreement upon common understanding between two or more separate nations. International law may include a particular country’s law applied internationally or in an international setting. For example, international law may subject the citizens of one nation to the jurisdiction of international courts or tribunals. The US Supreme Court addressed the United State’s view of international law as “a part of our law, and must be ascertained and administered by the courts of justice of appropriate jurisdiction as often as questions of right depending upon it are duly presented for their determination.” In any event, international law establishes standards or expectations for conduct between nations and between or by the citizens (including businesses) of other nations. Developing and employing an international legal framework in this manner provides additional certainty and stability between nations and between individuals. More specifically, international organizations and agreements facilitate trade and minimize the risk for businesses.

- *Note:* International law is generally binding upon a nation pursuant to that state’s voluntary agreement to be subject to that law. A business operating internationally may be subject to both international law and the law of the nation in which it is doing business. This is collectively referred to as international law throughout this chapter.
- **Discussion:** What do you think about the definition attributable to international law? Is the definition broader or narrower than you expected? Why do you think nations seek commonality of law in certain circumstances? In what way does it affect commerce between nations?
 - **Practice Question:** What are the differences between domestic laws in the United States and international laws? How do international laws come into existence? Who do they control?
 - **Resource Video:** <http://thebusinessprofessor.com/what-is-international-law/>

2. What are the types of international law?

International law is commonly divided into two categories:

- *Public International Law* - Public international law examines relationships between nations and the rules that are binding upon countries in the international community. It also governs the relationship between states and international entities. Public international law originates largely from the direct agreements or treaties between nations. In some cases, an agreement among some nations may involuntarily subject other nations to that law. Such is the case with certain criminal laws. Fields of international law include criminal law, maritime law, the law of war, human rights law, refugee law, and the law established by treaties between nations. When conflicts exist between nations, these sources of international law (as applied within the substantive field) generally guide those nations in resolving the conflict. In some instances, nations will empower a common court or tribunal to resolve international disputes. These nations agree to submit disputes to these courts or tribunals, which are charged with applying the sources of international law (along with any codifications or common law derived by those courts or

tribunals) in resolving the conflict. Resolution of conflicts between nations necessarily entails disparity in laws and ethical or moral principles. Therefore, public international law may employ principles present in international conventions, customs of the disputing nations, generally accepted community norms, principles of law recognized by civilized nations, and judicial philosophies or theories of jurisprudence in addressing conflicts between nations.

- *Private International Law* - Private international law primarily concerns disputes between individuals or businesses (not nations) in situations where the law of more than one nation may apply. This is often referred to as international conflict of law. These situations commonly arise through commercial transactions undertaken by parties from separate nations. Private international law addresses the questions of (1) which jurisdiction may hear a case, and (2) the law concerning which jurisdiction applies to the issues in the case. Parties typically utilize contracts to provide mutual understanding and some degree of continuity to international business transactions. In the event of conflict, in hopes of resolving the dispute, the parties may voluntarily or involuntarily submit the dispute to a legal system to interpret the agreement in accordance with the laws of either or both nations.
 - *Note:* When disputes arise as to the law that will apply to a specific transaction or situation, “conflict of law” rules are used to determine which country’s law will apply.

- **Discussion:** What do you think about the concept of international law? Does the voluntary nature of most international law affect your opinion? Can you think of situations in which the ethics and social norms adopted in one country’s law could conflict with those of another country? Why do you think that there is a distinction between public and private international law?
- **Practice Question:** What is the difference between public and private international law? Can individuals ever be the subject of public international law? Can governments ever be subject to private international law?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-public-and-private-international-law/>

3. What are the major international inter-governmental organizations?

Much public international law derives from treaty or agreement between individual nations and the law elected by private parties to govern their agreements. Other sources of international law are the numerous international organizations which develop standards for conduct among member nations or private parties. The most well-known international organizations contributing to international law include:

- *United Nations (UN)* - The UN formed after World War II “to save succeeding generations from the scourge of war”. The UN has a representative from nearly every commonly recognized country in the world. This structure provides all member nations a forum to voice concerns about threats to peace and stability. Collectively, the UN focuses on measures and collaborative efforts to identify threats to peace among member nations. A select group of 15 nations make up the UN Security Council. This body analyzes potential threats to world peace and has the authority to intervene through diplomatic efforts and recommend military action. The council may also undertake investigations of situations that could potentially affect world peace. Five countries hold permanent seats on the council (United States, Russia, China, France, and the United Kingdom), where other members rotate on and off. Each of the permanent council countries has the power to veto any council proposal made to the greater UN body.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-united-nations-and-how-does-it-affect-international-law/>

- *United Nations Commission on International Trade Law (UNCITRAL)* - UNCITRAL is a affiliate organization to the UN made up of business and legal professionals. This group develops model standards and procedures for dealing with issues affecting international business. Perhaps most notably, UNCITRAL promulgated the Convention on International Sale of Goods (CISG). The CISG is a model law commonly used as the governing provisions in contracts between parties from different nations.

- *Note:* You can think of the CISG as similar to the Uniform Commercial Code and Restatement of Contracts, which are model laws commonly adopted within the US.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-united-nations-commission-on-international-trade-law/>

- *United Nations Conference on Trade and Development (UNCTD)* - UNCTD is another UN affiliate organization that addresses matters of international trade reform. More specifically, it seeks to foster international trade globally with the purpose of providing trade benefits among developing countries.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-united-nations-conference-on-trade-and-development/>

- *The North Atlantic Treaty Organization (NATO)* - NATO is a military alliance among 28 member countries. Numerous other countries also participate in NATO programs to promote peace and international dialogue. Member nations agree to provide collective support to member nations in the event of attack by non-member nations. NATO also provides a judicial system for adjudicating breaches of international peace, known as the International Court of Justice.

- *Note:* Member nations must be accepted by the NATO body and meet certain defense spending and capability requirements.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-north-atlantic-treaty-organization-nato/>

- *Organization for Economic Cooperation and Development (OECD)* - The OECD is an international organization of 35 countries with the propose of fostering economic development and international trade. The objective of the organization is to develop common policies and understanding with regard to international trade practices. It provides model policies for countries to implement and facilitates the negotiation of treaties among participant

countries.

- *Note:* The Nuclear Energy Agency is a sub-organization of the OECD. It focuses on promoting the development, advancement, and use of nuclear power for peaceful purposes.
- *World Customs Organization (WCO)* - The WCO is an international organization of member governments focused on the development of international model rules and instruments to facilitate international trade. It focuses on the aspects of international trade commonly enforced through a country's customs agency.
 - *Note:* The WCO administers the international harmonized system and WTO customs valuation and rules of origin procedures.
- *Organization of Petroleum Exporting Countries (OPEC)* - OPEC is an intergovernmental organization of 14 oil-producing nations. It negotiates oil production policies among member nations with the purpose of stabilizing oil markets, including the supply, demand, and prices stabilization.
- *International Monetary Fund (IMF)* - The IMF is similar to an international bank with the underlying purpose of fostering global monetary policy, commerce, and trade. The intended result is to increase employment levels, drive economic growth, and reduce poverty. The IMF makes loans to developing countries, provides stable exchange rates between currencies, establishes policies for currency exchange among commercial banks, conducts statistical and economic analysis of economies, and monitors economies while encouraging sound economic policies. Notably, the IMF makes loans to developing countries under the condition that borrowing countries make efforts to improve or correct internal systems causing economic imbalances. Structural and policy improvements may include: reduced governmental spending, import and export policy (such as tariffs), currency valuation, security market regulation, price controls, privatization, foreign investment provisions, and anti-corruption measures.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-international-monetary-fund/>

- *World Bank* - The World Bank is a financial institution that promotes economic development in developing countries with the purpose of fostering economic strength and reducing poverty through increased foreign investment and international trade. The World Bank is a division of the World Bank Group, which is an affiliate of the United Nations. The World Bank Group is made up of 5 international organizations that collectively make loans to developing countries to finance necessary development projects and programs. Loans or grants are generally issued for infrastructure, health, or education purposes.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-world-bank/>

- *World Trade Organization (WTO)* - At the end of WWII, a large block of countries signed a treaty known as the General Agreement on Tariffs and Trade (GATT). The purpose of the treaty was to demonstrate an intent to foster trade among the countries of the world. In 1995, 123 countries signed the Marrakesh Agreement, which replaced the GATT and formed the WTO. The WTO provides a framework for developing trade agreements between

countries. The purpose of this organization is to foster trade and competition while avoiding trade practices that detriment society at large. The WTO also provides a forum and procedure for resolving trade disputes between its member countries. Member nations agree to adhere to WTO policies and to any result from the dispute resolution process. This includes honoring sanctions levied by the WTO against a nation that fails to adhere to WTO policies or decisions. A notable contribution of the WTO to trade policy is the development of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). TRIPS is a model agreement that deals with recognition and enforcement of intellectual property rights among signatory nations. Specifically, it seeks to curb the theft or misuse of intellectual property through the international sale of counterfeit goods or copyrighted property. TRIPS also provides a dispute resolution system for disagreements regarding intellectual property rights and enforcement among nations.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-world-trade-organization/>

- *The European Union (EU)* - The EU is a group of 27 European countries banded together to promote economic and social prosperity among the nations. Most notably, the EU has a pseudo-governmental body made up of representatives of member countries. The EU provides a standardized legal system governing trade and commerce among the nations that allows for the movement of persons, goods, capital and the provision of services across borders. Perhaps most notably, most countries use a single currency known as the EURO.

- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-european-union/>

- **Discussion:** How do you feel about the genesis and continued purpose of the above-listed international organizations? Do you think recognizing this mix of authoritative bodies is an effective method of administering international law?

4. What international courts exist and what are their functions?

International courts exist as a result of agreement between nations as to their formation and authority. The authority of the court over a country or its citizens may result from that country becoming a member of an international organization or signatory to an international agreement. Courts that exercise global jurisdiction over the actions by or among countries include:

- *UN Security Council* - While not technically a court, the United Nations Security Council claims jurisdiction over all countries with regard to activities potentially disturbing or jeopardizing world peace. This group may investigate and make determinations regarding activity potentially jeopardizing world peace. These investigations may end in a recommendation for action by the UN (or its member nations) to address the threatening activity through sanctions or military intervention.
- *UN International Court of Justice (ICJ)* - The ICJ is the judicial branch of the United Nations. It provides advisory opinions to international agencies concerning international law. Further, it adjudicates matters or disputes submitted to the court by the party countries or nations. In this way, the ICJ has very broad jurisdiction to

hear any type of dispute. Judges from developed legal systems throughout the world are elected by the UN General Assembly to sit on the court.

- *International Criminal Court (ICC)* - The ICC was formed pursuant to a multilateral treaty, known as the Rome Statute. The ICC, as the name implies, adjudicates criminal matters in the international context. The court will only hear a criminal matter when national courts will not or cannot prosecute individuals for the alleged criminal conduct. In this way, the ICC complements the criminal law system present in any country. Individual states may defer to the ICC and request that the ICC prosecute a case. This may occur when the country believes that this is the only manner or method of holding a fair trial. Common examples of ICC cases include acts of genocide or crimes against humanity.
- *WTO Appellate Body (Appellate Body)* - The Appellate Body hears appeals from disputes addressed by WTO panels. These panels often serve as arbitrator for disputes submitted to the panel by WTO members. The Appellate Body consists of seven individuals from WTO countries who act as appellate judges in reviewing panel decisions. These individuals may uphold, modify, or reverse a panel's decision in a dispute. The Appellate Body issues a report that affirmatively settles a dispute. The parties to the dispute must accept the Appellate Body's report as the final adjudication of the matter. The WTO may levy sanctions or offer other procedural methods for enforcing the Appellate Body's report.
- *International Tribunal for the Law of the Sea (ITLOS)* - The ITLOS is a UN sanctioned court that provides a system for adjudicating the law as it applies to the ocean and its resources. 167 countries are signatories to the agreement establishing this court. Notably, the court hears matters of mining on sea floors that are outside of a nation's geographic boundaries, territorial seas, the contiguous zone, and the continental shelf.

Numerous international courts or tribunals exist in specific regions or areas of the world. These courts or tribunals will hear diverse matters involving signatory nations within their subject matter and geographic jurisdictions.

- **Discussion:** How do you feel about the authority vested in these courts? Should the US government and its citizens be subjected to international law? What are the arguments for and against this? Does it matter whether the subject-matter is civil or criminal in nature? Does the mandatory or voluntary nature of some of the courts affect your opinion?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-there-international-courts-and-their-function/>

INTERNATIONAL BUSINESS AND THE LAW

5. What are the methods of carrying on international business?

US companies intending to carry on international business can do so in three separate manners:

- *International Sales* - A US company can carry out international sales by either selling directly to customers, selling to retailers, or selling to distributors (who then sell to retailers). Each of the methods of international selling requires different processes or procedures.
 - *Direct Sales* - Direct sales to customers may be achieved through foreign-listed websites, catalogs, and

international mail. Payment from the customers is often facilitated through third-party payment websites, such as PayPal or Apple Pay. The main issues with direct sales are the cost of shipment can be high, and customer service and returns can be difficult.

- *Example:* Doug is in the United States. He creates a website specifically targeting Brazilian customers. When someone from Brazil purchases a product, he undertakes international shipping to deliver the product. Doug also uses [Ebay.com](https://www.ebay.com) and [Amazon.com](https://www.amazon.com) to reach customers in these locations.
- *Sales to Retailers and Distributors* - The export of goods to retailers is generally carried out through a complicated payment process using “letters of credit”. A letter of credit is a payment device issued by a bank. The buyer of goods works with a commercial bank to acquire a letter of credit. This buyer’s bank is the issuing bank. The letter of credit, like a certified check, says that the bank will make payment to a financial institution presenting the letter of credit for payment. The buyer will post money with the issuing bank in an amount sufficient to pay the letter of credit. The buyer then provides a bank in the seller’s location (the confirming bank) with the letter of credit. The letter of credit ensures a confirming bank that the issuing bank will release funds to the confirming bank upon receipt of a “bill of lading”. A bill of lading is a document identifying the goods for sale under the contract and stating that goods have been shipped. Once the seller ships the conforming goods, he gets the bill of lading from the carrier. The seller takes the bill of lading to the confirming bank to get paid. The confirming bank forwards the letter of credit to the issuing bank to recover its money. Now the buyer pays the issuing bank and gets the bill of lading. The buyer then presents the bill of lading to the carrier to receive the goods. Needless to say, the bill of lading must comply strictly with the letter of credit for the transaction to be consummated.
- *Example:* Evan agrees to sell his product wholesale to distributors in Spain. As such, he needs to arrange to ship \$50,000 in goods to Spain and receive payment from the distributor. He agrees to a letter of credit situation. The distributor will deposit funds in an acceptable bank and acquire a letter of credit. The letter of credit is sent to Evan’s bank. Evan ships the goods and receives a bill of lading, which he provides to his bank. His bank sends the bill of lading to the distributor’s bank. The distributor’s bank pays Evan’s bank once the bill of lading arrives and is used to acquire the shipped goods.
- *Licenses or Franchises* - Licensing a brand or other intellectual property is the process of allowing a third-party to use the licensed subject matter for a fee. This is very similar to franchising, which is a formalized process of licensing a brand, intellectual property, and operational plans to third parties who pay for the privilege. A business that decides to license or franchise can expand the brand, products, or services to international markets without directly performing services or selling goods in that market. While this model is far easier than navigating the legal and competitive environment of a foreign market, the downside of this method is that the licensor and franchisor lose a certain level of control over the license or brand. Further, the financial reward from licensing or franchising may be less than direct sales in the country.
- *Example:* ABC Corp manufactures wood products. ABC wants to sell in Europe but does not want to navigate the various markets. ABC franchises its name and operational plans to European businesses. These businesses purchase and sell ABC’s products and pay a royalty to ABC.
- *Direct Foreign Investment* - US businesses may enter a foreign market by combining in some way with a business

that already carries on business in the foreign market. The US business may choose to simply partner with a foreign business as a joint venture. In other situations, the US business may choose to acquire, merge, or otherwise combine with a foreign entity. In either situation, the US business may continue to carry on business in the US while the foreign entity introduces the US business's product or service into the new market. The decision of whether to enter a joint venture or to acquire a foreign subsidiary business will depend upon competitive factors as well as the legal restrictions on such transactions.

- *Example:* Acquiring a controlling interest in a foreign entity may be prohibited under that country's laws. As such, entering the foreign market through a joint venture may be the only available option.

- **Discussion:** What do you think about the commonly accepted methods of transacting business in foreign countries? Can you think of other models of carrying on business? Hint: Think about services and Internet technology. Can you identify the legal challenges associated with each method of international business?
- **Practice Question:** ABC Corp is considering expanding the sale of its products into the international market. ABC has identified 5 countries where it would like to first sell its goods. Can you describe to ABC the various methods of entering the foreign markets?
- **Resource Video:** <http://thebusinessprofessor.com/methods-of-carrying-on-international-business/>

6. What are the legal risks associated with carrying on international business?

The competitive risks associated with carrying on business in a foreign market are numerous. For example, understanding the foreign market, communicating in a foreign language, and understanding the competitive environment can be extremely difficult. Important for this chapter, the legal risks associated with carrying on international business can be extensive. The following are examples of legal risks businesses commonly encounter:

- *Governing Laws* - What laws control business agreements? Contracts often employ some amalgam of contract laws from each country. Does the foreign country recognize and protect intellectual property rights? What are the legal hurdles in the importation process? What tariffs, duties, customs processes, etc., apply to the importation of goods? What labor laws apply to operations?
- *Enforcing Legal Rights* - How does one enforce legal agreements or one's property rights? Foreign court systems have varying methods of enforcing one's rights. The legal system may be difficult to navigate or unavailable to foreigners. Is there a risk of expropriation or nationalization of business assets?
- *Political Stability* - Is there a risk of political overturn, war, etc., that could disrupt business operations. This includes the potential for expropriation or nationalization of the company's resources.

This list is by no means exhaustive. Operating in a foreign market may give rise to any sort of specific legal barrier or hurdle for foreign entities.

- **Discussion:** Can you think of other legal risks that may present themselves when doing business in a foreign

country? How do these risks compare to other risks, such as the foreign competitive environment?

- **Practice Question:** ABC Corp is considering expanding its US-based operations into China. Can you identify some of the legal risks that ABC Corp will face in its expansion?
- **Resource Video:** <http://thebusinessprofessor.com/legal-risks-and-considerations-in-international-business/>

7. What major international agreements affect international trade?

The United States has entered into two types of treaty with multiple countries regarding the trade and shipment of goods. These treaties allow individuals from the US and the host country to sell and ship goods to the other country without special tariffs or duties. The two types of treaty are as follows:

- *Treaty of Friendship, Commerce, & Navigation* (FCN) - These are commerce agreements that the US maintains with over two-dozen countries. Many of these agreements have been replaced by other specific agreements.
- *Bilateral Investment Treaty* (BIT) - These agreements provide provisions for foreign countries (or its citizens) owning businesses within another country. The US is currently involved in over 40 BIT agreements with foreign nations.

Numerous direct agreements between countries affect the international sale of goods. The most commonly recognized international agreement is the North American Free Trade Agreement (NAFTA). NAFTA is an agreement between the US, Mexico, and Canada to increase trade and foreign investment across the countries. NAFTA allows for trade and shipping among these countries without tariff or duties. It also provides a system of dispute resolution for disagreements among trading parties. The US is a party to similar free-trade agreements with the Dominican Republic, Colombia, South Korea, and Panama, Israel, Jordan, Australia, Chile, Singapore, Bahrain, Morocco, Oman, and Peru.

- **Discussion:** Why do you think the US Government has so many international trade agreements with other countries? How do you think these agreements affect both countries? What are the arguments for and against these types of agreement? Hint: Think in terms of economic productivity and the role that each country plays in these types of relationships.
- **Practice Question:** ABC Corp is considering importing goods made in several Asian, European, and South American Countries. ABC will decide on the importation countries based upon the costs associated with importing. What types of treaties or agreements may aid ABC in its objectives?
- **Resource Video:** <http://thebusinessprofessor.com/types-of-international-agreement-affecting-us-trade/>

8. When is carrying on business in a foreign country prohibited under US Law?

Embargoes are prohibitions against carrying on business transactions with certain countries. The Office of Foreign Assets Control (OFAC), a division of the US Department of Treasury, is charged with carrying out embargoes and “targeted sanctions” against countries. Targeted sanctions are restrictions on business relations with a country that falls short of a total embargo. OFAC may designate persons or companies as “specially designated nationals” (SDNs). These individuals

or companies are treated with the same restrictions as the country to which they are designated. This keeps US citizens or businesses from using intermediaries to carry on business with a company subject to embargo. In order to carry on business with individuals from these countries (or purchase goods or services derived from these countries), the US company must request a license from OFAC.

- *Note:* Many western nations, including the United States, were previously members of the Coordinating Committee for Multilateral Export Controls. This committee sought to control global exports among member countries. It was dissolved in 1994.
- *Example:* The US currently has embargoes against Iran, Cuba, and the Sudan. The long-standing embargo against Cuba is the subject of controversy. The US has targeted sanctions against Syria and North Korea.
- **Discussion:** Why do you think the US issues embargoes against certain countries? Should diplomatic objectives be balanced against economic prosperity? Why or why not?
- **Practice Question:** ABC Corp regularly does business with 123 Corp. ABC recently learned that 123 is categorized by the US government as a specially designated national. What will this mean for ABC?
- **Resource Video:** <http://thebusinessprofessor.com/when-is-foreign-business-prohibited-under-us-law/>

9. What is the significance of boycotts between foreign countries?

The US issues restrictions on international business relationships through embargoes and targeted business sanctions. The US is not currently a part of an official boycott of countries or individuals. In fact, the US recognizes two prohibitions against US companies taking part in unsanctioned boycotts. These prohibitions are issued by the Department of Commerce or the Department of Treasury.

- *Department of Commerce (DOC)* - The DOC prohibits US companies from participating in any unsanctioned boycott of other countries or its citizens. This rule specifically prohibits US companies from maintaining lists of countries with which they will not do business based upon a non-US sanctioned boycott. The DOC also prohibits discrimination in carrying on business based upon an individual's race, religion, sex or national origin.
 - *Note:* Companies who receive specific requests to take action, such as not carrying on business pursuant to a boycott, must report that request to the DOC.
- *Department of Treasury (DOT)* - The DOT prohibits companies from participating in unsanctioned boycotts. Specifically, the DOT requires a US tax-reporting company to report on its income tax return all business activity with or in countries that actively participate in a non-sanctioned boycott of other countries, races, religions, ethnicities, etc. Carrying on business with these countries (or otherwise participating in the boycott activity) can result in the loss of certain foreign tax benefits.
 - *Note:* The DOT publishes a list of countries actively participating in non-sanctioned boycotts.

- **Discussion:** Why do you think the US does not participate in current boycotts? Why do you think the US prohibits US companies from participating in boycotts or, in some cases, doing business with companies that participate in boycotts? Are these restrictions appropriate?
- **Practice Question:** ABC Corp has had very bad experiences in its business dealings in Turkey. ABC puts out a company-wide memo that it will not do business with any Turkish company or any company with direct ties to Turkey. Is there a legal problem with this stance?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-the-significance-of-boycotts-on-international-law/>

10. What US laws apply to limit specific business practices in all foreign countries?

Numerous US laws limit specific types of conduct or business activity in foreign countries. Major limitations under US law include:

- *Antiterrorism and Effective Death Penalty Act of 1996* - This act prohibits doing business with companies that have been linked to terrorism.
- *USA Patriot Act of 2001 (Patriot Act)* - The Patriot Act prohibits individuals or companies from providing material support to any foreign individual, organization, or company engaging in terrorist activity. “Material support” may include providing money, assets, information, etc.
 - *Note:* The State Department designates certain organizations as providing material support for terrorist activity.
- *Foreign Corrupt Practices Act (FCPA)* - The FCPA was passed to prevent businesses using bribes to gain an unfair business advantage. The FCPA prohibits a business, its employees, or agents from offering or giving anything of value to a foreign official for the purpose of gaining an unfair business advantage. A foreign official includes government officials, candidates for office, political parties, any person who knows the money will be offered, given, or promised to a foreign official for purposes of securing improper advantage. An improper advantage includes securing additional business, permits, special taxation, or favor in judicial or legislative proceedings. This prohibition applies to all businesses. The FCPA also places accounting disclosure requirements on any company subject to SEC regulations. Companies must keep detailed records that reflect transactions and disposition of assets that are sufficient to provide reasonable assurance that transactions are carried out within management’s authorizations. The exception to this rule is that companies may pay officials to perform their routine government tasks. The prohibitive line is that payment cannot go to influence a positive decision for the company from an official empowered to make such decision. Companies may also pay statutory fees to officials or undertake marketing and promotion efforts.

US laws applicable to business operations may apply to the business’s foreign operations as well. The concept of applying US laws to businesses or operations outside of the United States is known as “extraterritoriality”. Example of US laws limiting foreign activity include:

- *Employment laws* - Title VII of the Civil Rights Act of 1964, the Americans with Disabilities Act, and the Age Discrimination in Employment Act of 1967 apply to US companies carrying on business abroad, as well as

companies controlled by a US employer.

- *Environmental Laws* - Environmental laws concerning the handling and disposal of hazardous material may apply to operations abroad.
- *Tax Laws* - US tax laws are extensive and complicated. There is a great deal of interplay between US taxation and foreign business activity.
- *Antitrust Laws* - US antitrust law applies to company activity outside of the United States if such activity has an intended or actual, substantial or foreseeable effect within the United States.
- *Foreign Bank Account Reporting* - The transfer of funds in excess of \$10,000 in or out of the United States must be reported to the US Customs and Board Protection or US Treasury.

The above list of foreign laws limiting specific activities in foreign countries is just a sample of the many laws or regulations that could apply to a company's foreign operations.

- **Discussion:** Do you agree that government efforts to thwart terrorist activity should trump a company's intentions to do business in a foreign country or with a foreign firm? Do you think the US prohibitions against discriminatory practices should also apply in countries that allow such conduct? Why do you think the US government seeks to prohibit bribes and other kickbacks to individuals outside of the US?
- **Practice Question:** ABC Corp imports goods from Country A, that has numerous laws that directly discriminate against individuals. Might ABC run into trouble in doing business with Country A?
- **Resource Video:** <http://thebusinessprofessor.com/what-us-laws-prohibit-business-practices-in-foreign-countries/>

IMPORTING AND EXPORTING GOODS

11. What regulations apply to exports from the United States?

US Export Administrative Regulations (EAR) cover the export and re-export of most commercial items, including some civilian and military grade items. An export includes any item transported outside of the country, whether temporary or permanent and whether sold, gifted, or transferred to a US subsidiary. This includes shipments originating in the US, shipped through the US, or being returned from the US to another country. EARs establish export requirements depending upon the product or service being exported and the destination country. Notably, the EAR places licensing requirements on certain types of exports. The Department of Commerce, Bureau of Industry and Security (BIS) is charged with implementing EARs. EARs also establish requirements for end-user control of licensed exports.

- *Note:* EARs completely ban the export of certain goods and any exports to certain countries (Iran, North Korea, Cuba, Sudan, Syria).
- *Example:* Items connected with nuclear, chemical, biological, or missile proliferation in specific countries would require a license.

EARs also control the sale of US strategic products and technologies abroad. These types of products may also include services or data. The purpose of these provisions is to control the acquisition and use of technologies by combatant nations. These regulations combine with the International Traffic in Arms Regulations (ITAR) that are administered by the State Department, which govern the export of any defense articles or services. Defense services may include design, development, engineering, manufacturing, assembly testing, destruction, etc., of defense items. A license is required to export any of these items.

- *Note:* The US is also signatory to the Wassenaar Arrangement, which is an international agreement among 33 Countries to control the spread of both military and dual-use technology to unstable areas of the world.
- **Discussion:** What do you think are the government interests involved in exporting goods outside of the United States? Do you think these commercial controls are adequate to achieve the objectives behind the regulations?
- **Practice Question:** ABC Corp manufactures a number of types of chemical fertilizer for plants. These fertilizers have properties that make them highly explosive in certain conditions. What laws apply to ABC if it intends to export these products outside of the United States?
- **Resource Video:** <http://thebusinessprofessor.com/what-laws-apply-to-the-export-of-goods-from-the-us/>

12. What are the limitations on importing goods into the United States for sale?

Below are the primary laws governing the importation of commercial goods.

- *The Customs Modernization Act (CMA)* - The CMA, a part of NAFTA, requires importers to declare attributes of imported goods with the Customs and Border Protection Agency (CBP). Typically, when goods are shipped into the US, the importer (or her agent) must complete documents disclosing the nature, value, origin, and other information about the goods. The CBP will inspect the goods and charge estimated duties on the value of the goods. The inspection generally seeks to ascertain the value of the goods, that the markings and labeling are accurate, that there are no prohibited items, and that the goods are correctly documented. The CBP may also assess additional duties on goods imported for sale at abnormally low prices. This is known as “anti-dumping” and “countervailing duties”. The purpose of this authority is to protect markets from the effect of selling products at a loss or at a lower price than in the foreign market simply to reduce inventory or push other merchants out of business. Importers can appeal or request administrative review of the assessed duties. Goods subject to countervailing duties must demonstrate that the pricing practice does not hurt a consumer market.
- *The Trademark Act of 1946 (Trademark Act)* - The Trademark Act prohibits the importation of products that mislead the public as to the point or origin, manufacturer, or brand. This includes importing items under a protected trademark that does not belong to the importer or purchaser of imported goods. Any such goods are subject to forfeiture or may be released to the importer upon adequate assurance of removing the deceptive markings or destroying the items.
- *Regulations of Various Products* - The US places restrictions on the importation of specific types of products. These products may require permits, licenses, inspections, labeling, etc. Restrictions for failure to meet specific requirements may include prohibitions on sale, limited ports of entry, restricted routing, storage, use, etc. The

purpose of these restrictions is to protect the US economy and the health and well being of US citizens.

- **Discussion:** Why do you think the government takes an interest in regulating the importation of goods? What are the primary interests? Do you think charging the Customs and Border Protection Agency with regulating imports is adequate to achieve these objectives?
- **Practice Question:** Arnold is going to import goods into the United States. What information is required to provide to the government before the goods may enter?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-limitations-on-importing-goods-into-the-us-for-resale/>

13. How are private international business agreements generally enforced?

The first method of enforcing one's rights pursuant to an international agreement is through a lawsuit or judicial action. When a dispute involves multiple parties from multiple countries, it becomes an issue as to how and where to handle the dispute. In the United States, the Alien Tort Claims Act grants jurisdiction to US federal district courts over "any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States." The following limitations apply to bringing a civil action against a foreigner party in US Courts:

- *Suing Foreign Firms in the US* - Plaintiffs may bring a legal action in federal court (the US District Court) against a foreign individual or business if the requirements for personal and subject-matter jurisdiction are met. That is, the Plaintiff must show that the foreign defendant has "minimum contacts" with the United States. In some cases, having significant assets in the United States will be sufficient to exercise jurisdiction over the foreign party. Service of process must be completed in accordance with the Hague Service Convention.
 - *Note:* Under the Foreign Sovereign Immunities Act, a foreign government is immune from suit in the United States for public acts, but may be subject to suit for private or commercial activity.
- *Arbitration* - Enforcing one's rights in a foreign court is often difficult. It may be difficult to access the court because of procedural rules; the court may not be independent and fair to foreign plaintiffs; and accessing the court could be prohibitively expensive. Aware of these concerns, parties frequently seek alternative methods of settling disputes or dictate the specific rules and procedures that will be applicable to the interpretation and resolution of the international business agreement. Two major international agreements with this purpose are:
 - *Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention)* - Parties to an international business agreement often employ alternative dispute resolution (ADR) clauses in their agreements. The most common ADR clause is an arbitration clause directing that any unresolved dispute be submitted to arbitration for resolution. The New York Convention is a treaty between many signatory countries (approximately 50 in total) that agree to recognize and enforce arbitration awards. Within the US, the recognition and collection of arbitration awards are carried out by filing the arbitration award with the country's judicial system.
 - *Note:* Other notable international arbitration bodies include, the China International Economic and Trade Arbitration Commission, which arbitrates trade disputes arising in China that are

voluntarily submitted to Commission. The World Intellectual Property Organization sponsors a voluntary arbitration and mediation center for disputes involving intellectual property. The international Centre for Settlement of Investment Disputes is an international arbitration body frequently used in disputes regarding international investment under Bilateral Investment Treaties.

- *Convention on the International Sale of Goods (CISG)* - As previously discussed, UNCITRAL promulgates the CISG. Most member countries of the UN have adopted the terms of the CISG. Further, individuals (even in non-CISG countries) regularly agree to abide by the terms outlined in this agreement. In CISG-signatory countries, the CISG is the default rule when an international agreement fails to indicate a different controlling law. Parties to an agreement, however, may opt out of the provisions of the CISG. The CISG specifically provides methods and procedures for dispute resolution.

It is important to remember that arbitration of most international disputes is voluntary. There may, however, be limited situations in which foreign activity becomes subject to mandatory arbitration provisions of a party's home country.

- **Discussion:** Why do you think dispute resolution is difficult for parties to international agreements? What do you think are the advantages and disadvantages of each method of enforcement?
- **Practice Question:** Jane enters into an agreement to sell goods to Will. Jane is in the United States, Will is in Sweden. When a dispute arises between Will and Jane, what are some of the methods that each party could pursue in resolving the dispute?
- **Resource Video:** <http://thebusinessprofessor.com/how-are-private-international-agreements-enforced/>

14. How do parties determine the rules, location, and method of resolving a dispute under an international agreement?

Parties to an international agreement generally employ various provisions to reduce uncertainty in the relationship and add a degree of confidence that a party will be able to enforce her rights. Below are three common clauses:

- *Choice-of-Law Clause* - A choice-of-law clause indicates the law that will govern the contractual relationship and any disputes arising thereunder. These clauses may identify the substantive and procedural law of a particular country, international treaty, or model law.
- *Forum Selection Clause* - These clauses indicate the appropriate venue for adjudicating disputes arising under the contract or business arrangement. It may also indicate a particular judicial body or geographic location.
- *Arbitration Clauses* - These clauses are extremely common in international agreements. They will generally require arbitration, indicate the rules that will apply, and designate the individuals or body to decide the dispute. Most countries in the world recognize and enforce arbitrations carried out in accordance with the requirements of the New York Convention. Numerous nations are members of treaties with other countries that provide further recognition and enforcement procedures for arbitration awards.

- **Discussion:** Why do you think the resolution of these terms of an international agreement are particularly important? If you were entering into an international agreement with a foreign party, how would you seek to address these provisions? Can you think of any other aspects of the agreement that should be fully addressed?
- **Practice Question:** Derek and Damien are negotiating a contract to export textiles from Haiti for sale in the United States. Explain the primary dispute resolution clauses that the parties should consider in their negotiations.
- **Resource Video:** <http://thebusinessprofessor.com/key-considerations-for-terms-of-private-international-agreements/>