MNGT 140 Business Law I – Open Educational Resource Textbook

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Preface

This textbook is for use with MNGT 140 Business Law I, a business law survey course covering a variety of legal topics, including sources of law, contracts, torts, criminal law, employment law, agency law, intellectual property and business ethics. The authors of this open educational resource text based the content on "Business and the Legal Environment" located at http://2012books.lardbucket.org/books/business-and-the-legal-environment/ pursuant to a Creative Commons license CC BY-NC-SA. Additional content has been provided by the authors under the same license, and third party content has been curated in sections below where noted.

The Second Edition of this text includes updates by the authors to the content, and includes new legal research on recent cases and changes to the law since the original edition was published for use in the classroom in 2018. In addition, new tables and figures have been added to the text, and a table of cases cited throughout the text has been added for quick reference.

Materials here are from other sources, but any errors that remain in the content provided remain the responsibility of the authors.

Figures, Tables & Cases

Cases

Introduction: Law and Legal Systems

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

Classifications of Law

What Is Law?

Law is a word that means different things at different times. Law is "any system of regulations to govern the conduct of the people of a community, society or nation, in response to the need for regularity, consistency and justice based upon collective human experience." http://dictionary.law.com/Default.aspx?selected=1111

Functions of the Law

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

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

Schools of Legal Thought

There are different schools (or philosophies) concerning what law is all about. Philosophy of law is also called jurisprudence, and the two main schools are legal positivism and natural law. Although there are others, these two are the most influential in how people think about the law.

Legal Positivism: Law as Sovereign Command

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

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

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

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

Natural Law

The natural-law school of thought emphasizes that law should be based on a universal moral order. Natural law was "discovered" by humans through the use of reason and by choosing between that which is good and that which is evil. "Natural law" represents standards of conduct derived from traditional moral principles (first mentioned by Roman jurists in the first century A.D.) and/or God's law and will." http://dictionary.law.com/Default.aspx?selected=1307

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

> **The Unanimous Declaration of the Thirteen United States of America**
> July 4, 1776
>
> When in the Course of human events, it becomes necessary for one people to dissolve the political bands which have connected them with another, and to assume among the powers of the earth, the separate and equal station to which the Laws of Nature and of Nature's God entitle them, a decent respect to the opinions of mankind requires that they should declare the causes which impel them to the separation.
>
> We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the Pursuit of Happiness.
>
> That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed.…

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

Civil disobedience—in the tradition of Henry Thoreau, Mahatma Gandhi, or Martin Luther King Jr.—becomes a matter of morality over "unnatural" law. For example, in his "Letter from Birmingham Jail," Martin Luther King Jr. claims that obeying an unjust law is not moral and that deliberately disobeying an unjust law is in fact a moral act that expresses "the highest respect for law." "An individual who breaks a law that conscience tells him is unjust, and who willingly accepts the penalty of imprisonment in order to arouse the conscience of the community over its injustice, is in reality expressing the highest respect for law.…One who breaks an unjust law must do so openly, lovingly, and with a willingness to accept the penalty." http://okra.stanford.edu/transcription/document_images/undecided/630416-019.pdf

Legal positivists, on the other hand, would say that we cannot know with real confidence what "natural" law or "universal" law is. In studying law, we can most effectively learn by just looking at what the written law says, or by examining how it has been applied. In response, natural-law thinkers would argue that if we care about justice, every law and every legal system must be held accountable to some higher standard, however hard that may be to define.

It is easier to know what the law "is" than what the law "should be." Equal employment laws, for example, have specific statutes, rules, and decisions about racial discrimination. There are always difficult issues of interpretation and decision, which is why courts will resolve differing views. But how can we know the more fundamental "ought" or "should" of human equality? For example, how do we *know* that "all men are created equal" (from the Declaration of Independence)? Setting aside for the moment questions about the equality of women, or that of slaves, who were not counted as men with equal rights at the time of the declaration—can the statement be empirically proven, or is it simply a matter of a priori knowledge? (*A priori* means "existing in the mind prior to and independent of experience.") Or is the statement about equality a matter of faith or belief, not really provable either scientifically or rationally? The dialogue between natural-law theorists and more empirically oriented theories of "what law is" will raise similar questions.

Table 1 Sources of US Law

International	Federal	State	Local
Treaties	Constitution	Constitutions	
	Exec Orders	Exec Orders	
	Statutes	Statutes	Ordinances
Int'l Courts	Courts	Courts	
	Regulations	Regulations	

Types of Laws

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

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

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

Constitutions

Constitutions are the foundation for a state or nation's other laws, providing the country's legislative, executive, and judicial framework. Among the nations of the world, the United States has the oldest constitution still in use. It is difficult to amend, which is why there have only been seventeen amendments following the first ten in 1789; two-thirds of the House and Senate must pass amendments, and three-fourths of the states must approve them.

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

Statutes and Treaties in Congress

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

Many consider this to be antidemocratic. The House of Representatives, on the other hand, is directly proportioned by population, though no state can have less than one representative.
Each Congressional legislative body has committees for various purposes. In these committees, proposed bills are discussed, hearings are sometimes held, and bills are either reported out (brought to the floor for a vote) or killed in committee. If a bill is reported out, it may be passed by majority vote. Because of the procedural differences between the House and the Senate, bills that have the same language when proposed in both houses are apt to be different after approval by each body. A conference committee will then be held to try to match the two versions. If the two versions differ widely enough, reconciliation of the two differing versions into one acceptable to both chambers (House and Senate) is more difficult.

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

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

Delegating Legislative Powers: Rules by Administrative Agencies

Congress has found it necessary and useful to create government agencies to administer various laws. The Constitution does not expressly provide for administrative agencies, but the US Supreme Court upheld the delegation of power to create federal agencies. Examples of administrative agencies would include the Occupational Safety and Health Administration (OSHA), the Environmental Protection Agency (EPA), and the Federal Trade Commission (FTC).

It is important to note that Congress does not have unlimited authority to delegate its lawmaking powers to an agency. It must delegate its authority with some guidelines for the agency and cannot altogether avoid its constitutional responsibilities. *U.S. v. Mead Corp.*, 533 U.S. 218 (2001).

Agencies propose rules in the Federal Register, published each working day of the year. Rules that are formally adopted (procedures for regulatory adoption are found in the Administrative Procedure Act, 5 U.S.C. § 500 *et seq.*) are published in the *Code of Federal Regulations*, or CFR, available online at http://www.access.gpo.gov/nara/cfr/cfr-table-search.html.

State Statutes and Agencies: Other Codified Law

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

Maryland's state legislature is known as the Maryland General Assembly and can be found online at Maryland General Assembly.

Maryland also has a number of state administrative agencies that can promulgate rules through regulation found in COMAR. Titles in COMAR are generally organized in the same manner as state statutes. For example, the Maryland statutes includes an article for the Department of Health; COMAR's Title 10 includes the regulations related to the Department of Health.

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

In Baltimore County, Maryland, the County Council enacts local ordinances and legislation. Once passed and signed into law by the County Executive, they can be found at Baltimore County Code.

Judicial Decisions: The Common Law

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

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

In England and in the laws of the original thirteen colonies, common-law decisions defined crimes such as arson, burglary, homicide, and robbery. As time went on, US state legislatures either adopted or modified common-law definitions of most crimes by putting them in the form of codes or statutes. This legislative ability—to modify or change common law into statutory law—points to an important phenomenon: the priority of statutory law over common law.

Civil versus Criminal Cases

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

Some of the basic differences between civil law and criminal law cases are illustrated below.

Table 2 Differences Between Civil and Criminal Cases

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

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

Substance versus Procedure

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

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

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

In the United States, all state procedural laws must be fair, since the due process clause of the Fourteenth Amendment directs that no state shall deprive any citizen of "life, liberty, or property," without due process of law. (The $200 fine plus court costs is designed to deprive you of property, that is, money, if you violate the speed limit.) Federal laws must also be fair, because the Fifth Amendment to the US Constitution has the exact same due process language as the Fourteenth Amendment.

Governmental Powers

General Structure of the Constitution

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

Federalism

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

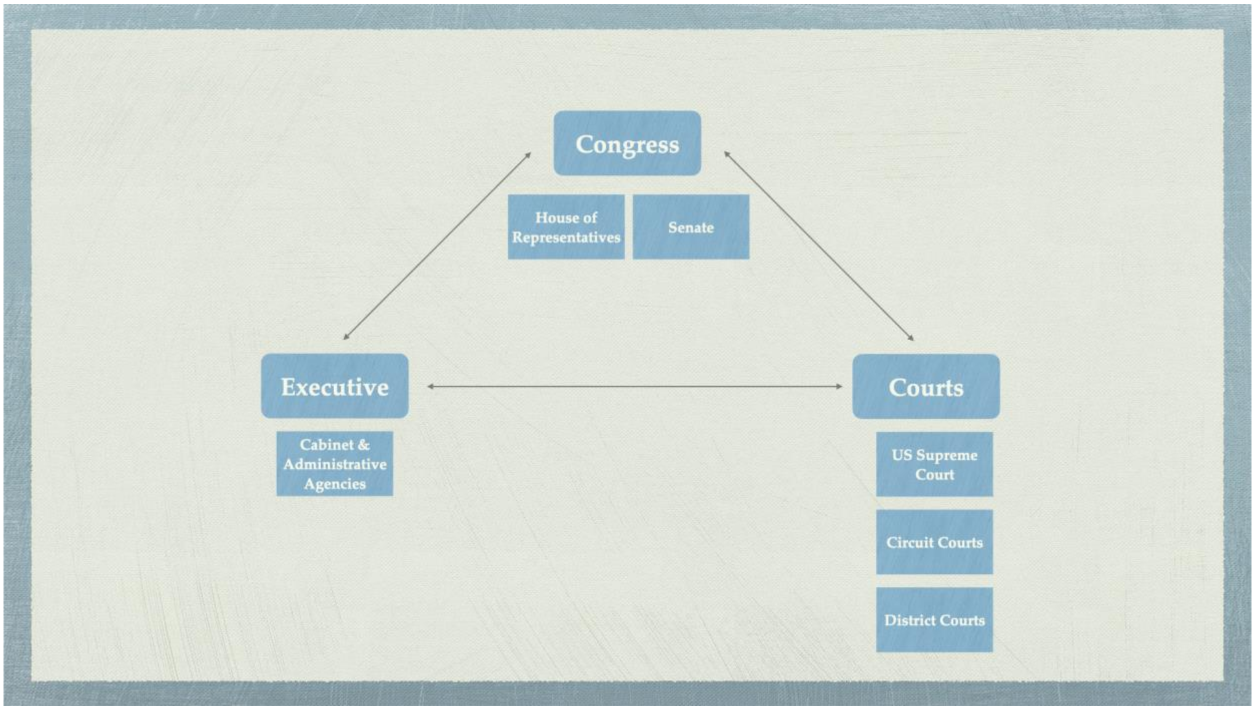

Figure 1 Basic Organization of Federal Government

Separation of Powers and Judicial Review

Because the Founding Fathers wanted to ensure that no single branch of the government, especially the executive branch, would be ascendant over the others, they created various checks and balances to ensure that each of the three principal branches had ways to limit or modify the power of the others. This is known as the separation of powers. Thus the president retains veto power, but the House of Representatives is entrusted with the power to initiate spending bills. The judiciary can declare a statute unconstitutional, and the Congress can amend the law to comport with the Constitution.

Power sharing was evident in the basic design of Congress, the federal legislative branch. The basic power imbalance was between the large states (with greater population) and the smaller ones (such as Delaware). The smaller ones feared a loss of sovereignty if they could be outvoted by the larger ones, so the federal legislature was constructed to guarantee two Senate seats for every state, no matter how small. The Senate was also given great responsibility in ratifying treaties and judicial nominations. The net effect of this today is that senators from a very small number of states can block treaties and other important legislation. The power of small states is also magnified by the Senate's cloture rule, which currently requires sixty out of one hundred senators to vote to bring a bill to the floor for an up-or-down vote, with the exception of certain spending legislation that can be voted on with a simple majority.

Because the Constitution often speaks in general terms (with broad phrases such as "due process" and "equal protection"), reasonable people have disagreed as to how those terms apply in specific cases. The United States is unique among industrialized democracies in having a Supreme Court that reserves for itself that exclusive power to interpret what the Constitution means. The famous case of *Marbury v. Madison,* 5 U.S. 137 (1803) began that tradition in 1803, when the Supreme Court had marginal importance in the new republic. The decision in *Bush v. Gore*, 531 U.S. 98 (2000), illustrates the power of the court to shape our destiny as a nation. In that case, the court overturned a ruling by the Florida Supreme Court regarding the way to proceed on a recount of the Florida vote for the presidency. The court's ruling was purportedly based on the "equal protection of the laws" provision in the Fourteenth Amendment.

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

Because the Supreme Court has this power of judicial review, there have been many arguments about how it should be exercised and what kind of "philosophy" a Supreme Court justice should have. President Richard Nixon often said that a Supreme Court justice should "strictly construe" the Constitution and not add to its language. Finding law in the Constitution was "judicial activism" rather than "judicial restraint." The general philosophy behind the call for "strict constructionist" justices is that legislatures make laws in accord with the wishes of the majority, and so unelected judges should not make law according to their own views and values. Nixon had in mind the 1960s Warren court, which "found" rights in the Constitution that were not specifically mentioned—the right of privacy, for example. In later years, critics of the Rehnquist court would charge that it "found" rights that were not specifically mentioned, such as the right of states to be free from federal antidiscrimination laws. See, for example, *Kimel v. Florida Board of Regents*, 528 US 62 (2000), or in the case of ***Citizens United v. Federal Election Commission*** 558 U.S. 310 (2010), which held that corporations are "persons" with "free speech rights" that include spending unlimited amounts of money in campaign donations and political advocacy.

State Courts and the Domain of State Law

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

- Contracts, including sales, commercial paper, letters of credit, and secured transactions

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

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

Priority of Laws

The Constitution as Preemptive Force in US Law

The US Constitution takes precedence over all statutes and judicial decisions that are inconsistent. For example, if Michigan were to decide legislatively that students cannot speak ill of professors in state-sponsored universities, that law would be void, since it is inconsistent with the state's obligation under the First Amendment to protect free speech. Or if the Michigan courts were to allow a professor to bring a lawsuit against a student who had said something about him that was derogatory but not defamatory, the state's judicial system would not be acting according to the First Amendment. This is the concept of **preemption**. Preemption applies not just to the U.S. Constitution but in instances where state laws conflict with federal law. If the Congress intended the federal law to be supreme, federal law would preempt state law.

Statutes and Cases

Statutes generally have priority, or take precedence, over case law (judicial decisions). Under common-law judicial decisions, employers could hire young children for difficult work, offer any wage they wanted, and not pay overtime work at a higher rate. But the federal Fair Labor Standards Act (1938) forbid the use of oppressive child labor and established a minimum pay wage and overtime pay rules. However, courts are called upon to apply and interpret statutes to particular cases and situations before them. As a result, courts employ various procedures for interpreting statutes. One of these methods is to "strictly construe" statutes that are in "derogation" of or that replace judicially made rules. *Breslin v. Powell*, 26 A.3d 878, 891 (Md. 2011). This principle means that changes to the common law must be plainly intended by the Legislature within the unambiguous language of the statute.

Treaties as Statutes: The "Last in Time" Rule

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

One example of treaty obligations overriding, or taking priority over, federal statutes was the tuna-dolphin dispute between the United States and Mexico. The Marine Mammal Protection Act amendments in 1988 spelled out certain protections for dolphins in the Eastern Tropical Pacific, and the United States began refusing to allow the importation of tuna that were caught using "dolphin-unfriendly" methods. This was challenged at a GATT dispute panel in Switzerland, and the United States lost. The discussion continued at the WTO under its dispute resolution process. In short, US environmental statutes can be ruled contrary to US treaty obligations.

Under most treaties, the United States can withdraw, or take back, any voluntary limitation on its sovereignty; participation in treaties is entirely elective. That is, the United States may "unbind" itself whenever it chooses. President Trump did this in 2017 when he pulled the US out of the Paris Climate Accord. For practical purposes, some limitations on sovereignty may be good for the nation. The argument goes something like this: if free trade in general helps the United States, then it makes some sense to be part of a system that promotes free trade; and despite some temporary setbacks, the WTO decision process will (it is hoped) provide far more benefits than losses in the long run. This argument invokes **utilitarian theory** (that the best policy does the greatest good overall for society).

Commerce Clause

Regulatory Powers of Government

Take a look at Article I, Section 8 of the U.S. Constitution listed below– this is known as the Commerce Clause. The commerce clause gives Congress the exclusive power to make laws relating to foreign trade and commerce and to commerce among the various states. Most of the federally created legal environment springs from this one clause: if Congress is not authorized in the Constitution to make certain laws, then it acts unconstitutionally and its actions may be ruled unconstitutional by the Supreme Court. Lately, the Supreme Court has not been shy about ruling acts of Congress unconstitutional.

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

> Section 8
> [Clause 1] The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;
>
> [Clause 2] To borrow Money on the credit of the United States;
>
> **[Clause 3] To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;**
>
> [Clause 4] To establish a uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States;
>
> [Clause 5] To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures;

Early Commerce Clause Cases

For many years, the Supreme Court was very strict in applying the commerce clause: Congress could only use it to legislate aspects of the movement of goods from one state to another. Anything else was deemed local rather than national. For example, in *Hammer v. Dagenhart*, 247 U.S. 251 (1918), a 1916 federal statute barred transportation in interstate commerce of goods produced in mines or factories employing children under fourteen or employing children fourteen and above for more than eight hours a day. A complaint was filed in the US District Court for the Western District of North Carolina by a father in his own behalf and on behalf of his two minor sons, one under the age of fourteen years and the other between fourteen and sixteen years, who were employees in a cotton mill in Charlotte, North Carolina. The father's lawsuit asked the court to enjoin (block) the enforcement of the act.

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

In each of those instances, the Supreme Court said, "[T]he use of interstate transportation was necessary to the accomplishment of harmful results." In other words, although the power over interstate transportation was to regulate, that could only be accomplished by prohibiting the use of the facilities of interstate commerce to effect the evil intended. But in *Hammer* that essential element was lacking. The law passed by Congress aimed to standardize among all the states the ages at which children could be employed in mining and manufacturing, while the goods themselves are harmless. Once the labor is done and the articles have left the factory, the "labor of their production is over, and the mere fact that they were intended for interstate commerce transportation does not make their production subject to federal control under the commerce power." *Hammer v. Dagenhart*, 247 U.S. 251 (1918)

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

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

During the global depression of the 1930s, the US economy saw jobless rates of a third of all workers, and President Roosevelt's New Deal program required more active federal legislation. Included in the New Deal program was the recognition of a "right" to form labor unions without undue interference from employers.

Congress created the National Labor Relations Board (NLRB) in 1935 to investigate and to enjoin employer practices that violated this right.

In *NLRB v. Jones & Laughlin Steel Corporation*, 301 U.S. 1 (1937), a union dispute with management at a large steel-producing facility near Pittsburgh, Pennsylvania, became a court case. In this case, the NLRB charged Jones & Laughlin Steel Corporation with discriminating against employees who were union members. The company's position was that the law authorizing the NLRB was unconstitutional, exceeding Congress's powers. The court held that the act was narrowly constructed so as to regulate industrial activities that had the potential to restrict interstate commerce. The earlier decisions under the commerce clause holding that labor relations had only an indirect effect on commerce were effectively reversed. Since the ability of employees to engage in collective bargaining (one activity protected by the act) is "an essential condition of industrial peace," the national government was justified in penalizing corporations engaging in interstate commerce that "refuse to confer and negotiate" with their workers. This was, however, a close decision, and the switch of one justice made this ruling possible. Without this switch, the New Deal agenda would have been effectively derailed.

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

Subsequent to *NLRB v. Jones & Laughlin Steel Corporation*, Congress and the courts generally accepted that even modest impacts on interstate commerce were "reachable" by federal legislation. For example, the case of *Wickard v. Filburn*, 317 U.S. 111 (1942), represents a fairly long reach for Congress in regulating what appear to be very local economic decisions. *Wickard* established that "substantial effects" in interstate commerce could be very local indeed!

In *Wickard* the issue was whether Congress could regulate the production of wheat when only a portion of the product is sold interstate. The Supreme Court held that Congress could so act in regulating actions that did not fall within interstate commerce where the actions were substantially related to such commerce. The farmer who filed suit raised a small portion of wheat on his farm. Some of the wheat was sold, some fed to the farmer's animals (some of which were in turn slaughtered and sold), some was used for personal consumption on the farm (as flour), and some saved for seeding the following year's crop. The Court found that even actions that were not direct interstate commerce could substantially impact interstate commerce – specifically the price of wheat in this case and Congress could so regulate the amount of wheat grown through a quota system restricting production.

Despite the wide latitude given to Congress under *Wickard*, commerce clause challenges to federal legislation continued. In the 1960s, the Civil Rights Act of 1964 was challenged on the ground that Congress lacked the power under the commerce clause to regulate what was otherwise fairly local conduct. For example, Title II of the act prohibited racial discrimination in public accommodations (such as hotels, motels, and restaurants), leading to the famous case of *Katzenbach v. McClung*, 379 US 294 (1964).

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

For nearly thirty years following, it was widely assumed that Congress could almost always find some interstate commerce connection for any law it might pass. It thus came as something of a shock in 1995 when the Rehnquist court decided *U.S. v. Lopez,* 514 U.S 549 (1995). Lopez was convicted under a federal law that prohibited possession of firearms within 1,000 feet of a school. The law was part of a twenty-year trend (roughly 1970 to 1990) for senators and congressmen to pass laws that were tough on crime. Lopez's lawyer admitted that Lopez had a gun within 1,000 feet of a San Antonio school yard but challenged the law itself, arguing that Congress exceeded its authority under the commerce clause in passing this legislation. The US government argued that Congress was within its constitutional rights under the commerce clause because education of the future workforce was the foundation for a sound economy and because guns at or near school yards detracted from students' education. The court rejected this analysis, noting that with the government's analysis, an interstate commerce connection could be conjured from almost anything. Lopez went free because the law itself was unconstitutional, according to the court.

Congress made no attempt to pass similar legislation after the case was decided. But in passing subsequent legislation, Congress was often careful to make a record as to why it believed it was addressing a problem that related to interstate commerce. In 1994, Congress passed the Violence Against Women Act (VAWA), having held hearings to establish why violence against women on a local level would impair interstate commerce. In 1994, while enrolled at Virginia Polytechnic Institute (Virginia Tech), Christy Brzonkala alleged that Antonio Morrison and James Crawford, both students and varsity football players at Virginia Tech, had raped her. In 1995, Brzonkala filed a complaint against Morrison and Crawford under Virginia Tech's sexual assault policy, *Brzonkala v. Morrison*, 529 U.S. 598 (2000). After a hearing, Morrison was found guilty of sexual assault and sentenced to immediate suspension for two semesters. Crawford was not punished. A second hearing again found Morrison guilty. After an appeal through the university's administrative system, Morrison's punishment was set aside, as it was found to be "excessive." Ultimately, Brzonkala dropped out of the university. Brzonkala then sued Morrison, Crawford, and Virginia Tech in federal district court, alleging that Morrison's and Crawford's attack violated 42 USC Section 13981 (part of the VAWA), which provides a federal civil remedy for the victims of gender-motivated violence. Morrison and Crawford moved to dismiss Brzonkala's suit on the ground that Section 13981's civil remedy was unconstitutional. In dismissing the complaint, the district court found that Congress lacked authority to enact Section 13981 under either the commerce clause or the Fourteenth Amendment, which Congress had explicitly identified as the sources of federal authority for the VAWA. Ultimately, the court of appeals affirmed, as did the Supreme Court.

In *Brzonkala*, the Supreme Court held that Congress lacked the authority to enact the statute under the commerce clause or the Fourteenth Amendment because the statute did not regulate an activity that substantially affected interstate commerce nor did it redress harm caused by the state. Chief Justice William H. Rehnquist wrote for the court that "under our federal system that remedy must be provided by the Commonwealth of Virginia, and not by the United States."

The absence of a workable judicial commerce clause touchstone remains. In 1996, California voters passed the Compassionate Use Act, legalizing marijuana for medical use. California's law conflicted with the federal Controlled Substances Act (CSA), which banned possession of marijuana. After the Drug Enforcement Administration (DEA) seized doctor-prescribed marijuana from a patient's home, a group of medical marijuana users sued the DEA and US Attorney General John Ashcroft in federal district court. *Gonzalez v. Raich,* 545 U.S. 1 (2005).

The medical marijuana users argued that the CSA—which Congress passed using its constitutional power to regulate interstate commerce—exceeded Congress's commerce clause power. The district court ruled against the group, but the Ninth Circuit Court of Appeals reversed and ruled the CSA unconstitutional because it applied to medical marijuana use solely within one state. In doing so, the Ninth Circuit relied on *U.S. v. Lopez* (1995) and *U.S. v. Morrison, 529 U.S. 598* (2000) to say that using medical marijuana did not "substantially affect" interstate commerce and therefore could not be regulated by Congress.

But by a 6–3 majority, the Supreme Court held that the commerce clause gave Congress authority to prohibit the local cultivation and use of marijuana, despite state law to the contrary. Justice John Paul Stevens argued that the court's precedents established Congress's commerce clause power to regulate purely local activities that are part of a "class of activities" with a substantial effect on interstate commerce. The majority argued that Congress could ban local marijuana use because it was part of such a class of activities: the national marijuana market. Local use affected supply and demand in the national marijuana market, making the regulation of intrastate use "essential" to regulating the drug's national market. Recreational marijuana laws may be brought to the test in 2018 as the US Department of Justice rescinded an Obama era policy of not prosecuting commercial growers, sellers and distributors of marijuana in states that had legalized the drug. Marijuana is still illegal under federal law, and now state level growers, sellers and distributors for recreational use may be subject to federal prosecution.

Dormant Commerce Clause

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

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

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

Discrimination cases such as *Hunt v. Washington Apple Advertising Commission* 432 U.S. 333 (1977), pose a different standard. The court has been fairly inflexible here: if one state discriminates in its treatment of any article of commerce based on its state of origin, the court will strike down the law. In *Hunt*, the Court found that a North Carolina statute requiring that all apples sold or shipped into North Carolina in closed containers be identified by no grade on the containers other than the applicable federal grade or a designation that the apples are not graded was a violation of the Commerce Clause as overly burdensome to Washington state apples sold interstate. The North Carolina statute did not effect North Carolina apple growers and was therefor unconstitutional.

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

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

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

Bill of Rights and Businesses

The Bill of Rights (the first ten amendments to the Constitution) was originally meant to apply to federal actions only. During the twentieth century, the court began to apply selected rights to state action as well. For example, federal agents were prohibited from using evidence seized in violation of the Fourth Amendment, but state agents were not, until *Mapp v. Ohio*, 367 U.S. 643 (1960), when the Supreme Court applied the guarantees (rights) of the Fourth Amendment to state action as well. In this and in similar cases, the Fourteenth Amendment's due process clause was the basis for the Court's action. The due process clause commanded that states provide due process in cases affecting the life, liberty, or property of US citizens, and the court saw in this command certain "fundamental guarantees" that states would have to observe. Over the years, most of the important guarantees in the Bill of Rights came to apply to state as well as federal action. The court refers to this process as selective incorporation. The process is not a simple one, but involves many individual cases decided by the Supreme Court – and in some cases, reversals by the Court on how a particular provision applies to state action. *Ramos v. Louisiana*, 590 U.S. 1390, 1408 (2020).

Here are some very basic principles to remember:

The guarantees of the Bill of Rights apply *only* to state and federal government action. They do not limit what a company or person in the private sector may do (but the law is changing in this area). For example, states may not impose censorship on the media or limit free speech in a way that offends the First Amendment, but your boss (in the private sector) may order you not to talk to the media.

In some cases, a private company may be regarded as participating in "state action." For example, a private defense contractor that gets 90 percent of its business from the federal government has been held to be public for purposes of enforcing the constitutional right to free speech (the company had a rule barring its employees from speaking out in public against its corporate position). It has even been argued that public regulation of private activity is sufficient to convert the private into public activity, thus subjecting it to the requirements of due process. But the Supreme Court rejected this extreme view in 1974 when it refused to require private power companies, regulated by the state, to give customers a hearing before cutting off electricity for failure to pay the bill. *Jackson v. Metropolitan Edison Co.*, 419 US 345 (1974).

States have rights, too. While "states rights" was a battle cry of Southern states before the Civil War, the question of what balance to strike between state sovereignty and federal union has never been simple. In *Kimel v. Florida*, 528 U.S. 62 (2000), the Supreme Court found in the words of the Eleventh Amendment a basis for declaring that states may not have to obey certain federal statutes.

First Amendment

Freedom of Speech

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

Because of its higher level of protection, political speech can be false or misleading. *New York Times v. Sullivan*, 376 U.S. 254 (1964). A public official in the United States must be prepared to withstand all kinds of false accusations and cannot succeed in an action for defamation unless the defendant has acted with "malice" and "reckless disregard" of the truth. Public figures, such as CEOs of the largest US banks, must also be prepared to withstand accusations that are false. In any defamation action, truth is a defense, but a defamation action brought by a public figure or public official must prove that the defendant not only has his facts wrong but also lies to the public in a malicious way with reckless disregard of the truth. Celebrities such as Lindsay Lohan and Jon Stewart have the same burden to go forward with a defamation action. It is for this reason that the *National Enquirer* writes exclusively about public figures, public officials, and celebrities; it is possible to say many things that aren't completely true and still have the protection of the First Amendment.

Political speech is so highly protected that the Court recognized the right of people to support political candidates through campaign contributions and thus promote the particular viewpoints and speech of those candidates. Fearing the influence of money on politics, Congress has from time to time placed limitations on corporate contributions to political campaigns. But the Supreme Court has had mixed reactions over time. Initially, the court recognized the First Amendment right of a corporation to donate money, subject to certain limits in the case of *Buckley v. Valeo*, 424 US 1 (1976).

In another case, *Austin v. Michigan Chamber of Commerce*, 494 U.*S. 652* (1990), the Michigan Campaign Finance Act prohibited corporations from using treasury money for independent expenditures to support or oppose candidates in elections for state offices. But a corporation could make such expenditures if it set up an independent fund designated solely for political purposes. The law was passed on the assumption that "the unique legal and economic characteristics of corporations necessitate some regulation of their political expenditures to avoid corruption or the appearance of corruption."

The Michigan Chamber of Commerce wanted to support a candidate for Michigan's House of Representatives by using general funds to sponsor a newspaper advertisement and argued that as a nonprofit organization, it was not really like a business firm. The Court disagreed and upheld the Michigan law. Justice Marshall found that the chamber was akin to a business group, given its activities, linkages with community business leaders, and high percentage of members (over 75 percent) that were business corporations. Furthermore, Justice Marshall found that the statute was narrowly crafted and implemented to achieve the important goal of maintaining integrity in the political process. But in *Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010), *Austin* was overruled; corporations are recognized as "persons" with First Amendment political speech rights that cannot be impaired by Congress or the states without some compelling governmental interest with restrictions on those rights that are "narrowly tailored."

Freedom of Religion

In addition to the freedom of speech, the First Amendment is also known as providing for the freedom of religion. This is accomplished through two specific clauses: the Establishment Clause and the Free Exercise Clause.

The Establishment Clause prohibits the government from "establishing" a religion. The precise definition of "establishment" is unclear. Historically, it meant prohibiting state-sponsored churches, such as the Church of England. Today, what constitutes an "establishment of religion" is often governed under the three-part test set forth by the U.S. Supreme Court in *Lemon v. Kurtzman*, 403 U.S. 602 (1971) (though the Court has abrogated the Lemon rule in some applications of the Establishment Clause such as in *American Legion v. Humanist Association*, 139 S.Ct 2067 (2019)). Under the "Lemon" test, government can assist religion only if (1) the primary purpose of the assistance is secular, (2) the assistance must neither promote nor inhibit religion, and (3) there is no excessive entanglement between church and state.

The Free Exercise Clause protects citizens' right to practice their religion as they please, so long as the practice does not run afoul of "public morals" or a "compelling" governmental interest. For instance, in *Prince v. Massachusetts*, 321 U.S. 158 (1944), the Supreme Court held that a state could force the inoculation of children whose parents would not allow such action for religious reasons. The Court held that the state had an overriding interest in protecting public health and safety. In 2014, the Supreme Court held that the free exercise clause can also extend to closely held businesses in the *Burwell v. Hobby Lobby Stores, Inc.* case. *Burwell v. Hobby Lobby Stores, Inc.*, 134 S. Ct. 2751 (2014). In that case, the Court held that a mandate by the U.S. Department of Health and Human Services to provide health insurance coverage for certain forms of contraception violated the company owners' free exercise rights under the first amendment.

Sometimes the Establishment Clause and the Free Exercise Clause come into conflict. The federal courts help to resolve such conflicts, with the Supreme Court being the ultimate arbiter. **Material obtained from http://www.uscourts.gov/educational-resources/educational-activities/first-amendment-and-religion**

Fourth Amendment

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

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

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

Dow had really wanted privacy from governmental intrusion, it could have covered the pipes and machinery that were otherwise outside and in open fields.) *Dow Chemical v. U.S.*, 476 U.S. 227 (1986).

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

Fifth Amendment

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

The Fifth Amendment has three principal aspects: procedural due process, the takings clause, and substantive due process. In terms of procedural due process, the amendment prevents government from arbitrarily taking the life of a criminal defendant. In civil lawsuits, it is also constitutionally essential that the proceedings be fair. This is why, for example, the defendant in *Burger King v. Rudzewicz,* 471 U.S. 462 (1985), had a serious constitutional argument, even though he lost.

In *Burger King*, the Defendants were Michigan residents and franchisees of Burger King, a Florida corporation. The franchise agreement provided that in the event of suit, the courts in Florida would be the proper forum for all cases (known as a forum selection clause). Burger King sued for non-payment of franchise fees in federal court in Florida under diversity jurisdiction. The Defendants moved to dismiss arguing Florida did not have personal jurisdiction over the out of state Defendants. In finding for Burger King, the Supreme Court held that where the parties have agreed to a forum selection clause in their agreement and one of the parties is a corporation located within the forum state (Florida), unless undue hardship exists, the forum selection clause is valid and not a violation of due process.

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

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

In addition to the takings clause and aspects of procedural due process, the Fifth Amendment is also the source of what is called substantive due process. During the first third of the 20th century, the Supreme Court often nullified state and federal laws using substantive due process. In 1905, for example, in *Lochner v. New York*, 198 U.S. 45 (1905), the Supreme Court voided a New York statute that limited the number of hours that bakers could work in a single week. New York had passed the law to protect the health of employees, but the court found that this law interfered with the basic constitutional right of private parties to freely contract with one another. Over the next 30 years, dozens of state and federal laws were struck down that aimed to improve working conditions, secure social welfare, or establish the rights of unions. However, in 1934, during the Great Depression, the court reversed itself and began upholding the kinds of laws it had struck down earlier.

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

The Supreme Court has identified two distinct categories of fundamental liberties. The first category includes most of the liberties expressly enumerated in the Bill of Rights. Through a process known as selective incorporation, the court interpreted the due process clause of the Fourteenth Amendment to bar states from denying their residents the most important freedoms guaranteed in the first ten amendments to the federal Constitution. Only the Third Amendment right (against involuntary quartering of soldiers) and the Fifth Amendment right (to be indicted by a grand jury) have not been made applicable to the states. Because these rights are still not applicable to state governments, the Supreme Court is often said to have “selectively incorporated” the Bill of Rights into the due process clause of the Fourteenth Amendment, with a recent case of incorporating the Eighth Amendment’s prohibition against excessive fines decided by the Supreme Court in 2019, adding to the list of rights so incorporated. *Timbs v. Indiana*, 139 S. Ct. 682 (2019).

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

These liberty interests often are grouped to form a general right to privacy, which was first recognized in *Griswold v. Connecticut*, 381 U.S. 479 (1965), where the Supreme Court struck down a state statute forbidding married adults from using, possessing, or distributing contraceptives on the ground that the law violated the sanctity of the marital relationship. According to Justice Douglas’s plurality opinion, this penumbra of privacy, though not expressly mentioned in the Bill of Rights, must be protected to establish a buffer zone or breathing space for those freedoms that are constitutionally enumerated.

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

The Court has extended its interpretation of this liberty interest in the right of interracial marriage, *Loving v. Virginia*, 388 U.S. 1, 12 (1967), the right of same sex marriage, *Obergefell v. Hodges*, 576 U.S. 644 (2015), and similar fundamental rights in family relationships, procreation, and childrearing. *Lawrence v. Texas*, 539 U.S. 558 (2003).

Fourteenth Amendment: Due Process and Equal Protection Guarantees

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

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

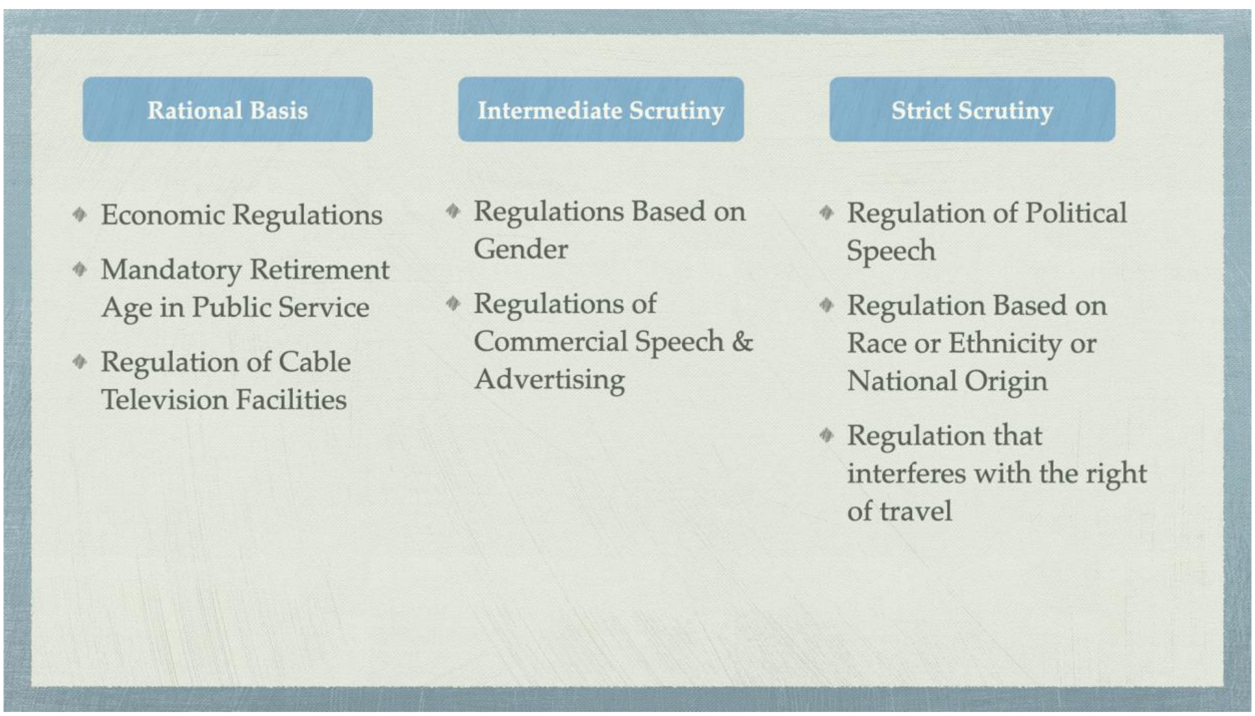

Figure 2 Examples of Different Levels of Scrutiny Under 14th Amendment

"Equal protection of the laws" is a phrase that originates in the Fourteenth Amendment, adopted in 1868. The amendment provides that no state shall "deny to any person within its jurisdiction the equal protection of the laws." This is the equal protection clause. It means that, generally speaking, governments must treat people equally. Unfair classifications among people or corporations will not be permitted. A well-known example of unfair classification would be race discrimination: requiring white children and black children to attend different public schools or requiring "separate but equal" public services, such as water fountains or restrooms. Yet despite the clear intent of the 1868 amendment, "separate but equal" was the law of the land from 1896 in *Plessy v. Ferguson*, 163 US 537 (1896), until *Brown v. Board of Education,* 347 U.S. 483 (1954).

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

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

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

Under intermediate scrutiny, the city of New Orleans might limit the number of street vendors who are men. For example, suppose that the city council decreed that all street vendors must be women, thinking that would attract even more tourism. A classification like this, based on sex, will have to meet a sterner test than a classification resulting from economic or social regulation. A law like this would have to substantially relate to important government objectives. Increasingly, courts have nullified government sex classifications as societal concern with gender equality has grown. *See United States v. Virginia*, 518 US 515 (1996) (where the US Government successfully sued the Virginia Military Institute, a male only educational institution, arguing its male only admission policy was a violation of the Equal Protection Clause).

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

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

Common Law

Our English Tradition

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

Most judicial decisions that don't deal with criminal law will involve one of three areas of law—property, contract, or tort. Property law deals with the rights and duties of those who can legally own land (real property), how that ownership can be legally confirmed and protected, how property can be bought and sold, what the rights of tenants (renters) are, and what the various kinds of "estates" in land are (e.g., fee simple, life estate, future interest, easements, or rights of way). Contract law deals with what kinds of promises courts should enforce. For example, should courts enforce a contract where one of the parties was intoxicated, underage, or insane? Should courts enforce a contract where one of the parties seemed to have an unfair advantage? What kind of contracts would have to be in writing to be enforced by courts?

Tort law deals with the types of cases that involve some kind of harm and or injury between the plaintiff and the defendant when no contract exists. Thus if you are libeled or a competitor lies about your product, your remedy would be in tort, not contract. If you slipped and fell in the neighborhood store- your remedy would be in tort for personal injury. The thirteen original colonies had been using English common law for many years, and they continued to do so after independence from England. Early cases from the first states are full of references to already-decided English cases. As years went by, many precedents were established by US state courts, so that today a judicial opinion that refers to a seventeenth- or eighteenth-century English common-law case is quite rare.

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

Equitable Remedies versus Legal Remedies

What do we mean by a remedy in terms of law? A remedy is what you (as the plaintiff) are asking the court to do for you. Do you want monetary damages? Do you want the defendant to be prohibited from doing something, such as playing their radio at 11:00 pm at night? Do you want the defendant to have to do something, such as complete their agreement to sell you their house? The action you are asking a court to take is what lawyers refer to as remedies. There are two main categories of remedies – legal and equitable. Legal are the easiest to understand – this is money. You are asking the court to award you monetary damages. For example, assume you were involved in a car accident. You incurred $5,000 in damage to your car and $3,500 in medical bills. In filing suit against the plaintiff for these amounts you are asking the court to award you legal damages – aka money.

If money is legal damages, then what are equitable damages? Equitable damages is where you are asking the court to have the defendant do something or to stop from doing something. Equitable damages are typically used when money alone will not make the plaintiff whole or compensate them for the harm they are claiming.

For example, you enter into a contract to buy the defendant's house. Everything seems fine and you are ready to settle on the property. Suddenly the defendant changes his mind and tells you he does not want to sell you his house- he has decided not to move. You had your heart set on the house and still want to buy it. You can sue the defendant and ask the court for the equitable remedy called specific performance. Specific performance is where the court will order the defendant to attend settlement and sell you the property.

Another type of equitable remedy is an injunction. This is used to stop the defendant from doing something. For example, your neighbor decides he is going to practice with his heavy metal band every night from 11:00 pm-2:00 am, which keeps you awake. You can file suit asking the court to issue an injunction to prevent your neighbor from practicing at this hour as it violates local noise ordinances.

Other types of equitable damages include contract reformation and contract rescission which will be covered more in the section on Contract Performance, Breach and Remedies.

Legal and Political Systems of the World

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

Comparing Common-Law Systems with Other Legal Systems

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

Civil-Law Systems

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

Civil-law systems are used throughout Europe as well as in Central and South America. Some nations in Asia and Africa have also adopted codes based on European civil law. Germany, Holland, Spain, France, and Portugal all had colonies outside of Europe, and many of these colonies adopted the legal practices that were imposed on them by colonial rule, much like the original thirteen states of the United States, which adopted English common-law practices.

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

Role of Judiciary

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

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

Robinson v. Audi

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

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

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

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

As state courts are concerned with federal law, so federal courts are often concerned with state law and with what happens in state courts. Federal courts will consider state-law-based claims when a case involves claims using both state and federal law. Claims based on federal laws will permit the federal court to take jurisdiction over the whole case, including any state issues raised. In those cases, the federal court is said to exercise "pendent jurisdiction" over the state claims. Also, the U.S. Supreme Court will occasionally take appeals from a state supreme court where state law raises an important issue of federal law to be decided. For example, a convict on death row may claim that the state's chosen method of execution using the injection of drugs is unusually painful and involves "cruel and unusual punishment," raising an 8th Amendment issue under the U.S. Constitution.

There is also a broad category of cases heard in federal courts that concern only state legal issues—namely, cases that arise between citizens of different states where the amount in controversy is greater than $75,000 (excluding interest and attorneys' fees). The federal courts are permitted to hear these cases under their diversity of citizenship jurisdiction (or diversity jurisdiction). A citizen of New Jersey may sue a citizen of New York over a contract dispute in federal court, but if both were citizens of New Jersey, the plaintiff would be limited to the state courts. The Constitution established diversity jurisdiction because it was feared that local courts would be hostile toward people from other states and that they would need separate courts. In 2009, nearly a third of all lawsuits filed in federal court were based on diversity of citizenship. In these cases, the federal courts were applying state law.

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

State Court Systems

The vast majority of civil lawsuits in the United States are filed in state courts. Two aspects of civil lawsuits are common to all state courts: trials and appeals. A trial court has original jurisdiction—that is, jurisdiction to determine the facts of the case and apply the law to them. A court that hears appeals from the trial court is said to have appellate jurisdiction—it must accept the facts as determined by the trial court and limit its review to the lower court's theory of the applicable law.

For an overview of the Maryland Court system – please check out this short video:
Maryland Court System

Limited Jurisdiction Courts

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

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

General Jurisdiction Courts

All other civil and criminal cases are heard in the general trial courts, or courts of general jurisdiction. These go by a variety of names: superior, circuit, district, or common pleas court (New York calls its general trial court the supreme court). These are the courts in which people seek redress for incidents such as automobile accidents and injuries, or breaches of contract. These state courts also prosecute those accused of felony crimes such as murder, rape, robbery, and other serious crimes. The fact finder in these general jurisdiction courts may be a judge (known as a bench trial) or a jury of citizens (usually 6-12 depending on the type of case). Jury trials usually require a unanimous finding by the jury.

Although courts of general jurisdiction can hear all types of cases, in most states more than half involve family matters (divorce, child custody disputes, and the like). A third are commercial cases, and slightly over 10 percent were devoted to car accident cases and other torts.
Most states have specialized courts that hear only a certain type of case, such as landlord-tenant disputes or probate of wills. Decisions by judges in specialized courts are usually final, although any party dissatisfied with the outcome may be able to get a new trial in a court of general jurisdiction. Because there has been one trial already, this is known as a trial de novo. It is not an appeal, since the case essentially starts over.

Appellate Courts

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

The last type of appeal within the state courts system is to the state's highest court, the state supreme court, which is composed of a single panel of between five and nine judges and is usually located in the state capital.

(The intermediate appellate courts are usually composed of panels of three judges and are situated in various locations around the state.) In a few states, the highest court goes by a different name: in New York and Maryland, it is known as the court of appeals. In certain cases, appellants to the highest court in a state have the right to have their appeals heard, but more often a state's highest appellate court selects the cases it wishes to hear through a writ of certiorari . For most litigants, the ruling of the state's highest appellate court is final. In a relatively small class of cases—those in which federal constitutional claims are made—appeal to the US Supreme Court remains a possibility through a writ of certiorari.

The Federal Court System

District Courts

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

Courts of Appeal

Cases from the district courts can then be appealed to the circuit courts of appeal, of which there are thirteen (Figure 1.1 "The Federal Judicial Circuits"). Each circuit oversees the work of the district courts in several states. For example, the US Court of Appeals for the Second Circuit hears appeals from district courts in New York, Connecticut, and Vermont. The US Court of Appeals for the Ninth Circuit hears appeals from district courts in California, Oregon, Nevada, Montana, Washington, Idaho, Arizona, Alaska, Hawaii, and Guam. The US Court of Appeals for the District of Columbia Circuit hears appeals from the district court in Washington, DC, as well as from numerous federal administrative agencies. The US Court of Appeals for the Federal Circuit, also located in Washington, hears appeals in patent and customs cases. Appeals are usually heard by three-judge panels, but sometimes there will be a rehearing at the court of appeals level, in which case all judges for that court sit to hear the case "en banc."

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

United States Supreme Court

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

Figure 3 The Federal Judicial Circuits

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

Jurisdiction

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

There are two questions about jurisdiction in each case that must be answered before a court will hear a case: the question of subject matter jurisdiction and the question of personal jurisdiction. We will consider the question of subject matter jurisdiction first. If a judge determines that he or she has no power to hear and decide that kind of case, they will dismiss the case. Later we will discuss personal jurisdiction in terms of a court's power to exercise jurisdiction over a defendant and issue a judgment against a defendant.

Subject Matter Jurisdiction: The Federal-State Balance — Federalism

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

Take a close look at Article III of the Constitution:

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

Article III makes clear that federal courts are courts of limited power or jurisdiction. Notice that the only kinds of cases federal courts are authorized to deal with have strong federal connections. For example, federal courts have jurisdiction when a federal law is being used by the plaintiff or prosecutor (a "federal question" case) or the case arises "in admiralty" (meaning that the problem arose not on land but on sea, beyond the territorial jurisdiction of any state, or in navigable waters within the United States). Implied in this list is the clear notion that states would continue to have their own laws, interpreted by their own courts, and that federal courts were needed only where the issues raised by the parties had a clear federal connection. The exception to this is diversity jurisdiction.

The Constitution was constructed with the idea that state courts would continue to deal with basic kinds of claims such as tort, contract, or property claims. Since states sanction marriages and divorce, state courts would deal with "domestic" (family) issues. Since states deal with birth and death records, it stands to reason that paternity suits, probate disputes, and the like usually wind up in state courts. You wouldn't go to the federal building or courthouse to get a marriage license, ask for a divorce, or probate a will: these matters have traditionally been dealt with by the states (and the thirteen original colonies before them). Matters that historically get raised and settled in state court under state law include not only domestic and probate matters but also law relating to corporations, partnerships, agency, contracts, property, torts, and commercial dealings generally.

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

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

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

Exclusive Subject Matter Jurisdiction in Federal Courts

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

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

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

- *Suits between states.* Cases in which two or more states are a party.
- *Cases involving ambassadors and other high-ranking public figures*. Cases arising between foreign ambassadors and other high-ranking public officials.
- *Federal crimes*. Crimes defined by or mentioned in the US Constitution or those defined or punished by federal statute. Such crimes include treason against the United States, piracy, counterfeiting, crimes against the law of nations, and crimes relating to the federal government's authority to regulate interstate commerce. However, most crimes are state matters.
- *Bankruptcy*. The statutory procedure, usually triggered by insolvency, by which a person is relieved of most debts and undergoes a judicially supervised reorganization or liquidation for the benefit of the person's creditors.
- *Patent, copyright, and trademark cases*
- *Patent*. The exclusive right to make, use, or sell an invention for a specified period (usually seventeen years), granted by the federal government to the inventor if the device or process is novel, useful, and nonobvious.
- *Copyright*. The body of law relating to a property right in an original work of authorship (such as a literary, musical, artistic, photographic, or film work) fixed in any tangible medium of expression, giving the holder the exclusive right to reproduce, adapt, distribute, perform, and display the work.
- *Trademark*. A word, phrase, logo, or other graphic symbol used by a manufacturer or seller to distinguish its product or products from those of others.
- *Admiralty*. The system of laws that has grown out of the practice of admiralty courts: courts that exercise jurisdiction over all maritime contracts, torts, injuries, and offenses.
- *Antitrust*. Federal laws designed to protect trade and commerce from restraining monopolies, price fixing, and price discrimination.
- *Securities and banking regulation*. The body of law protecting the public by regulating the registration, offering, and trading of securities and the regulation of banking practices.
- *Other cases specified by federal statute*. Any other cases specified by a federal statute where Congress declares that federal courts will have exclusive jurisdiction.

Concurrent Subject Matter Jurisdiction: State and Federal Courts

When a plaintiff takes a case to state court, it is because state courts typically hear that kind of case (i.e., there is subject matter jurisdiction). If the plaintiff's main cause of action comes from a state's constitution, statutes, or court decisions, the state courts have subject matter jurisdiction over the case. If the plaintiff's main cause of action is based on federal law (e.g., Title VII of the Civil Rights Act of 1964), the federal courts have subject matter jurisdiction over the case.

Federal courts will also have subject matter jurisdiction over certain cases that have only a state-based cause of action under diversity jurisdiction which are *cases where the plaintiff(s) and the defendant(s) are from different states and the amount in controversy is more than $75,000*. State courts can have subject matter jurisdiction over certain cases that have only a federal-based cause of action. The U.S. Supreme Court has now made clear that state courts have concurrent jurisdiction of any federal cause of action unless Congress has given exclusive jurisdiction to federal courts.

In short, a case with a federal question can be often be heard in either state or federal court, and a case that has parties with a diversity of citizenship can be heard in state courts or in federal courts where the tests of complete diversity and amount in controversy are met.
Whether a case will be heard in a state court or moved to a federal court will depend on the parties. If a plaintiff files a case in state trial court where concurrent jurisdiction with the federal courts applies, a defendant may (or may not) ask that the case be removed to federal district court.

Table 3 below summarizes how tort and contract cases are divided among the possible Maryland trial courts based on the amount in controversy. Note that the Maryland District Court has exclusive jurisdiction over small claims of $5,000 and under, but the Federal District court and Maryland Circuit courts have concurrent jurisdiction over large claims over $75,000.

Table 3 Subject Matter Jurisdiction over Tort and Contract Cases in Maryland

Amount in Controversy	Federal District Court of Maryland*	Maryland Circuit Court	Maryland District Court
Over $75,000	Yes	Yes	No
Between $30,000 and $75,000	No	Yes	No
Between $5,000 and $30,000	No	Yes	Yes
$5,000 and less	No	No	Yes

* Assuming that the plaintiffs and defendants have diversity of citizenship under 28 U.S.C. § 1332

Summary of Rules on Subject Matter Jurisdiction

A court must always have subject matter jurisdiction, *and personal jurisdiction* over at least one defendant, to hear and decide a case.

A state court will have subject matter jurisdiction over any case that is not required to be brought in a federal court. Some cases can *only* be brought in federal court, such as bankruptcy cases, cases involving federal crimes, patent cases, and Internal Revenue Service tax court claims. The list of cases for exclusive federal jurisdiction is fairly short. That means that almost any state court will have subject matter jurisdiction over almost any kind of case. If it is a case based on state law, a state court will always have subject matter jurisdiction.

A federal court will have subject matter jurisdiction over any case that is either based on a federal law (statute, case, or US Constitution) OR a federal court will have subject matter jurisdiction over any case based on state law where there is diversity jurisdiction: meaning, the parties are (1) from different states and (2) the amount in controversy is at least $75,000.(1) The different states requirement means that no plaintiff can have permanent residence in a state where any defendant has permanent residence—there must be complete diversity of citizenship as between all plaintiffs and defendants.(2) The amount in controversy requirement means that a good-faith estimate of the amount the plaintiff may recover is at least $75,000. NOTE: For purposes of permanent residence, a corporation is considered a resident where it is incorporated AND where it has a principal place of business.

In diversity cases, the following rules apply. (1) Federal civil procedure rules apply to how the case is conducted before and during trial and any appeals, but (2) State law will be used as the basis for a determination of legal rights and responsibilities. This "choice of law" process is interesting but complicated. Basically, each state has its own set of judicial decisions that resolve conflict of laws. For example, just because A sues B in a Texas court, the Texas court will not necessarily apply Texas law. Anna and Bobby collide and suffer serious physical injuries while driving their cars in Roswell, New Mexico. Both live in Austin, and Bobby files a lawsuit in Austin. The court there could hear it (having subject matter jurisdiction and personal jurisdiction over Bobby) but would apply New Mexico law, which governs motor vehicle laws and accidents in New Mexico. Why would the Texas judge do that? The Texas judge knows that which state's law is chosen to apply to the case can make a decisive difference in the case, as different states have different substantive law standards. For example, in a breach of contract case, one state's version of the Uniform Commercial Code may be different from another's, and which one the court decides to apply is often exceedingly good for one side and dismal for the other. In *Anna v. Bobby*, if Texas has one kind of comparative negligence statute and New Mexico has a different kind of comparative negligence statute, who wins or loses, or how much is awarded, could well depend on which law applies. Because both were under the jurisdiction of New Mexico's laws at the time of the accident, it makes sense to apply New Mexico law. (3) If a defendant does not want to be in state court and there is diversity, what is to be done? (a) Make a motion for removal to the federal court. (b) The federal court will not want to add to its caseload, or docket, but must take the case unless there is *not* complete diversity of citizenship or the amount in controversy is *less than* $75,000.

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

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

Back to our hypothetical case: Robinson v. Audi

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

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

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

Table 4 Sample Conflict-of-Law Principles

Substantive Law Issue	Law to be Applied
Liability for injury caused by tortious conduct	State in which the injury was inflicted
Real property	State where the property is located
Personal Property: inheritance	Domicile of deceased (not location of property)
Contract: validity	State in which contract was made
Contract: breach	State in which contract was to be performed*

Legal Procedure, Including Due Process and Personal Jurisdiction

In this section, we consider how lawsuits are begun and how the court knows that it has both subject matter jurisdiction and personal jurisdiction over at least one of the named defendants.
To get the attention of a court, the plaintiff must make a claim based on existing laws. Courts do not reach out for cases. Cases are brought to them, usually when an attorney files a case with the right court in the right way, following the various laws that govern civil procedures in a state or in the federal system. (Most US states' procedural laws are similar to the federal procedural code.)

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

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

The method of adjudication—the act of making an order or judgment—has several important features. First, it focuses the conflicting issues. Other, secondary concerns are minimized or excluded altogether. Relevance is a key concept in any trial. The judge is required to decide the questions presented at the trial, not to talk about unrelated matters. Second, adjudication requires that the judge's decision be reasoned, and that is why judges write opinions explaining their decisions (an opinion may be omitted when the verdict comes from a jury). Third, the judge's decision must not only be reasoned but also be responsive to the case presented: the judge is not free to say that the case is unimportant and that he therefore will ignore it. Unlike other branches of government that are free to ignore problems pressing upon them, judges *must* decide cases. (For example, a legislature need not enact a law, no matter how many people petition it to do so.) Fourth, the court must respond in a certain way. The judge must pay attention to the parties' arguments and his decision must result from their evidence and arguments. Evidence that is not presented and legal arguments that are not made cannot be the basis for what the judge decides. Also, judges are bound by standards of weighing evidence: the burden of proof in a civil case is generally a "preponderance of the evidence"- meaning more likely than not – a 51%-49% standard.

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

Criminal prosecutions carry the most rigorous burden of proof: the government must prove its case against the defendant *beyond a reasonable doubt* (known as the 95%-5% standard). That is, even if it seems very likely that the defendant committed the crime, as long as there remains some reasonable doubt (5%)—perhaps he was not clearly identified as the culprit, perhaps he has an alibi that could be legitimate—the jury must vote to acquit rather than convict.
By contrast, the burden of proof in ordinary civil cases—those dealing with contracts, personal injuries—is a *preponderance of the evidence*, which means that the plaintiff's evidence must outweigh whatever evidence the defendant can muster that casts doubts on the plaintiff's claim. This is not merely a matter of counting the number of witnesses or of the length of time that they talk: the judge in a trial without a jury (a bench trial), or the jury where one is impaneled, must apply the preponderance of evidence test by determining which side has the greater weight of credible, relevant evidence.

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

How a Case Proceeds

Complaint and Summons

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

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

Jurisdiction and Venue

The place of filing is equally important, and there are two issues regarding location. The first is subject matter jurisdiction, as already noted. A claim for breach of contract, in which the amount at stake is $1 million, cannot be brought in a local county court with jurisdiction to hear cases involving sums of up to only $1,000. Likewise, a claim for copyright violation cannot be brought in a state superior court, since federal courts have exclusive jurisdiction over copyright cases.
The second consideration is venue—the proper geographic location of the court. For example, every county in a state might have a superior court, but the plaintiff is not free to pick any county. Again, a statute or rule will spell out to which court the plaintiff must go and the proper court location (e.g., the county in which the plaintiff resides or the county in which the defendant resides or maintains an office).

Service of Process and Personal Jurisdiction

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

Even if a court has subject matter jurisdiction, it must also have personal jurisdiction over each defendant against whom an enforceable judgment can be made. Often this is not a problem; you might be suing a person who lives in your state or regularly does business in your state. Or a nonresident may answer your complaint without objecting to the court's "in personam" (personal) jurisdiction. But many defendants who do not reside in the state where the lawsuit is filed would rather not be put to the inconvenience of contesting a lawsuit in a distant forum. Fairness—and the due process clause of the Fourteenth Amendment—dictates that nonresidents should not be required to defend lawsuits far from their home base, especially where there is little or no contact or connection between the nonresident and the state where a lawsuit is brought. This is called the minimum contacts requirement and was set forth by the U.S. Supreme Court in 1945 in the famous case of *International Shoe Co. v. Washington*, 326 U.S. 310 (1945). A defendant must have some minimum contacts with the forum state in order to be sued there- either the defendant lives in the state, works in the state, conducts business in the state, committed an injury in the state, etc. allowing the state to exercise personal jurisdiction over him or her.

Summary of Rules on Personal Jurisdiction

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

The court's decision in the first lawsuit (against defendant 1) does not determine the liability of the nonparticipating defendants.

This involves the principle of res judicata, which means that you can't bring the same cause of action against the same person (or entity) twice. It's like the civil side of double jeopardy. *Res* means "thing," and *judicata* means "adjudicated." Thus the "thing" has been "adjudicated" and should not be judged again. But, as to nonparticipating parties, it is not over. And, if you have a *different* case against the same defendant—one that arises out of a completely different situation—that case is not barred by res judicata. However, issues litigated in a prior case can also have a preclusive effect in subsequent litigation involving a different cause of action as a result of the doctrine of collateral estoppel. *MPC Inc. v. Kenny*, 279 Md. 29 (1977).

Service of process is a necessary condition for getting personal jurisdiction over a particular defendant (see rule 4).

In order to get a judgment in a civil action, the plaintiff must serve a copy of the complaint and a summons on the defendant.

There are many ways to do this.

- The process server personally serves a complaint on the defendant.
- The process server leaves a copy of the summons and complaint at the residence of the defendant, in the hands of a competent person- usually another resident over the age of 16.
- The process server sends the summons and complaint by certified mail, restricted delivery, return receipt requested.
- The process server, if all other means are not possible, notifies the defendant by publication in a newspaper having a minimum number of readers (as may be specified by law).
- In addition to successfully serving the defendant with process, a plaintiff must convince the court that exercising personal jurisdiction over the defendant is consistent with due process and any statutes in that state that prescribe the jurisdictional reach of that state (the so-called long-arm statutes). The U.S. Supreme Court has long recognized various bases for judging whether such process is fair.
- Consent. The defendant agrees to the court's jurisdiction by coming to court, answering the complaint, and having the matter litigated there.
- Domicile. The defendant is a permanent resident of that state.
- Event. The defendant did something in that state, related to the lawsuit, that makes it fair for the state to say, "Come back and defend!"
- Service of process within the state will effectively provide personal jurisdiction over the nonresident.

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

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

Choice of Law and Choice of Forum Clauses

In a series of cases, the U.S. Supreme Court has made clear that it will honor contractual choices of parties in a lawsuit. Suppose the parties to a contract wind up in court arguing over the application of the contract's terms. If the parties are from two different states, the judge may have difficulty determining which law to apply (see Table 2 "Sample Conflict-of-Law Principles"). But if the contract says that a particular state's law will be applied if there is a dispute, then ordinarily the judge will apply that state's law as a rule of decision in the case.

For example, Kumar Patel (a Missouri resident) opens a brokerage account with Goldman, Sachs and Co., and the contractual agreement calls for "any disputes arising under this agreement" to be determined "according to the laws of the state of New York." When Kumar claims in a Missouri court that his broker is "churning" his account, and, on the other hand, Goldman, Sachs claims that Kumar failed to meet his margin call and owes $38,568.25 (plus interest and attorney's fees), the judge in Missouri will apply New York law based on the contract between Kumar and Goldman, Sachs.

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

Standing

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

Case or Controversy: Standing to Sue

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

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

Alternative Dispute Resolution

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

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

While there are many forms of alternative dispute resolution, the three main forms are: Negotiation, Mediation and Arbitration.

Negotiation

Negotiation is just what its name implies – negotiation. The parties to the dispute work together, sometimes through counsel- sometimes without counsel, to try and settle the dispute without involving the courts or a third party mediator or arbitrator. Negotiation is voluntary and usually occurs in most disputes where one side tries to explain its position to the other side, and vice versa in an attempt to reach a resolution.

Negotiation is non-binding if the parties do not reach an agreement, and then they are free to pursue other forms of alternative dispute resolution or resort to the courts to resolve their issue.

Mediation

Mediation allows a neutral third party, a trained mediator who has completed dispute resolution training, to hear the pros and cons of each party's side of the dispute and work with them to reach a decision or settlement of the case. Mediation, like negotiation, is non-binding. The mediator is a neutral go-between who attempts to help the parties negotiate a solution, but does not impose a solution on the parties.

The mediator will communicate the parties' positions to each other, will facilitate the finding of common ground, and will suggest possible outcomes. But the parties have complete control: they may ignore the recommendations of the mediator entirely, settle in their own way, find another mediator, agree to binding arbitration, go to court, or forget the whole thing.

In Maryland, the court system requires mediation of most Circuit Court civil cases unless the parties opt out of mediation after filing suit. For more information on Maryland's mediation program see MACRO- Maryland Mediation.

Arbitration

Arbitration is a type of adjudication. The parties use a private decision maker, the arbitrator, and the rules of procedure are considerably more relaxed than those that apply in the courtroom. Arbitrators might be retired judges, lawyers, or anyone with the kind of specialized knowledge and training that would be useful in making a final, binding decision on the dispute.

In a contractual relationship, the parties can decide even before a dispute arises to use arbitration when, and if, the time comes. Or parties can decide after a dispute arises to use arbitration instead of litigation. In a pre-dispute arbitration agreement (often part of a larger contract), the parties can spell out the rules of procedure to be used and the method for choosing the arbitrator. For example, they may name the specific person to be the arbitrator or delegate the responsibility of choosing the arbitrator to some neutral person, or they may each designate an arbitrator and the two designees may jointly pick a third arbitrator- where the type of dispute needs a panel of three arbitrators.

Many arbitrations take place under the auspices of the American Arbitration Association, a private organization headquartered in New York, with regional offices in many other cities. The association uses published sets of rules for various types of arbitration (e.g., labor arbitration or commercial arbitration); parties who provide in contracts for arbitration through the association are agreeing to be bound by the association's rules.

Similarly, the National Association of Securities Dealers provides arbitration services for disputes between clients and brokerage firms. International commercial arbitration often takes place through the auspices of the International Chamber of Commerce. A multilateral agreement known as the Convention on the Recognition and Enforcement of Arbitral Awards provides that agreements to arbitrate—and arbitral awards—will be enforced across national boundaries.

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

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

Torts

Overview of Tort Law

In civil litigation, contract and tort claims are by far the most common. The law attempts to adjust for harms done by awarding damages to a successful plaintiff who demonstrates that the defendant was the cause of the plaintiff's losses. Torts can be intentional torts, negligent torts, or strict liability torts. This section explains the different kind of torts, as well as available defenses to tort claims.

Definition of Tort

The term *tort* is the French equivalent of the English word *wrong*. The word *tort* is also derived from the Latin word *tortum*, which means twisted or crooked or wrong. Thus conduct that is twisted or crooked is a tort. The term was introduced into the English law by the Norman jurists.

Long ago, *tort* was used in everyday speech; today it is left to the legal system. A judge will instruct a jury that a tort is usually defined as a wrong for which the law will provide a remedy, most often in the form of money damages. The law does not remedy all "wrongs." The preceding definition of tort does not reveal the underlying principles that divide wrongs in the legal sphere from those in the moral sphere. Hurting someone's feelings may be more devastating than saying something untrue about him behind his back; yet the law will not provide a remedy for saying something cruel to someone directly, while it may provide a remedy for "defaming" someone, orally or in writing, to others.

Although the word is no longer in general use, tort suits are the stuff of everyday headlines. More and more people injured by exposure to a variety of risks now seek redress (some sort of remedy through the courts). Headlines boast of multimillion-dollar jury awards against doctors who bungled operations, against newspapers that libeled subjects of stories, and against oil companies that devastate entire ecosystems. All are examples of tort suits.

The law of torts developed almost entirely in the common-law courts; that is, statutes passed by legislatures were not the source of law that plaintiffs usually relied on. Usually, plaintiffs would rely on the common law (judicial decisions). Through thousands of cases, the courts have fashioned a series of rules that govern the conduct of individuals in their noncontractual dealings with each other. Through contracts, individuals can craft their own rights and responsibilities toward each other. In the absence of contracts, tort law holds individuals legally accountable for the consequences of their actions. Those who suffer losses at the hands of others can be compensated.

Many acts (like homicide) are both criminal and tortious. It is a crime because there are state laws against homicide. It is a tort because intentionally or unintentionally hurting another person is known as wrongful death under civil law. Most intentional torts are also crimes.
But torts and crimes are different, and the difference is worth noting. A crime is an act against the people as a whole. Society punishes the murderer; it does not usually compensate the family of the victim. Tort law, on the other hand, views the death as a private wrong for which damages are owed. In a civil case, the tort victim or his family, not the state, brings the action. The judgment against a defendant in a civil tort suit is expressed in monetary terms, not in terms of prison times or fines, and is the legal system's way of trying to make up for the victim's loss.

By example – if you are old enough to remember the O.J. Simpson case with the murder of his ex-wife, Nicole Brown-Simpson, and her friend Ron Goldman. Mr. Simpson was charged criminally with the murder of both individuals, for which he was acquitted (found not guilty). He was then sued civilly by the family of Ron Goldman for his son's wrongful death. Mr. Simpson was found liable for the wrongful death of Ron Goldman, even though he was acquitted of his murder.

Kinds of Torts

There are three kinds of torts: intentional torts, negligent torts, and strict liability torts. Intentional torts arise from intentional acts, whereas unintentional torts (aka negligence) often result from carelessness (e.g., when a surgical team fails to remove a clamp from a patient's abdomen when the operation is finished). Both intentional torts and negligent torts imply some fault on the part of the defendant. In strict liability torts, by contrast, there may be no fault at all, but tort law will sometimes require a defendant to make up for the victim's losses even where the defendant was not careless and did not intend to do harm, but harm resulted nonetheless.

Dimensions of Tort Liability

There is a clear moral basis for recovery through the legal system where the defendant has been careless (negligent) or intentionally caused harm. Using the concepts that we are free and autonomous beings with basic rights, when others interfere with either our freedom or our autonomy, we will usually react negatively. As the old saying goes, "Your right to swing your arm ends at the tip of my nose." The law takes this even one step further: under intentional tort law, if you frighten someone by swinging your arms toward the tip of her nose, you may have committed the tort of assault, even if there is no actual touching (battery).

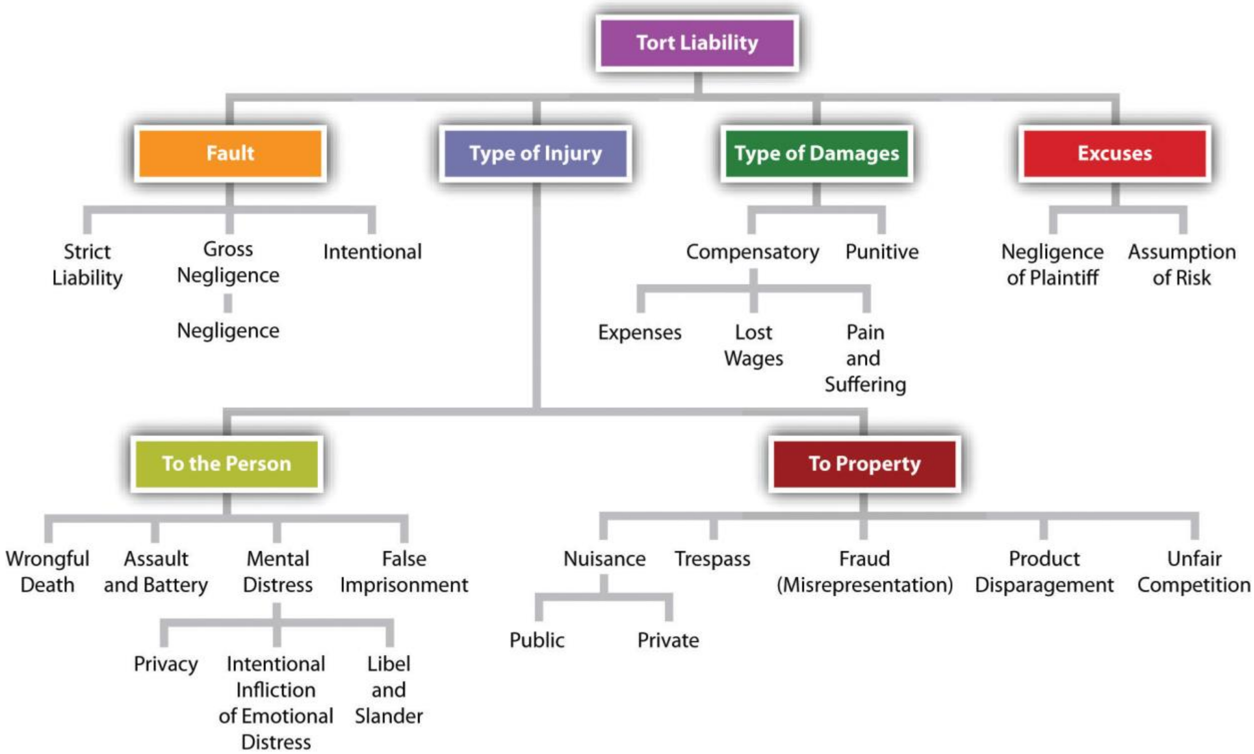

Figure 4 Dimensions of Tort Liability

Dimensions of Tort: Fault

Tort principles can be viewed along different dimensions. One is the **fault** dimension. Like criminal law, tort law requires a wrongful act by a defendant for the plaintiff to recover. Unlike criminal law, however, there need not be a specific intent. Since tort law focuses on injury to the plaintiff, it is less concerned than criminal law about the reasons for the defendant's actions. An innocent act may still provide the basis for liability. Nevertheless, tort law—except for strict liability—relies on standards of fault, or blameworthiness.

The most obvious standard is willful conduct. If the defendant (often called the tortfeasor—i.e., the one committing the tort) intentionally injures another, there is little argument about tort liability. Thus all crimes resulting in injury to a person or property (murder, assault, arson, etc.) are also torts, and the plaintiff may bring a separate lawsuit to recover damages for injuries to his person, family, or property.

Most tort suits do not rely on *intentional* fault. They are based, rather, on negligent conduct that in the circumstances is careless or poses unreasonable risks of causing damage. Most automobile accident and medical malpractice suits are examples of negligence suits.

The fault dimension is a continuum. At one end is the deliberate desire to do injury. The middle ground is occupied by careless conduct. At the other end is conduct that most would consider entirely blameless, in the moral sense. The defendant may have observed all possible precautions and yet still be held liable. This is called strict liability. An example is that incurred by the manufacturer of a defective product placed on the market despite all possible precautions, including quality-control inspection. In many states, if the product causes injury, the manufacturer will be held liable.

Dimensions of Tort: Nature of Injury

Tort liability also varies by the type of injury caused. The most obvious type is physical harm to the person (assault, battery, infliction of emotional distress, wrongful death) or property (trespass, conversion, nuisance, arson, interference with contract). Mental suffering can be redressed if it is a result of physical injury (e.g., shock and depression following an automobile accident). A few states now permit recovery for mental distress alone (a mother's shock at seeing her son injured by a car while both were crossing the street). Other protected interests include a person's reputation (injured by defamatory statements or writings), privacy (injured by those who divulge secrets of his personal life), and economic interests (misrepresentation to secure an economic advantage, certain forms of unfair competition).

Dimensions of Tort: Defenses

A third element in the law of torts is the defense or excuse for committing an apparent wrong. The law does not condemn every act that ultimately results in injury. There are many potential defenses to a tort claim, and much depends on the specific type of claim the plaintiff filed. Below we will briefly address two of the most common defenses: assumption of risk and contributory or comparative negligence.

One common defense is assumption of risk. A baseball fan who sits along the third base line close to the infield assumes the risk that a line drive foul ball may fly toward him and strike him. He will not be permitted to complain in court that the batter should have been more careful or that management should have either warned him or put up a protective barrier.

Another excuse is negligence of the plaintiff. This is broken down into two forms: contributory negligence and comparative negligence. With contributory negligence, which is only followed in a small minority of states- including Maryland, the defendant argues that the negligent conduct of the plaintiff contributed to the plaintiff's injuries. In states that allow this defense, it is a complete bar to recovery if proven by the defendant that the plaintiff was even 1% negligent. However, as with everything in law- there are exceptions to this rule.

In comparative negligence states, applied in the majority of the states in the U.S., any negligence of the plaintiff in causing the injury is used to offset the amount of damage award. Meaning, if the court finds the actions of the plaintiff contributed 15% to the injury, then the award against the defendant would be reduced by 15%. Plaintiff therefore bears the cost of their own negligent conduct. There are various forms of comparative negligence depending on the state you are in – but the basic concept is the same that the plaintiff bears the cost of their negligence.

Damages

Compensatory Damages

Since the purpose of tort law is to compensate the victim for harm actually done, damages are usually measured by the extent of the injury. Expressed in monetary terms, these include replacement of property destroyed, compensation for lost wages, reimbursement for medical expenses, and dollars that are supposed to approximate the pain that is suffered. Damages for these injuries are called compensatory damages.

Compensatory damages are broken down into two sub-categories: general damages and special damages. General damages are basically pain and suffering, damages anyone injured in a similar tort would incur. Special damages are unique to the plaintiff based on the type of injury and include medical bills, property damages, lost wages, etc.

Punitive Damages

In certain instances, the courts will permit an award of punitive damages. As the word *punitive* implies, the purpose is to punish the defendant's actions. Because a punitive award (sometimes called exemplary damages) is at odds with the general purpose of tort law, it is allowable only in extreme situations. The law in most states permits recovery of punitive damages only when the defendant deliberately committed a wrong with malicious intent or otherwise did something outrageous.

Punitive damages are rarely allowed in negligence cases for that reason. But if someone sets out intentionally and maliciously to hurt another person, punitive damages may well be appropriate. Punitive damages are intended not only to punish the wrongdoer, by exacting an additional and sometimes heavy payment (the exact amount is left to the discretion of jury and judge), but also to deter others from similar conduct. The punitive damage award has been subject to heavy criticism in recent years in cases in which it has been awarded against manufacturers. One fear is that huge damage awards on behalf of a multitude of victims could swiftly bankrupt the defendant. Unlike compensatory damages, punitive damages are taxable.

Nominal Damages

A final category of damages is nominal damages. Where plaintiff can show a wrong was suffered but he has no out of pocket costs- the court may award nominal damages – such as $1 or $10. An example would be your neighbor cuts across your backyard every day to get to the bus stop. This really annoys you and is technically trespassing. You file suit to stop your neighbor from walking across your lawn. As long as your neighbor has not damaged your lawn in any way- there are no monetary losses you can claim. So while the court will order your neighbor to stop- you will not recover any damages because you have not suffered any losses. What the court may do instead is issue an injunction requiring the plaintiff to stop walking on your lawn. An injunction is a court order to do something or in our example to stop doing something.

Table 5 Summary of Intentional Torts

Intentional Torts Against Persons	**Intentional Torts Against Property**
• Assault • Battery • False Imprisonment • Intentional Infliction of Emotional Distress (and Negligent Infliction) • Fraud, Deceit, Intentional Misrepresentation (and Negligent Misrepresentation) • Intentional Interference with Contract • Malicious Prosecution & Abuse of Process • Defamation • Invasion of Privacy	• Trespass To Land • Trespass to Personal Property (Chattels) • Conversion • Disparagement of Property (or Title)

Intentional Torts Against Persons

The analysis of most intentional torts is straightforward and parallels the substantive crimes covered in the material on Criminal Law. When physical injury or damage to property is caused, there is rarely debate over liability if the plaintiff deliberately undertook to produce the harm. Certain other intentional torts are worth noting for their relevance to business.

Assault and Battery

One of the most obvious intentional torts is assault and battery. Both criminal law and tort law serve to restrain individuals from using physical force on others.

- ***Assault is (1) the threat of immediate harm or offense of contact or (2) any act that would arouse reasonable apprehension of imminent harm.***
- ***Battery is unauthorized and harmful or offensive physical contact with another person that causes injury.***

Often an assault results in battery, but not always. In *Western Union Telegraph Co. v. Hill*, 67 F.2d 487 (1933) for example, the defendant did not touch the plaintiff's wife, but the case presented an issue of possible assault even without an actual battery; the defendant employee attempted to kiss a customer across the countertop, couldn't quite reach her, but nonetheless created actionable fear (or, as the court put it, "apprehension") on the part of the plaintiff's wife.

It is also possible to have a battery without an assault. For example, if someone hits you on the back of the head with an iron skillet and you didn't see it coming, there is a battery but no assault. Likewise, if Andrea passes out from drinking too much at the fraternity party and a stranger (Andre) kisses her on the lips while she is passed out, she would not be aware of any threat of offensive contact and would have no apprehension of any harm. Thus there has been no tort of assault, but she could allege the tort of battery. (The question of what damages, if any, would be an interesting argument.)

Can a person be battered through a computer file? That was the question posed in *Eichenwald v. Rivello*, 318 F. Supp. 3d 766 (D. Md. 2018), where the defendant sent a specially crafted, epileptogenic image file that, when opened, would display a fast-flashing strobe light with flashing circles and images flying toward the screen to the plaintiff, a journalist that suffered from epilepsy, and which caused the plaintiff to suffer several seizures as a result. While there was no direct, physical contact by the defendant against the plaintiff, the court found that the intentional delivery of such a computer file to a person that the defendant knew would suffer a seizure was sufficient to establish a battery under Texas law. *Id.* at 772.

Under the doctrine of transferred intent, if Draco aims his wand at Harry but Harry ducks just in time and the impact is felt by Hermione instead, English law (and American law) would transfer Draco's intent from the target to the actual victim of the act. Thus Hermione could sue Draco for battery for any damages she suffered.

False Imprisonment

The tort of false imprisonment originally implied a locking up, as in a prison, but today it can occur if a person is restrained in a room or a car or even if his or her movements are restricted while walking down the street.

- ***False imprisonment is the intentional confinement or restraint by physical or non-physical means (aka verbal threats).***

People have a right to be free to go as they please, and anyone who, without cause, deprives another of personal freedom has committed a tort. Damages are allowed for time lost, discomfort and resulting ill health, mental suffering, humiliation, loss of reputation or business, and expenses such as attorneys' fees incurred as a result of the restraint (such as a false arrest). But as the case of *Lester v. Albers Super Markets, Inc.*, 94 Ohio App. 313 (1952) shows, the defendant must be shown to have restrained the plaintiff in order for damages to be allowed.

In *Lester*, the defendant had a policy of searching bags brought into its store from outside. The plaintiff came into the store with a bag containing a purchase she had made from another store. While rushing to leave the defendant's store to catch her bus, the plaintiff was asked to allow the store to search her bag. The plaintiff argued with the store manager that she did not have time but eventually allowed the search. The Ohio Appellate Court held that the plaintiff was not restrained to qualify as false imprisonment.

Intentional Infliction of Emotional Distress
Until recently, the common-law rule was that there could be no recovery for acts, even though intentionally undertaken, that caused purely mental or emotional distress. For a case to go to the jury, the courts required that the mental distress result from some physical injury. In recent years, many courts have overthrown the older rule and now recognize the so-called new tort. In an employment context, however, it is rare to find a case where a plaintiff is able to recover. The most difficult hurdle is proving that the conduct was "extreme" or "outrageous."

- ***Intentional Infliction of Emotional Distress is where the defendant acts either intentionally or recklessly in an extreme or outrageous manner that causes the plaintiff severe emotional or mental distress. There must be a causal connection between the action and the emotional distress.***

In *Roche v. Stern*, *675 N.Y.S.2d 133 (1998)*, the famous cable television talk show host Howard Stern had tastelessly discussed the remains of Deborah Roche, a deceased topless dancer and cable access television host. The remains had been brought to Stern's show by a close friend of Roche, Chaunce Hayden, and a number of crude comments by Stern and Hayden about the remains were videotaped and broadcast on a national cable television station. Roche's sister and brother sued Howard Stern and Infinity broadcasting and were able to get past the defendant's motion to dismiss to have a jury consider their claim.

A plaintiff's burden in these cases is to show that the mental distress is severe. Many states require that this distress must result in physical symptoms such as nausea, headaches, ulcers, or, as in the case of the pregnant wife, a miscarriage. Other states have not required physical symptoms, finding that shame, embarrassment, fear, and anger constitute severe mental distress. In Maryland, the emotional distress must be "severely disabling," such that "no reasonable man could be expected to endure it." Being "upset" and "embarrassed" is not sufficient to show severe emotional distress. Evidence that the plaintiff could continue with his normal life activities or that he did not seek professional treatment can show that the distress is not "severe."

In *Green v. Shoemaker*, *111 Md. 69 (1909)*, the Maryland Court of Appeals determined that a plaintiff cannot recover for emotional distress unless a "physical injury" results from the tort. Later, the court expanded a "physical injury" to include injuries "manifested by an external condition or by symptoms clearly indicative of a resultant pathological, physiological, or mental state." The physical injury can be proven through evidence of an "external condition or by symptoms of a pathological or physiological state." Also, it can be proven through evidence that indicates a "mental state." However, medical testimony is not required in order to show mental distress. The Court relaxed the physical injury rule in more recent cases, adding an alternative theory of recovery for emotional distress where the injury is "capable of objective determination resulting therefrom." *Montgomery Cablevision Ltd. v. Beynon*, 696 A.2d 941, 503 (Md. Ct. Spec. App. 1997).

Fraud or Intentional Misrepresentation

Businesses often make claims about their products in marketing their products to the public. If these claims are false, then the business may be liable for the tort of **intentional misrepresentation**, known in some states as fraud.

- ***Fraud is where the tortfeasor misrepresents facts (not opinions) with knowledge that they are false or with reckless disregard for the truth.***

An “innocent” misrepresentation, such as someone who lies without knowing he or she is lying, is not enough—the defendant must know he or she is lying. Fraud can arise in any number of business situations, such as lying on your résumé to gain employment, lying on a credit application to obtain credit or to rent an apartment, or in product marketing. Here, there is a fine line between puffery, or seller’s talk, and an actual lie. If an advertisement claims that a particular car is the “fastest new car you can buy,” then fraud liability arises if there is in fact a car that travels faster. On the other hand, an advertisement that promises “unparalleled luxury” is only puffery since it is opinion. Makers of various medicinal supplements and vitamins are often the target of fraud lawsuits for making false claims about their products.

In *Martens Chevrolet v. Seney*, 292 Md. 328 (1982), the Court of Appeals recognized the common law tort of deceit as requiring intentional conduct by the defendant to deceive the plaintiff of a material fact, and that the evidence of this intention was lacking in the case. However, the Court acknowledged a separate tort of negligent misrepresentation – a kissing cousin to fraud – where the defendant knew or should have known that material fact was incorrect and in essence negligently represented the information to the plaintiff causing injury.

Intentional Interference with Contractual Relations

Tortious interference with a contract can be established by proving four elements:

- ***There was a contract between the plaintiff and a third party.***
- ***The defendant knew of the contract.***
- ***The defendant improperly induced the third party to breach the contract or made performance of the contract impossible.***
- ***There was injury to the plaintiff.***

In a famous case of contract interference, Texaco was sued by Pennzoil for interfering with an agreement that Pennzoil had with Getty Oil. T*exaco v. Pennzoil*, 729 S.W.2d 768 (Tex. Ct. App. 1987). After complicated negotiations between Pennzoil and Getty, a takeover share price was struck, a memorandum of understanding was signed, and a press release announced the agreement in principle between Pennzoil and Getty. Texaco’s lawyers, however, believed that Getty oil was “still in play,” and before the lawyers for Pennzoil and Getty could complete the paperwork for their agreement, Texaco announced it was offering Getty shareholders an additional $12.50 per share over what Pennzoil offered.

Texaco later increased its offer to $228 per share, and the Getty board of directors soon began dealing with Texaco instead of Pennzoil. Pennzoil decided to sue in Texas state court for tortious interference with a contract. After a long trial, the jury returned an enormous verdict against Texaco: $7.53 billion in actual damages and $3 billion in punitive damages. The verdict was so large that it would have bankrupted Texaco. Appeals from the verdict centered on an obscure rule of the Securities and Exchange Commission (SEC), Rule 10(b)-13, and Texaco’s argument was based on that rule and the fact that the contract had not been completed. If there was no contract, Texaco could not have legally interfered with one. After the SEC filed a brief that supported Texaco’s interpretation of the law, Texaco agreed to pay $3 billion to Pennzoil to dismiss its claim of tortious interference with a contract.

Malicious Prosecution

- ***Malicious prosecution is the tort of causing someone to be prosecuted for a criminal act, knowing that there was no probable cause to believe that the plaintiff committed the crime.***

The plaintiff must show that the defendant acted with malice or with some purpose other than bringing the guilty to justice. A mere complaint to the authorities is insufficient to establish the tort, but any official proceeding will support the claim—for example, a warrant for the plaintiff's arrest. The criminal proceeding must terminate in the plaintiff's favor in order for his suit to be sustained.

A majority of US courts, though by no means all, permit a suit for wrongful civil proceedings. Civil litigation is usually costly and burdensome, and one who forces another to defend himself against baseless accusations should not be permitted to saddle the one he sues with the costs of defense. However, because, as a matter of public policy, litigation is favored as the means by which legal rights can be vindicated—indeed, the U.S. Supreme Court even ruled that individuals have a constitutional right to litigate—the plaintiff must meet a heavy burden in proving his case. The mere dismissal of the original lawsuit against the plaintiff is not sufficient proof that the suit was unwarranted. The plaintiff in a suit for wrongful civil proceedings must show that the defendant (who was the plaintiff in the original suit) filed the action for an improper purpose and had no reasonable belief that his cause was legally or factually well grounded. Under Maryland law, the court requires proof of "malice or a primary purpose other then bringing the plaintiff to justice" as an element of this tort. *Okwa v. Harper*, 757 A. 2d 118, 130 (Md. 2000) ("malice … may be inferred from a lack of probable cause"). However, the Court noted that punitive damages may only be award for demonstrated actual malice – conducted motivated by ill-will towards the plaintiff, rather than just an absence of probable cause. *Id.* at 133.

Defamation

Defamation is injury to a person's good name or reputation. In general, if the harm is done through the spoken word—one person to another, by telephone, by radio, or on television—it is called slander. If the defamatory statement is published in written form, it is called libel.

- ***Defamation's elements are the (1) publication, (2) of false statements, and (3) that cause harm to the person's reputation. Public figures need to show a fourth element that the statements were made with actual malice.***

The Restatement (Second) of Torts defines a defamatory communication as one that "so tends to harm the reputation of another as to lower him in the estimation of the community or to deter third persons from associating or dealing with him." Restatement (Second) of Torts, Section 559 (1965).

A statement is not defamatory unless it is false. Truth is an absolute defense to a charge of libel or slander. Moreover, the statement must be "published"—that is, communicated to a third person. You cannot be libeled by one who sends you a letter full of false accusations and scurrilous statements about you unless a third person opens it first (your roommate, perhaps). Any living person is capable of being defamed, but the dead are not. Corporations, partnerships, and other forms of associations can also be defamed, if the statements tend to injure their ability to do business or to garner contributions.

The statement must have reference to a particular person, but he or she need not be identified by name. A statement that "the company president is a crook" is defamatory, as is a statement that "the major network weathermen are imposters." The company president and the network weathermen could show that the words were aimed at them. But statements about large groups will not support an action for defamation (e.g., "all doctors are butchers" is not defamatory of any particular doctor).

The law of defamation is largely built on strict liability, even though defamation is categorized as an intentional tort. That a person did not intend to defame is ordinarily no excuse; a typographical error that converts a true statement into a false one in a newspaper, magazine, or corporate brochure can be sufficient to make out a case of libel. Even the exercise of due care is usually no excuse if the statement is in fact communicated, though such claims require proof of actual damages by the private plaintiff for recovery against the negligent defendant. *Hearst Corp. v. Hughes*, 297 Md. 112, 130 (1983). Repeating a libel is itself a libel; a libel cannot be justified by showing that you were quoting someone else. However, though a plaintiff may be able to prove that a statement was defamatory, he is not necessarily entitled to an award of damages. That is because the law contains a number of privileges that excuse the defamation.

In the business context, publishing false information about another business's product constitutes the tort of slander of quality, or trade libel. In some states, this is known as the tort of product disparagement. It may be difficult to establish damages, however. A plaintiff must prove that actual damages proximately resulted from the slander of quality and must show the extent of the economic harm as well.

In addition to truth, other defenses to a defamation claim are absolute privilege and qualified privilege.

Absolute Privilege

Statements made during the course of judicial proceedings are absolutely privileged, meaning that they cannot serve as the basis for a defamation suit. Accurate accounts of judicial or other proceedings are absolutely privileged; a newspaper, for example, may pass on the slanderous comments of a judge in court. "Judicial" is broadly construed to include most proceedings of administrative bodies of the government. Attorneys, as to their statements in open court and in filed court documents, also enjoy an absolute privilege, but attorneys must be careful about statements made outside of judicial process. Restatement (Second) of Torts §§ 585-592A (1977) The Constitution exempts members of Congress from suits for libel or slander for any statements made in connection with legislative business. The courts have constructed a similar privilege for many executive branch officials.

Qualified Privilege

Absolute privileges pertain to those in the public sector. A narrower privilege exists for private citizens. In general, a statement that would otherwise be actionable is held to be justified if made in a reasonable manner and for a reasonable purpose. Thus you may warn a friend to beware of dealing with a specific third person, and if you had reason to believe that what you said was true, you are privileged to issue the warning, even though false.

Maryland recognizes both a "Fair Reporting" and "Fair Comment" privilege against defamation. Fair Reporting immunizes a defendant that fairly reports information from a court case file, trial testimony or the like. "Fair Comment" immunizes a defendant from liability who "honestly expresses a fair and reasonable opinion or comment on matters of legitimate public concern." *Piscatelli v. Smith*, 35 A.3d 1140, 1152 (Md. 2012).

Likewise, an employee may warn an employer about the conduct or character of a fellow or prospective employee, and a parent may complain to a school board about the competence or conduct of a child's teacher. There is a line to be drawn, however, and a defendant with nothing but an idle interest in the matter (an "officious intermeddler") must take the risk that his information is wrong.

Public Figures and Constitutional Malice

In 1964, the Supreme Court handed down its historic decision in *New York Times v. Sullivan*, 376 U.S. 254 (1964), holding that under the First Amendment a libel judgment brought by a public official against a newspaper cannot stand unless the plaintiff has shown "actual malice," which in turn was defined as "knowledge that [the statement] was false or with a reckless disregard of whether it was false or not." In subsequent cases, the Court extended the constitutional doctrine further, applying it not merely to government officials but to public figures, people who voluntarily place themselves in the public eye or who involuntarily find themselves the objects of public scrutiny. Whether a private person is or is not a public figure is a difficult question that has so far eluded rigorous definition and has been answered only from case to case. A CEO of a private corporation ordinarily will be considered a private figure unless he puts himself in the public eye—for example, by starring in the company's television commercials.

Invasion of Privacy

The right of privacy—the right "to be let alone"—did not receive judicial recognition until the twentieth century, and its legal formulation is still evolving. In fact there is no single right of privacy. Courts and commentators have discerned at least four different types of interests:

- ***(1) the right to control the appropriation of your name and picture for commercial purposes,***
- ***(2) the right to be free of intrusion on your "personal space" or seclusion,***
- ***(3) freedom from public disclosure of private or embarrassing and intimate facts of your personal life, and***
- ***(4) the right not to be presented in a "false light."***

Appropriation of Name or Likeness

The earliest privacy interest recognized by the courts was appropriation of name or likeness: someone else placing your photograph on a billboard or cereal box as a model or using your name as endorsing a product or in the product name. A New York statute makes it a misdemeanor to use the name, portrait, or picture of any person for advertising purposes or for the purposes of trade (business) without first obtaining written consent. The law also permits the aggrieved person to sue and to recover damages for unauthorized profits and also to have the court enjoin (judicially block) any further unauthorized use of the plaintiff's name, likeness, or image. This is particularly useful to celebrities.

Because the publishing and advertising industries are concentrated heavily in New York, the statute plays an important part in advertising decisions made throughout the country. Deciding what "commercial" or "trade" purposes are is not always easy. Thus a newsmagazine may use a baseball player's picture on its cover without first obtaining written permission, but a chocolate manufacturer could not put the player's picture on a candy wrapper without consent.

The Restatement (Second) of Torts, § 652C defines this tort as "one who appropriates to his own use or benefit the name or likeness of another." The Restatement does not require that the plaintiff demonstrate that they are famous for this tort to apply, only that the use of the person's name or likeness "may be of benefit to him or to others." Restatement (Second) § 652C comm. a.

Maryland common law takes a slightly different tact for actions involving appropriation of name or likeness from New York, in that Maryland courts consider whether the initial use of the photograph of the plaintiff was proper and whether its subsequent republication was incidental. *Lawrence v. AS Abell Co.*, 475 A. 2d 448 (Md. 1984). In Lawrence, the Baltimore Sun had initially taken a photograph of several individuals, including children, for a story about the Afram Festival, with the permission of the persons photographed. Subsequently, the Sun used the photograph in commercial advertising for subscriptions to the paper. The Court found that the subsequent use was incidental to the Sun's advertising, rather than as an endorsement by the children of the newspaper.

Freedom from intrusion

The Restatement (Second) of Torts defines intrusion upon seclusion as "one who intentionally intrudes, physically or otherwise, upon the solitude or seclusion of another or his private affairs or concerns, is subject to liability … if the intrusion would be highly offensive to the reasonable person." Restatement (Second) of Torts § 652B. One form of intrusion upon a person's solitude—trespass—has long been actionable under common law. Physical invasion of home or other property is not a new tort. But in recent years, the notion of intrusion has been broadened considerably. Now, taking photos of someone else with your cell phone in a locker room could constitute invasion of the right to privacy. Reading someone else's mail or e-mail could also constitute an invasion of the right to privacy. Photographing someone on a city street is not tortious, but subsequent use of the photograph could be. Whether the invasion is in a public or private space, the amount of damages will depend on how the image or information is disclosed to others.

Public Disclosure of Private Facts

The Restatement (Second) of Torts defines publicity given to private life as "one who gives publicity to a matter concerning the private life of another is subject to liability … if the matter publicized is a kind that (a) would be highly offensive to a reasonable person and (b) is not of legitimate concern to the public." Restatement (Second) of Torts § 652D. Circulation of false statements that do injury to a person are actionable under the laws of defamation. What about true statements that might be every bit as damaging—for example, disclosure of someone's income tax return, revealing how much he earned? The general rule is that if the facts are truly private and of no "legitimate" concern to the public, then their disclosure is a violation of the right to privacy. But a person who is in the public eye cannot claim the same protection.

False Light

A final type of privacy invasion is that which paints a false picture in a publication. The Maryland Court of Special Appeals held that the tort of false light is "giving publicity to a matter concerning another that places the other before the public in a false light if (a) the false light in which the other person was placed would be highly offensive to a reasonable person and (b) the actor had knowledge of or acted in reckless disregard as to the falsity of the publicized matter and the false light in which the other would be placed." *Lindenmuth v. McCreer*, 165 A.3d 544, 558 (Md. Ct of Spec. App. 2017). Though false, the matter might not be libelous, since the publication need contain nothing injurious to the reputation of the plaintiff. In *Lindenmouth*, the plaintiff was a mechanic of Coca-Cola Enterprises. After being sent home from work, a rumor began circulating that the plaintiff was planning to return to the mechanic shop with a weapon and shoot other employees. The Court affirmed judgement for the defendant supervisor on the grounds that the plaintiff had failed to demonstrate that the statements about him were false and failed to show that any of the employees acted with actual malice in reporting their concerns to McCreer.

Indeed, the publication might even glorify the plaintiff, making him seem more heroic than he actually is. *Spahn v. Julian Messner, Inc.*, 18 N.Y.2d 324 (1966). Subject to the First Amendment requirement that the plaintiff must show intent or extreme recklessness, statements that put a person in a false light, like a fictionalized biography, are actionable. In *Spahn*, the defendant publisher had created a fictional biography of Warren Spahn, a well-known major league baseball player, in which the defendant invented various stories about Spahn, such as a false claim that he was a decorated war hero. The New York Court of Appeals held that such a fictionalization of events was not protected speech and could be subject to an injunction of publication of the work.

Intentional Torts Against Property

Unlike intentional torts against persons, where an individual is injured, intentional torts to property result in no personal damage but in damage to property, or interference in another's use of property, due to the intentional conduct of another.

Trespass to Land

- ***Trespass is intentionally going on land that belongs to someone else or putting something on someone else's property and refusing to remove it.***

This part of tort law shows how strongly the law values the rights of property owners. The person or item going onto another's property does not even have to damage the property to have a cause of action for trespass. There are limits to property owners' rights, however.

In *Katko v. Briney*, 183 N.W.2d 657 (Iowa 1971), the plaintiff was injured by a spring gun while trespassing on the defendant's property. The defendant had set up No Trespassing signs after ten years of trespassing and housebreaking events, with the loss of some household items. Windows had been broken, and there was "messing up of the property in general." The defendants had boarded up the windows and doors in order to stop the intrusions and finally had set up a shotgun trap in the north bedroom of the house. One defendant had cleaned and oiled his 20-gauge shotgun and taken it to the old house where it was secured to an iron bed with the barrel pointed at the bedroom door. "It was rigged with wire from the doorknob to the gun's trigger so would fire when the door was opened." The angle of the shotgun was adjusted to hit an intruder in the legs. The spring could not be seen from the outside, and no warning of its presence was posted.

The plaintiff, Katko, had been hunting in the area for several years and considered the property abandoned. He knew it had long been uninhabited. He and a friend had been to the house and found several old bottles and fruit jars that they took and added to their collection of antiques. When they made a second trip to the property, they entered by removing a board from a porch window. When the plaintiff opened the north bedroom door, the shotgun went off and struck him in the right leg above the ankle bone. Much of his leg was blown away. While Katko knew he had no right to break and enter the house with intent to steal bottles and fruit jars, the court held that a property owner could not protect an unoccupied boarded-up farmhouse by using a spring gun capable of inflicting death or serious injury.

In *Katko*, there is an intentional tort. But what if someone trespassing is injured by the negligence of the landowner? States have differing rules about trespass and negligence. In some states, a trespasser is only protected against the gross negligence of the landowner. In other states, trespassers may be owed the duty of due care on the part of the landowner. The burglar who falls into a drained swimming pool, for example, may have a case against the homeowner unless the courts or legislature of that state have made it clear that trespassers are owed the limited duty to avoid gross negligence. Or a very small child may wander off his own property and fall into a gravel pit on a nearby property and suffer death or serious injury; if the pit should (in the exercise of due care) have been filled in or some barrier erected around it but was not, then there was negligence. Many states refer to this as the "attractive nuisance" doctrine. And it comes into play frequently with swimming pools, back yard play sets, etc. under the theory that a small child will not appreciate the dangers that an adult would. But if the state law holds that the duty to trespassers is only to avoid gross negligence, even if the trespasser is a child, the child's family would lose. Maryland is one state that does not recognize the attractive nuisance doctrine for children.

In general, individuals with permission to be on another's property such as guests, licensees, and invitees are owed a duty of due care and in many instances a duty to be warned of potential hazards that are not open and obvious dangers. For example, a grocery store will post signs noting wet floors to prevent customers (aka business invitees) from slipping and falling. A trespasser may not be owed such a duty, but check your state's specific rules on this, especially when the trespasser is in a special category such as a child.

Trespass to Personal Property
(OTHERWISE KNOWN AS "trespass to chattels")

A "chattel" is personal property that is visible, tangible and moveable. Personal property is anything that is not land (land is also called "real property"), and not permanently affixed to real property. For example, suppose that instead of standing in my field, you hop onto my horse in the field, and sit there to admire the view. My horse is the chattel- because it is moveable. If you do not have my permission to sit on my horse- you have committed a trespass to chattels.

- ***Trespass to personal property or chattels is the intentional unlawful taking or harming of another's personal property without the owner's permission.***

Trespass to chattels is the intentional interference with an owner's right to use and possess his or her property. Restatement (Second) of Torts § 217(b). The property does not have to be damaged in any way – just the right of ownership interfered with resulting in harm to the plaintiff. In *Register.com, Inc. v. Verio, Inc.*, 356 F.3d 393, 404 (2nd cir. 2004), the Second Circuit found that a computer program that automated data collection by the defendant could be the basis of a trespass to chattels case against the defendant, on the grounds that the search robot could consume significant computing capacity of the plaintiff's systems, resulting in damage to the plaintiff.

Conversion

Conversion takes trespass to chattels one step further (you not only sit on my horse, but you also ride it off into the sunset). The basic idea is that you not only deprive another of the exclusive use and possession of her property, but you expect to do so permanently, without just cause. Conversion is the civil equivalent to the crime of theft.

- ***Conversion is the intentional interference with another's use or possession of personal property to the extent that the defendant must pay the value of the property to the plaintiff.***

In determining if a defendant's interference with another's personal property rises to the level of conversion, the Restatement (Second) of Torts, Section 222A sets forth six factors the courts will use:
- the extent and duration of the defendant's exercise of control over the property;
- the extent and duration of the resulting interference with the plaintiff's right of control;
- the defendant's intent to assert a right inconsistent with the plaintiff's right of control;
- the defendant's good faith;
- the harm done to the chattel; and
- the inconvenience and expense caused to the plaintiff.

Disparagement of Property

This is the type of "defamation" that is directed more at "defaming" *property* than persons—it's called "injurious falsehood (trade disparagement)" and has also been called "slander of quality" or "slander of title," depending upon the circumstances. According to the treatise *Washington Practice*, which digests Washington law according to case law and statutes, "Tort Law and Practice," Section 19.3, a claim for "slander of title" requires proof of the following five elements:

- the statements concerning the plaintiff's title must be false;
- the statements must be maliciously published [not made in good faith or with a reasonable belief in its truthfulness];
- the statements must be spoken with reference to some pending sale or purchase of the plaintiff's property;
- the plaintiff must suffer pecuniary [monetary] loss or injury as a result of the false statements; and
- the statements must be such as to defeat the plaintiff's title [indicate that plaintiff does not have an ownership interest in the property].

See also Disparagement of Title – Wiki

Negligence

Negligence is basically carelessness. When an individual is careless, but not intentional in their conduct, and someone is injured as a result, a cause of action for negligence may exist.

Table 6 Theories of Negligence

Negligence	*Res Ipsa Loquitor*	Negligence *Per Se*
• Duty • Breach • Causation (in fact and proximate) • Damages	• Instrument under exclusive control of defendants • Accident ordinarily would not occur absent negligence	• Violation of statute • Damages to plaintiff

Elements of Negligence

Physical harm need not be intentionally caused. A pedestrian knocked over by an automobile does not hurt less because the driver intended no wrong but was merely careless. The law imposes a duty of care on all of us in our everyday lives. Accidents caused by negligence are actionable.

Determining negligence is not always easy. If a driver runs a red light, we can say that he is negligent because a driver must always be careful to ascertain whether the light is red and be able to stop if it is. Suppose that the driver was carrying a badly injured person to a nearby hospital and that after slowing down at an intersection, went through a red light, blowing his horn, whereupon a driver to his right, seeing him, drove into the intersection anyway and crashed into him. Must one always stop at a red light? Is proof that the light was red always proof of negligence? Usually, but not always: negligence is an abstract concept that must always be applied to concrete and often widely varying sets of circumstances.

The tort of negligence has four elements:

- ***a duty of due care that the defendant had,***
- ***(2) the breach of the duty of due care,***
- ***(3) connection between cause and injury, and***
- ***(4) actual damage or loss.***

Even if a plaintiff can prove each of these aspects, the defendant may be able to show that the law excuses the conduct that is the basis for the tort claim. We examine each of these factors below.

Duty: Standard of Care

Not every unintentional act that causes injury is negligent. If you brake to a stop when you see a child dart out in front of your car, and if the noise from your tires gives someone in a nearby house a heart attack, you have not acted negligently toward the person in the house. The purpose of the negligence standard is to protect others against the risk of injury that foreseeably would ensue from unreasonably dangerous conduct.

Not every careless act is negligence where the defendant does not owe a duty to the plaintiff to act reasonably. With the prior example, as a driver you owe a duty of car to the other drivers on the road and the pedestrians crossing the street. You would not owe a duty to the person sitting in their house as it would not be foreseeable (we will discuss causation and foreseeability below) that you would potentially injure that person by driving your car. However, in those situations where you are found to owe a duty, – the duty is to act reasonable under the circumstances.

Given the infinite variety of human circumstances and conduct, no general statement of a reasonable standard of care is possible. Nevertheless, the law tried to encapsulate it in the form of the famous standard of "the reasonable man." This fictitious person "of ordinary prudence" is the model that juries are instructed to compare defendants with in assessing whether those defendants have acted negligently. Analysis of this mythical personage baffled several generations of commentators. How much knowledge must he have of events in the community, of technology, of cause and effect? With what physical attributes, courage, or wisdom is this nonexistent person supposedly endowed? If the defendant is a person with specialized knowledge, like a doctor or an automobile designer, must the jury also treat the "reasonable man" as having this knowledge, even though the average person in the community will not? (Answer: in most cases, yes.)

Despite the many difficulties, the concept of the reasonable man is one on which most negligence cases ultimately turn. If a defendant acted "unreasonably under the circumstances" and his conduct posed an unreasonable risk of injury, then he is liable for injury caused by his conduct. Perhaps in most instances, it is not difficult to divine what the reasonable man would do. The reasonable man stops for traffic lights and always drives at reasonable speeds, does not throw baseballs through windows, performs surgical operations according to the average standards of the medical profession, ensures that the floors of his grocery store are kept free of fluids that would cause a patron to slip and fall, takes proper precautions to avoid spillage of oil from his supertanker, and so on. The "reasonable man" standard imposes hindsight on the decisions and actions of people in society; the circumstances of life are such that courts may sometimes impose a standard of due care that many people might not find reasonable.

Duty of Care and Its Breach

The law does not impose on us a duty to care for every person. If the rule were otherwise, we would all, in this interdependent world, be our brothers' keepers, constantly unsure whether any action we took might subject us to liability for its effect on someone else. The law copes with this difficulty by limiting the number of people toward whom we owe a duty to be careful.

In general, the law imposes no obligation to act in a situation to which we are strangers. We may pass the drowning child without risking a lawsuit. But if we do act, then the law requires us to act carefully. The law of negligence requires us to behave with due regard for the foreseeable consequences of our actions in order to avoid unreasonable risks of injury. As noted above, this is the reasonable man standard. If we do not act reasonably in a given situation, we may be liable for negligence as we would have breached our duty of care.

For example, if you own a grocery store it would be reasonable to have the aisles inspected for various hazards on a regular basis – maybe every hour. This would prevent patrons from being injured by items that have fallen on the floor. It would also be reasonable for you to post signs noting any hazardous conditions on the floor – such as wet floors. If you fail to regularly inspect the store aisles or to post signs when there are hazards on the floors and someone gets injured you would have breached your duty of care by not acting reasonably given the situation.

Part of the duty of care and its breach is whether or not a specific action could foreseeably cause injury. During the course of the twentieth century, the courts have constantly expanded the notion of "foreseeability," so that today many more people are held to be within the zone of injury than was once the case. For example, it was once believed that a manufacturer or supplier owed a duty of care only to immediate purchasers, not to others who might use the product or to whom the product might be resold. This limitation was known as the rule of privity. And users who were not immediate purchasers were said not to be in privity with a supplier or manufacturer. The privity limitation has long since gone away in the legal field and now anyone injured by a product, even from misuse of a product- if the misuse was foreseeable, can sue the seller, manufacturer, distributor, etc. for damages. Go back to our Robinson v. Audi case under the Role of the Judiciary section.

Determining a duty of care can be a vexing problem. Physicians, for example, are bound by principles of medical ethics to respect the confidences of their patients. Suppose a patient tells a psychiatrist that he intends to kill his girlfriend. Does the physician then have a higher legal duty to warn prospective victim? The California Supreme Court has said yes. *Tarasoff v. Regents of University of California*, 551 P.2d 334 (Calif. 1976).

Establishing a breach of the duty of due care where the defendant has violated a statute or municipal ordinance is eased considerably with the doctrine of negligence per se, a doctrine common to all US state courts (though Maryland follows a modified doctrine of negligence per se, in that violation of a statute is evidence of negligence, but more must be demonstrated by the plaintiff for the violation to make the defendant liable, namely that the violation was the proximate cause of the plaintiff's injury *Brooks v. Lewin Realty*, 835 A.2d 616 (Md. 2003)). If a legislative body sets a minimum standard of care for particular kinds of acts to protect a certain set of people from harm and a violation of that standard causes harm to someone in that set, the defendant is negligent per se.

If Harvey is driving sixty-five miles per hour in a fifty-five-mile-per-hour zone when he crashes into Haley's car and the police accident report establishes that or he otherwise admits to going ten miles per hour over the speed limit, Haley does not have to prove that Harvey breached a duty of due care. She will only have to prove that the speeding was an actual and proximate cause of the collision and will also have to prove the extent of the resulting damages to her.

Causation: Actual "But For" Cause and Proximate Cause

"For want of a nail, the kingdom was lost," as the old saying has it. Virtually any cause of an injury can be traced to some preceding cause. The problem for the law is to know when to draw the line between causes that are immediate and causes too remote for liability reasonably to be assigned to them. In tort theory, there are two kinds of causes that a plaintiff must prove: actual cause and proximate cause.

Actual cause (causation in fact) can be found if the connection between the defendant's act and the plaintiff's injuries passes the "but for" test: if an injury would not have occurred "but for" the defendant's conduct, then the defendant is the cause of the injury. Still, this is not enough causation to create liability. The injuries to the plaintiff must also be foreseeable, or not "too remote," for the defendant's act to create liability. This is proximate cause: a cause that is not too remote or unforeseeable.

Suppose that the person who was injured was not one whom a reasonable person could have expected to be harmed. Such a situation was presented in one of the most famous US tort cases, *Palsgraf v. Long Island Railroad*, 248 N.Y. 339, 162 N.E. 99 (1928), which was decided by Judge Benjamin Cardozo. Although Judge Cardozo persuaded four of his seven brethren to side with his position, the closeness of the case demonstrates the difficulty that unforeseeable consequences and unforeseeable plaintiffs present.

In *Palsgraf*, the plaintiff was standing on a platform of defendant's railroad after buying a ticket to go to Rockaway Beach. A train stopped at the station, bound for another place. Two men ran forward to catch it. One of the men reached the platform of the car without mishap, though the train was already moving. The other man, carrying a package, jumped aboard the car, but seemed unsteady as if about to fall. A guard on the car, who had held the door open, reached forward to help him in, and another guard on the platform pushed him from behind. In this act, the package the man was carrying was dislodged, and fell upon the rails. It was a package of small size, about fifteen inches long, and was covered by a newspaper. In fact it contained fireworks, but there was nothing in its appearance to give notice of its contents. The fireworks exploded when they fell. The shock of the explosion threw down some scales at the other end of the platform, many feet away. The scales struck the plaintiff, causing injuries. *Palsgraf v. Long Island Railroad*, 248 N.Y. 339, 340-41, 162 N.E. 99 (1928).

In finding for the defendant in *Palsgraf*, the Court held that it was not foreseeable that the package would have exploded as nothing indicated its contents where explosive, nor was it foreseeable that the explosion would have caused scales on the far end of the platform to fall over injuring Mrs. Palsgraf.

Damages

For a plaintiff to win a tort case, she must allege and prove that she was injured. The fear that she might be injured in the future is not a sufficient basis for a suit. This rule has proved troublesome in medical malpractice and industrial disease cases. A doctor's negligent act or a company's negligent exposure of a worker to some form of contamination might not become manifest in the body for years. In the meantime, the tort statute of limitations might have run out, barring the victim from suing at all. An increasing number of courts have eased the plaintiff's predicament by ruling that the statute of limitations does not begin to run until the victim discovers that she has been injured or contracted a disease.

The law allows an exception to the general rule that damages must be shown when the plaintiff stands in danger of immediate injury from a hazardous activity. If you discover your neighbor experimenting with explosives in his basement, you could bring suit to enjoin him from further experimentation, even though he has not yet blown up his house—and yours.
Damage awards in tort cases require proof of actual loss. As such, damages are limited to compensatory damages in 99.9% of all negligence cases. As we discussed in the general section on Torts, there are three main types of damages for torts: compensatory, punitive and nominal. Punitive damages rarely apply in negligence cases as the conduct has to be egregious and that usually falls beyond the bounds of negligence- unless you are arguing a gross negligence standard. And nominal damages are awarded where the plaintiff has been wronged but incurred no out of pocket losses – again, not typically seen in negligence as damages are an element of the cause of action.

As noted previously, compensatory damages are divided into general and special damages depending on the type of injury incurred. General damages typically cover pain and suffering – damages general to all similarly situated plaintiffs. Special damages are unique to the plaintiff and include lost wages, medical bills, property damages, etc.

Gross Negligence/Recklessnesss

Between intentional conduct and mere negligence is a middle level of gross negligence, often referred to as recklessness. This is conduct that is not intentional but is more than merely unreasonable. It is conduct that results in a willful disregard for the safety of others. The defendant does not intend for anyone to be injured as a result of his actions, but it is highly likely that someone will. Some examples of gross negligence include:

- a driver speeding through a parking lot where pedestrians are walking;

- a doctor amputating the wrong limb;
- a person shooting a gun in the air in a crowd of people;
- a person throwing a lit pack of fireworks into a crowd.

Problems of Proof

The plaintiff in a tort suit, as in any other, has the burden of proving his allegations by a preponderance of the evidence standard.

He must show that the defendant took the actions complained of as negligent, demonstrate the circumstances that make the actions negligent, and prove the occurrence and extent of injury. Factual issues are for the jury to resolve. Since it is frequently difficult to make out the requisite proof, the law allows certain presumptions and rules of evidence that ease the plaintiff's task, on the ground that without them substantial injustice would be done.

One important rule goes by the Latin phrase res ipsa loquitur, meaning "the thing speaks for itself." The best evidence is always the most direct evidence: an eyewitness account of the acts in question. But eyewitnesses are often unavailable, and in any event they frequently cannot testify directly to the reasonableness of someone's conduct, which inevitably can only be inferred from the circumstances.

In many cases, therefore, circumstantial evidence (evidence that is indirect) will be the only evidence or will constitute the bulk of the evidence. Circumstantial evidence can often be quite telling: though no one saw anyone leave the building, muddy footprints tracing a path along the sidewalk are fairly conclusive. Res ipsa loquitur is a rule of circumstantial evidence that permits the jury to draw an inference of negligence. A common statement of the rule is the following: "There must be reasonable evidence of negligence but where the thing is shown to be under the management of the defendant or his servants, and the accident is such as in the ordinary course of things does not happen if those who have the management use proper care, it affords reasonable evidence, in the absence of explanation by the defendants, that the accident arose from want of care."*Scott v. London & St. Katherine Docks Co.*, 3 H. & C. 596, 159 Eng. Rep. 665 (Q.B. 1865).

If a barrel of flour rolls out of a factory window and hits someone, or a soda bottle explodes, or an airplane crashes, courts in every state permit juries to conclude, in the absence of contrary explanations by the defendants, that there was negligence. The plaintiff is not put to the impossible task of explaining precisely how the accident occurred. A defendant can always offer evidence that he acted reasonably—for example, that the flour barrel was securely fastened and that a bolt of lightning, for which he was not responsible, broke its bands, causing it to roll out the window. But testimony by the factory employees that they secured the barrel, in the absence of any further explanation, will not usually serve to rebut the inference. That the defendant was negligent does not conclude the inquiry or automatically entitle the plaintiff to a judgment. Tort law provides the defendant with several excuses, some of which are discussed briefly in the next section.

Defenses

There are more defenses (excuses) than are listed here, but contributory negligence or comparative negligence, assumption of risk and Act of God are among the principal defenses that will completely or partially excuse the negligence of the defendant.

Contributory and Comparative Negligence

Under an old common-law rule, contributory negligence was a complete defense to show that the plaintiff in a negligence suit was himself negligent, if only partially. Therein, even if the plaintiff was only mildly negligent, most of the fault being chargeable to the defendant, the court would dismiss the suit if the plaintiff's conduct contributed to his injury in a contributory negligence state. In a few states today, including Maryland, this rule of contributory negligence is still in effect.

Although referred to as negligence, the contributory negligence rule encompasses a narrower form than that with which the defendant is charged, because the plaintiff's only error in such cases is in being less careful of himself than he might have been, whereas the defendant is charged with conduct careless toward others. This rule was so manifestly unjust in many cases that most states, either by statute or judicial decision, have changed to some version of comparative negligence.

Under the rule of comparative negligence, damages are apportioned according to the defendant's degree of culpability. Some states follow a "pure" form of comparative negligence and some follow a modified comparative negligence form. In a pure comparative negligence state, even if plaintiff was 80% negligent in causing his injury, plaintiff can sue defendant for his 20% of the fault.

In modified comparative negligence, plaintiff's negligence must be less than the defendant's negligence. Under comparative negligence, plaintiff's negligence must be less than 50% in order to recover. For example, if the plaintiff has sustained a $100,000 injury and is 20 percent responsible, the defendant will be liable for $80,000 in damages.

Assumption of Risk

Risk of injury pervades the modern world, and plaintiffs should not win a lawsuit simply because they took a risk and lost. The law provides, therefore, that when a person knowingly takes a risk, he or she must suffer the consequences.

The assumption of risk doctrine comes up in three ways. The plaintiff may have formally agreed with the defendant before entering a risky situation that he will relieve the defendant of liability should injury occur. ("You can borrow my car if you agree not to sue me if the brakes fail, because they're worn and I haven't had a chance to replace them.") Or the plaintiff may have entered into a relationship with the defendant knowing that the defendant is not in a position to protect him from known risks (the fan who is hit by a line drive in a ballpark). Or the plaintiff may act in the face of a risky situation known in advance to have been created by the defendant's negligence (failure to leave, while there was an opportunity to do so, such as getting into an automobile when the driver is known to be drunk).

The difficulty in many cases is to determine the dividing line between subjectivity and objectivity. If the plaintiff had no actual knowledge of the risk, he cannot be held to have assumed it. On the other hand, it is easy to claim that you did not appreciate the danger, and the courts will apply an objective standard of community knowledge (a "but you should have known" test) in many situations. When the plaintiff has no real alternative, however, assumption of risk fails as a defense (e.g., a landlord who negligently fails to light the exit to the street cannot claim that his tenants assumed the risk of using it).

At the turn of the century, courts applied assumption of risk in industrial cases to bar relief to workers injured on the job. They were said to assume the risk of dangerous conditions or equipment. This rule has been abolished by workers' compensation statutes in most states.

Act of God

Technically, the rule that no one is responsible for an "act of God," or *force majeure* as it is sometimes called, is not an excuse but a defense premised on a lack of causation. If a force of nature caused the harm, then the defendant was not negligent in the first place. A marina, obligated to look after boats moored at its dock, is not liable if a sudden and fierce storm against which no precaution was possible destroys someone's vessel.

However, if it is foreseeable that harm will flow from a negligent condition triggered by a natural event, then there is liability. For example, a work crew failed to remove residue explosive gas from an oil barge. Lightning hit the barge, exploded the gas, and injured several workmen. The plaintiff recovered damages against the company because the negligence consisted in the failure to guard against any one of a number of chance occurrences that could ignite the gas.

Vicarious Liability

Liability for negligent acts does not always end with the one who was negligent. Under certain circumstances, the liability is imputed to others. For example, an employer is responsible for the negligence of his employees if they were acting in the scope of employment. This rule of vicarious liability is often called *respondeat superior*, meaning that the higher authority must respond to claims brought against one of its agents. Respondeat superior is not limited to the employment relationship but extends to a number of other agency relationships as well.

Legislatures in many states have enacted laws that make people vicariously liable for acts of certain people with whom they have a relationship, though not necessarily one of agency. It is common, for example, for the owner of an automobile to be liable for the negligence of one to whom the owner lends the car. So- called dram shop statutes place liability on bar and tavern owners and others who serve too much alcohol to one who, in an intoxicated state, later causes injury to others. In these situations, although the injurious act of the drinker stemmed from negligence, the one whom the law holds vicariously liable (the bartender) is not himself necessarily negligent—the law is holding him *strictly liable.*

Strict Liability

Historical Basis of Strict Liability: Animals and Ultrahazardous Activities
To this point, we have considered principles of liability that in some sense depend upon the "fault" of the tortfeasor.

Aside from acts intended to harm, the fault lies in a failure to live up to a standard of reasonableness or due care. But this is not the only basis for tort liability. Innocent mistakes can be a sufficient basis. As we have already seen, someone who unknowingly trespasses on another's property is liable for the damage that he does, even if he has a reasonable belief that the land is his. And it has long been held that someone who engages in ultrahazardous (or sometimes, abnormally dangerous) activities is liable for damage that he causes, even though he has taken every possible precaution to avoid harm to someone else.

Likewise, the owner of animals that escape from their pastures or homes and damage neighboring property may be liable, even if the reason for their escape was beyond the power of the owner to stop (e.g., a fire started by lightning that burns open a barn door). In such cases, the courts invoke the principle of strict liability, or, as it is sometimes called, liability without fault. The reason for the rule is explained in *Klein v. Pyrodyne Corporation*, 810 P.2d 917 (Wash. 1991).

In *Klein*, the Washington Supreme Court held Pyrodyne Corp. liable when fireworks misfired during a 4th of July fireworks celebration. The court found the activity to the abnormally dangerous and satisfied four of the six factors for determining strict liability of abnormally dangerous activities:

- Existence of a high degree of risk of some harm to the person, land or chattels of others.
- Likelihood that the harm that results from it will be great.
- Inability to eliminate the risk by the exercise of reasonable care.
- Extent to which the activity is not a matter of common usage.
- Inappropriateness of the activity to the place where it is carried on.
- Extent to which its value to the community is outweighed by its dangerous attributes

Strict Liability for Products

Because of the importance of products liability, we will cover Products Liability in detail in a later section. However, strict liability may also apply as a legal standard for products, even those that are not ultrahazardous. In some national legal systems, strict liability is not available as a cause of action to plaintiffs seeking to recover a judgment of products liability against a manufacturer, wholesaler, distributor, or retailer. (Some states limit liability to the manufacturer.) But it is available in the United States and initially was created by a California Supreme Court decision in the case of *Greenman v. Yuba Power Products, Inc.*, 377 P.2d 897 (Cal. 1963).

In *Greenman*, the plaintiff used a home power saw and bench, the Shopsmith, designed and manufactured by the defendant. The plaintiff was experienced in using power tools and was injured while using the approved lathe attachment to the Shopsmith to fashion a wooden chalice. The case was decided on the premise that Greenman had done nothing wrong in using the machine but that the machine had a defect that was "latent" (not easily discoverable by the consumer). Rather than decide the case based on warranties, or requiring that Greenman prove how the defendant had been negligent, the court found for the plaintiff based on the overall social utility of strict liability in cases of defective products. According to the decision, the purpose of such liability is to ensure that the "cost of injuries resulting from defective products is borne by the manufacturers…rather than by the injured persons who are powerless to protect themselves."

Today, the majority of US states recognize strict liability for defective products, although some states limit strict liability actions to damages for personal injuries rather than property damage. Injured plaintiffs have to prove the product caused the harm but do not have to prove exactly how the manufacturer was careless. Purchasers of the product, as well as injured guests, bystanders, and others with no direct relationship with the product, may also sue for damages caused by the product.

The Restatement of the Law of Torts, Section 402(a), was originally issued in 1964. It is a widely accepted statement of the liabilities of sellers of goods for defective products. The Restatement specifies six requirements, all of which must be met for a plaintiff to recover using strict liability for a product that the plaintiff claims is defective:

- The product must be in a defective condition when the defendant sells it.
- The defendant must normally be engaged in the business of selling or otherwise distributing the product.
- The product must be unreasonably dangerous to the user or consumer because of its defective condition.
- The plaintiff must incur physical harm to self or to property by using or consuming the product.
- The defective condition must be the proximate cause of the injury or damage.
- The product must not have been substantially changed from the time the product was sold to the time the injury was sustained.

Section 402(a) also explicitly makes clear that a defendant can be held liable even though the defendant exercised "all possible care." Thus in a strict liability case, the plaintiff does not need to show "fault" (or negligence).

Defenses

For defendants, who can include manufacturers, distributors, processors, assemblers, packagers, bottlers, retailers, and wholesalers, there are a number of defenses that are available, including assumption of risk, product misuse and comparative or contributory negligence, commonly known dangers, and the knowledgeable-user defense. We have already seen assumption of risk and comparative/contributory negligence in terms of negligence actions; the application of these is similar in products-liability actions.

Under product misuse, a plaintiff who uses a product in an unexpected and unusual way will not recover for injuries caused by such misuse. For example, suppose that someone uses a rotary lawn mower to trim a hedge and that after twenty minutes of such use loses control because of its weight and suffers serious cuts to his abdomen after dropping it. Here, there would be a defense of product misuse, as well as comparative or contributory negligence. However, product misuse will fail as a defense where the misuse was foreseeable by the defendant. A misuse is foreseeable where the a product is used in an unintended way – but a way that could be predicted by general human behavior. http://www.iadclexicon.org/reasonably-foreseeable-misuse/

Consider the urban (or Internet) legend of Mervin Gratz, who supposedly put his Winnebago on autopilot to go back and make coffee in the kitchen, then recovered millions after his Winnebago turned over and he suffered serious injuries. There are multiple defenses to this alleged action; these would include the defenses of contributory negligence, comparative negligence, and product misuse. (There was never any such case, and certainly no such recovery; it is not known who started this legend, or why.)

Another defense against strict liability as a cause of action is the knowledgeable user defense. If the parents of obese teenagers bring a lawsuit against McDonald's, claiming that its fast-food products are defective and that McDonald's should have warned customers of the adverse health effects of eating its products, a defense based on the knowledgeable user is available. In one case, the court found that the high levels of cholesterol, fat, salt, and sugar in McDonald's food is well known to users. The court stated, "If consumers know (or reasonably should know) the potential ill health effects of eating at McDonald's, they cannot blame McDonald's if they, nonetheless, choose to satiate their appetite with a surfeit of supersized McDonald's products." *Pelman v. McDonald's Corp.*, 237 F.2d 512 (S.D.N.Y. 2003).

Criminal Law

At times, unethical behavior by businesspeople can be extreme enough that society will respond by criminalizing certain kinds of activities. Ponzi schemes, arson, various kinds of fraud, embezzlement, racketeering, foreign corrupt practices, tax evasion, and insider trading are just a few. A corporation can face large fines, and corporate managers can face both fines and jail sentences for violating criminal laws. This section aims to explain how criminal law differs from civil law, to discuss various types of crimes, and to relate the basic principles of criminal procedure.

Criminal law is the most ancient branch of the law. Many wise observers have tried to define and explain it, but the explanations often include many complex and subtle distinctions. A traditional criminal law course would include a lot of discussions on criminal intent, the nature of criminal versus civil responsibility, and the constitutional rights accorded the accused. But in this chapter, we will consider only the most basic aspects of intent, responsibility, and constitutional rights.

Unlike civil actions, where plaintiffs seek compensation or other remedies for themselves, crimes involve "the state" (the federal government, a state government, or some subunit of state government). This is because crimes involve some "harm to society" and not just harm to certain individuals. But "harm to society" is not always evident in the act itself. For example, two friends of yours at a party argue, take the argument outside, and blows are struck; one has a bloody nose and immediately goes home. The crimes of assault and battery have been committed, even though no one else knows about the fight and the friends later make up. By contrast, suppose a major corporation publicly announces that it is closing operations in your community and moving operations to Southeast Asia. There is plenty of harm to society as the plant closes down and no new jobs take the place of the company's jobs. Although the effects on society are greater in the second example, only the first example is a crime.

Crimes are generally defined by legislatures, in statutes; the statutes describe in general terms the nature of the conduct they wish to criminalize. For government punishment to be fair, citizens must have clear notice of what is criminally prohibited. Ex post facto laws—laws created "after the fact" to punish an act that was legal at the time—are expressly prohibited by the US Constitution. Overly vague statutes can also be struck down by courts under a constitutional doctrine known as "void for vagueness."

What is considered a crime will also vary from society to society and from time to time. For example, while cocaine use was legal in the United States at one time, it is now a controlled substance, and unauthorized use is now a crime. Medical marijuana was not legal fifty years ago when its use began to become widespread, and in some states its use or possession was a felony. Now, some states make it legal to use or possess it under some circumstances. In the United States, you can criticize and make jokes about the president of the United States without committing a crime, but in many countries it is a serious criminal act to criticize a public official. Attitudes about appropriate punishment for crimes will also vary considerably from nation to nation. Uganda decreed long prison sentences for homosexuals and death to repeat offenders. In Saudi Arabia, the government proposed to deliberately paralyze a criminal defendant who criminally assaulted someone and unintentionally caused the victim's paralysis. Limits on punishment are set in the United States through the Constitution's prohibition on "cruel or unusual punishments" under the 8th Amendment to the Constitution.

It is often said that ignorance of the law is no excuse. But there are far too many criminal laws for anyone to know them all. Also, because most people do not actually read statutes, the question of "criminal intent" comes up right away: if you don't know that the legislature has made driving without a seat belt fastened a misdemeanor, you cannot have intended to harm society. You might even argue that there is no harm to anyone but yourself!

The usual answer to this is that the phrase "ignorance of the law is no excuse" means that society (through its elected representatives) gets to decide what is harmful to society, not you. Still, you may ask, "Isn't it my choice whether to take the risk of failing to wear a seat belt? Isn't this a victimless crime? Where is the harm to society?" A policymaker or social scientist may answer that your injuries, statistically, are generally going to be far greater if you don't wear one and that your choice may actually impose costs on society. For example, you might not have enough insurance, so that a public hospital will have to take care of your head injuries, injuries that would likely have been avoided by your use of a seat belt.

But, as just noted, it is hard to know the meaning of some criminal laws. Teenagers hanging around the sidewalks on Main Street were sometimes arrested for "loitering." The constitutional void-for-vagueness doctrine has led the courts to overturn statutes that are not clear. For example, "vagrancy" was long held to be a crime, but US courts began some forty years ago to overturn vagrancy and "suspicious person" statutes on the grounds that they are too vague for people to know what they are being asked not to do.

This requirement that criminal statutes not be vague does not mean that the law always defines crimes in ways that can be easily and clearly understood. Many statutes use terminology developed by the common-law courts. For example, a California statute defines murder as "the unlawful killing of a human being, with malice aforethought." If no history backed up these words, they would be unconstitutionally vague. But there is a rich history of judicial decisions that provides meaning for much of the arcane language like "malice aforethought" strewn about in the statute books.

Because a crime is an act that the legislature has defined as socially harmful, the parties involved cannot agree among themselves to forget a particular incident, such as a barroom brawl, if the authorities decide to prosecute. This is one of the critical distinctions between criminal and civil law. An assault is both a crime and a tort. The person who was assaulted may choose to forgive his assailant and not to sue him for damages. But he cannot stop the prosecutor from bringing an indictment against the assailant. (However, because of crowded dockets, a victim that declines to press charges may cause a busy prosecutor to choose to not to bring an indictment.)

A crime consists of an act defined as criminal—an actus reus—and the requisite "criminal intent." Someone who has a burning desire to kill a rival in business or romance and who may actually intend to murder but does not act on his desire has not committed a crime. He may have a "guilty mind"—the translation of the Latin phrase mens rea—but he is guilty of no crime. A person who is forced to commit a crime at gunpoint is not guilty of a crime, because although there was an act defined as criminal—an actus reus—there was no criminal intent.

Types of Crimes

Most classifications of crime turn on the seriousness of the act. In general, **seriousness** is defined by the nature or duration of the punishment set out in the statute. A **felony** is a crime punishable (usually) by imprisonment of more than one year or by death. (Crimes punishable by death are sometimes known as **capital crimes**; they are increasingly rare in the United States.) The major felonies include murder, rape, kidnapping, armed robbery, embezzlement, insider trading, fraud, and racketeering. All other crimes are usually known as misdemeanors, petty offenses, or infractions. Another way of viewing crimes is by the type of social harm the statute is intended to prevent or deter, such as offenses against the person, offenses against property, and white-collar crime.

Table 7 Major Crimes

Major Crimes Against Persons	Major Crimes Against Property	Crimes Against Public Order
• Homicide (Murder and Manslaughter) • Robbery • Assault & Battery (Criminal Assault) • Rape (Sexual Assault)	• Theft (Larceny) • Receiving Stolen Property • Burglary • Arson • Forgery • Mail & Wire Fraud • Theft of Trade Secrets • Insider Trading • Fraud • Foreign Corrupt Practices Act (FCPA) • Racketeering Influenced and Corrupt Organizations Act (RICO) • Money Laundering • Cyber Crime	• Bribery & Blackmail • Perjury • Attempt & Conspiracy • Food & Drug Act Violations

Major Offenses against the Person

There are many crimes that are considered offenses against the person. For the purposes of this course, we are only going to consider homicide, robbery and assault/battery.

Homicide

Homicide is the killing of one person by another. Not every killing is criminal. When the law permits one person to kill another—for example, a soldier killing an enemy on the battlefield during war, or a killing in self-defense—the death is considered the result of justifiable homicide.

All other homicides are criminal. The most severely punished form is **murder**, defined as homicide committed with "malice aforethought." This is a term with a very long history. Boiled down to its essentials, it means that the defendant had the intent to kill. A killing need not be premeditated for any long period of time; the premeditation might be quite sudden, as in a bar fight that escalates in that moment when one of the fighters reaches for a knife with the intent to kill.

Sometimes a homicide can be murder even if there is no intent to kill; an intent to inflict great bodily harm can be murder if the result is the death of another person. A killing that takes place while a felony (such as armed robbery) is being committed is also murder, whether or not the killer intended any harm. This is the so-called felony murder rule. Examples are the accidental discharge of a gun that kills an innocent bystander or the asphyxiation death of a fireman from smoke resulting from a fire set by an arsonist. The felony murder rule is more significant than it sounds, because it also applies to the accomplices of one who does the killing. Thus the driver of a getaway car stationed a block away from the scene of the robbery can be convicted of murder if a gun accidentally fires during the robbery and someone is killed.

Manslaughter is an act of killing that does not amount to murder. **Voluntary manslaughter** is an intentional killing, but one carried out in the "sudden heat of passion" as the result of some provocation. An example is a fight that gets out of hand. **Involuntary manslaughter** entails a lesser degree of willfulness; it usually occurs when someone has taken a reckless action that results in death (e.g., a death resulting from a traffic accident in which one driver recklessly runs a red light).

Robbery

Robbery is the taking of personal property or obtaining services from another by force or threat of force. It is considered a crime against a person because the perpetrator's actions are directed at an individual. So when a person comes home and find their house has been broken into and the TV stolen, it is incorrect to state that they have been robbed. You cannot rob a house, you can only rob a person. Your house has been burgled-which will be discussed later. In committing a robbery, the perpetrator's intent must be to permanently deprive the individual of their property.

Assault and Battery

Ordinarily, we would say that a person who has struck another has "assaulted" him. Technically, that is a **battery**—the unlawful application of force to another person. The force need not be violent. Indeed, a man who kisses a woman is guilty of a battery if he does it against her will. The other person may consent to the force. That is one reason why surgeons require patients to sign consent forms, giving the doctor permission to operate. In the absence of such a consent, an operation is a battery. That is also why football players are not constantly being charged with battery. Those who agree to play football agree to submit to the rules of the game, which of course include the right to tackle. But the consent does not apply to all acts of physical force: a hockey player who hits an opponent over the head with his stick can be prosecuted for the crime of battery.

Criminal assault is an *attempt* to commit a battery or the deliberate placing of another in fear of receiving an immediate battery. If you throw a rock at a friend, but he manages to dodge it, you have committed an assault. Some states limit an assault to an attempt to commit a battery by one who has a "present ability" to do so. Pointing an unloaded gun and threatening to shoot would not be an assault, nor, of course, could it be a battery. The modem tendency, however, is to define an assault as an attempt to commit a battery by one with an *apparent* ability to do so.

Assault and battery may be excused. For example, a bar owner (or her agent, the bouncer) may use reasonable force to remove an unruly patron. If the use of force is excessive, the bouncer can be found guilty of assault and battery, and a civil action could arise against the bar owner as well.

Rape & Sexual Assault

Under the common law, **Rape** was defined as the sexual penetration of a person without consent and with the threat of violence. By modern statute, this type of conduct is generally described as a "rape in the first degree." Md. Crim. Law Code Ann. §. 3-303. However, many states recognize many other types of sexual crimes, including prohibitions against adults engaging in any form of sexual contact, even consensual contact, with a minor. Md. Crim. Law Code Ann. § 3-307(a)(3)-(5) (engaging in sexual act with a minor under 14 and the perpetrator is at least four years older, or a perpetrator over age 21 engaging in a sexual act with a 14 or 15 year old).

Theft and Related Property Offenses

Theft: Larceny, Embezzlement, False Pretenses

The concept of theft is familiar enough. Less familiar is the way the law has treated various aspects of the act of stealing. Criminal law distinguishes among many different crimes that are popularly known as theft. Many technical words have entered the language—burglary, larceny, embezzlement—but are often used inaccurately. Brief definitions of the more common terms are discussed here.

The basic crime of stealing personal property is **larceny**. By its old common-law definition, still in use today, larceny is the wrongful "taking and carrying away of the personal property of another with intent to steal the same." Today, most statutes define **theft** more broadly as any property, including real estate, personal property (whether tangible or intangible), and services. And most modern statutes have done away with the requirement of taking and carrying away and simply make it a crime to exert unauthorized control over property.

Larceny involves the taking of property from the possession of another. Suppose that a person legitimately comes to possess the property of another and wrongfully appropriates it—for example, an automobile mechanic entrusted with your car refuses to return it, or a bank teller who is entitled to temporary possession of cash in his drawer takes it home with him. The common law had trouble with such cases because the thief in these cases already had possession; his crime was in assuming ownership. Today, such wrongful conversion, known as **embezzlement**, has been made a statutory offense in all states. Maryland treats any unauthorized control as theft and limits embezzlement to the fraudulent and willful appropriation of money or anything of value by a fiduciary. Md. Code Ann., Crim. Law Sec. 7-113. 2017.

Statutes against larceny and embezzlement did not cover all the gaps in the law. A conceptual problem arises in the case of one who is tricked into giving up his title to property. In larceny and embezzlement, the thief gains possession or ownership without any consent of the owner or custodian of the property. Suppose, however, that an automobile dealer agrees to take his customer's present car as a trade-in. The customer says that he has full title to the car. In fact, the customer is still paying off an installment loan and the finance company has an interest in the old car. If the finance company repossesses the car, the customer—who got a new car at a discount because of his false representation—cannot be said to have taken the new car by larceny or embezzlement. Nevertheless, he tricked the dealer into selling, and the dealer will have lost the value of the repossessed car. Obviously, the customer is guilty of a criminal act; the statutes outlawing it refer to this trickery as the crime of false pretenses, defined as obtaining ownership of the property of another by making untrue representations of fact with intent to defraud.

A number of problems have arisen in the judicial interpretation of false-pretense statutes. One concerns whether the taking is permanent or only temporary. The case of *State v. Mills,* 396 P.2d 5 (Ariz. 1964) shows the subtle questions that can be presented and the dangers inherent in committing "a little fraud." In the *Mills* case, the claim was that a mortgage instrument dealing with one parcel of land was used instead for another. This is a false representation of fact. Suppose, by contrast, that a person misrepresents his state of mind: "I will pay you back tomorrow," he says, knowing full well that he does not intend to. Can such a misrepresentation amount to false pretenses punishable as a criminal offense? In most jurisdictions it cannot. A false-pretense violation relates to a past event or existing fact, not to a statement of intention. If it were otherwise, anyone failing to pay a debt might find himself facing criminal prosecution, and business would be less prone to take risks.

Receiving Stolen Property

One who engages in receiving stolen property with knowledge that it is stolen is guilty of a felony or misdemeanor, depending on the value of the property. The receipt need not be personal; if the property is delivered to a place under the control of the receiver, then he is deemed to have received it. "Knowledge" is construed broadly: not merely actual knowledge, but (correct) belief and suspicion (strong enough not to investigate for fear that the property will turn out to have been stolen) are sufficient for conviction.

Forgery

Forgery is false writing of a document of legal significance (or apparent legal significance!) with intent to defraud. It includes the making up of a false document or the alteration of an existing one. The writing need not be done by hand but can be by any means—typing, printing, and so forth. Documents commonly the subject of forgery are negotiable instruments (checks, money orders, and the like), deeds, receipts, contracts, and bills of lading. The forged instrument must itself be false, not merely contain a falsehood. If you fake your neighbor's signature on one of his checks made out to cash, you have committed forgery. But if you sign a check of your own that is made out to cash, knowing that there is no money in your checking account, the instrument is not forged, though the act may be criminal if done with the intent to defraud.

The mere making of a forged instrument is unlawful. So is the "uttering" (or presentation) of such an instrument, whether or not the one uttering it actually forged it. The usual example of a false signature is by no means the only way to commit forgery. If done with intent to defraud, the backdating of a document, the modification of a corporate name, or the filling in of lines left blank on a form can all constitute forgery.

Extortion

Under common law, **extortion could** only be committed by a government official, who corruptly collected an unlawful fee under color of office. A common example is a salaried building inspector who refuses to issue a permit unless the permittee pays him. Under modern statutes, the crime of extortion has been broadened to include the wrongful collection of money or something else of value by anyone by means of a threat (short of a threat of immediate physical violence, for such a threat would make the demand an act of robbery). This kind of extortion is usually called **blackmail**. The blackmail threat commonly is to expose some fact of the victim's private life or to make a false accusation about him.

Offenses against Property and Other Public Order Offenses

Burglary

Depending on the jurisdiction **burglary** can be defined as a property crime or a crime against habitation. Under common law it was limited to "the breaking and entering of the dwelling of another in the nighttime with intent to commit a felony." Today, jurisdictions have removed the nighttime requirement and consider it burglary when someone breaks and enters into the dwelling of another with the intent to commit theft or a crime of violence. Md. Code Ann., Crim. Law. Sec. 6-202. (2017).

The intent to steal is not an issue: a man who sneaks into a woman's home intent on raping her has committed a burglary, even if he does not carry out the act. The student doing critical thinking will no doubt notice that the definition provides plenty of room for argument. What is "breaking"? (The courts do not require actual destruction; the mere opening of a closed door, even if unlocked, is enough.) What is entry? Courts usually allow for any crossing of the threshold of a dwelling to suffice. What kind of intent? Whose dwelling? Can a landlord burglarize the dwelling of his tenant? (Yes.) Can a person burglarize his own home? (No.)

Arson

Under common law, arson was the malicious burning of the dwelling of another. Burning one's own house for purposes of collecting insurance was not an act of arson under common law. The statutes today make it a felony intentionally to set fire to any building, whether or not it is a dwelling and whether or not the purpose is to collect insurance. So, today the intentional burning of one's own residence can be prosecuted as arson.

Bribery

Bribery is a corrupt payment (or receipt of such a payment) for official action. The payment can be in cash or in the form of any goods, intangibles, or services that the recipient would find valuable. Under common law, only a public official could be bribed. In most states, bribery charges can result from the bribe of anyone performing a public function.

Bribing a public official in government procurement (contracting) can result in serious criminal charges. Bribing a public official in a foreign country to win a contract can result in charges under the Foreign Corrupt Practices Act.

Perjury

Perjury is the crime of giving a false oath, either orally or in writing, in a judicial or other official proceeding (lies made in proceedings other than courts are sometimes termed "false swearing"). To be perjurious, the oath must have been made corruptly—that is, with knowledge that it was false or without sincere belief that it was true. An innocent mistake is not perjury. A statement, though true, is perjury if the maker of it believes it to be false. Statements such as "I don't remember" or "to the best of my knowledge" are not sufficient to protect a person who is lying from conviction for perjury. To support a charge of perjury, however, the false statement must be **"material,"** meaning that the statement is relevant to whatever the court is trying to find out.

White-Collar Crime

White-collar crime, as distinguished from "street crime," refers generally to fraud-related acts carried out in a nonviolent way, usually connected with business. Armed bank robbery is not a white-collar crime, but embezzlement by a teller or bank officer is. Many white-collar crimes are included within the statutory definitions of embezzlement and false pretenses. Most are violations of state law. Depending on how they are carried out, many of these same crimes are also violations of federal law.

Any act of fraud in which the United States postal system is used or which involves interstate phone calls or Internet connections is a violation of federal law. Likewise, many different acts around the buying and selling of securities can run afoul of federal securities laws. Other white-collar crimes include tax fraud; price fixing; violations of food, drug, and environmental laws; corporate bribery of foreign companies; and—the newest form—computer fraud.

Mail and Wire Fraud

Federal law prohibits the use of the mails or any interstate electronic communications medium for the purpose of furthering a "scheme or artifice to defraud." The statute is broad, and it is relatively easy for prosecutors to prove a violation. The law also bans attempts to defraud, so the prosecutor need not show that the scheme worked or that anyone suffered any losses.

"Fraud" is broadly construed: anyone who uses the mails or telephone to defraud anyone else of virtually anything, not just of money, can be convicted under the law. In one case, a state governor was convicted of mail fraud when he took bribes to influence the setting of racing dates. The court's theory was that he defrauded the citizenry of its right to his "honest and faithful services" as governor. *United States v. Isaacs*, 493 F.2d 1124 (7th Cir. 1974), cert. denied, 417 US 976 (1974) (though the *McNally* court subsequently limited the mail fraud statute to property rights, rather than the "intangible right of the citizen to good government" *McNally v. U.S.*, 483 U.S. 350 (1987)).

Violations of the Food and Drug Act

The federal Food, Drug, and Cosmetic Act prohibits any person or corporation from sending into interstate commerce any adulterated or misbranded food, drug, cosmetics, or related device. For example, in a 2010 case, drug manufacturer, Allergen paid a criminal fine for marketing Botox as a headache or pain reliever, a use that had not been approved by the Food and Drug Administration.

Unlike most criminal statutes, willfulness or deliberate misconduct is not an element of the act. As in the case *United States v. Park*, 412 U.S. 658 (1978), an executive can be held criminally liable even though he may have had no personal knowledge of the violation.

Theft of Trade Secrets

The assets of any business include not only its product, inventory, equipment, etc. but also its customer lists, business practices, creative or artistic works, inventions, and others. These intangible items are commonly referred to as **trade secrets** of a business. For example, for decades the recipe for Kentucky Fried Chicken was a closely guarded trade secret of 12 secret herbs and spices. Bush's Baked Beans has commercials regarding its secret recipe. These are trade secrets that a company protects just as much as its protects its tangible assets from potential theft.

The owner of a trade secret is entitled to its exclusive use and enjoyment. A trade secret is valuable not only because it enables a company to gain advantage over a competitor but also because it may be sold or licensed like any other property right. In contrast, commercial information that is revealed to the public, or at least to a competitor, retains limited commercial value. Consequently, courts vigilantly protect trade secrets from disclosure, appropriation, and theft. Businesses or opportunistic members of the general public may be held liable for any economic injuries that result from their theft of a trade secret. Employees may be held liable for disclosing their employer's trade secrets, even if the disclosure occurs after the employment relationship has ended.

"Unfair Competition." Legal Dictionary, *The Free Dictionary*, 17 July 2017, legal-dictionary.thefreedictionary.com/unfair+competition

Insider Trading

"Insider trading" is a term that most investors have heard and usually associate with illegal conduct. But the term actually includes both legal and illegal conduct. The legal version is when corporate insiders—officers, directors, and employees—buy and sell stock in their own companies. When corporate insiders trade in their own securities, they must report their trades to the Securities and Exchange Commission (SEC).

Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information.

Examples of insider trading cases that have been brought by the SEC are cases against:

- Corporate officers, directors, and employees who traded the corporation's securities after learning of significant, confidential corporate developments;
- Friends, business associates, family members, and other "tippees" of such officers, directors, and employees, who traded the securities after receiving such information;
- Employees of law, banking, brokerage and printing firms who were given such information to provide services to the corporation whose securities they traded;
- Government employees who learned of such information because of their employment by the government; and
- Other persons who misappropriated, and took advantage of, confidential information from their employers.

Because insider trading undermines investor confidence in the fairness and integrity of the securities markets, the SEC has treated the detection and prosecution of insider trading violations as one of its enforcement priorities."

"Insider Trading." *Fast Answers*, Securities and Exchange Commission, 17 July 2017, www.sec.gov/fast-answers/answersinsiderhtm.html/.

Bankruptcy Fraud

Bankruptcy fraud is a white-collar crime that commonly takes four general forms:

- A debtor conceals assets to avoid having to forfeit them.
- An individual intentionally files false or incomplete forms. Including false information on a bankruptcy form may also constitute perjury.
- An individuals files multiple times using either false information or real information in several jurisdictions.
- An individual bribes a court-appointed trustee.

Commonly, the criminal commits one of these forms of fraud with another crime, such as identity theft, mortgage fraud, money laundering, and public corruption.

Common Forms of Fraud

Nearly 70% of all bankruptcy fraud involves the concealment of assets. Creditors can only liquidate assets listed by the debtor; thus, if the debtor fails to reveal certain assets, he can fraudulently keep them despite owing an outstanding debt. For further concealment, the debtor might transfer undisclosed assets to friends, relatives, or associates so it cannot be found. Fraudulent concealment makes loans more expensive, because it raises the risk and costs associated with lending and creditors passes those costs on to other hopeful borrowers.

Petition mills are one type of bankruptcy fraud scheme on the rise in the United States. Petition mills pass themselves off as consulting services, purporting to help tenants experiencing financial difficulties avoid eviction. While the tenant believes the service is negotiating on his behalf, the petition mill actually files for bankruptcy in his name and drags out the proceeding and charges him exorbitant fees. The tenant is left with no savings and a credit score in ruins.

Multiple filing fraud occurs when a debtor files for bankruptcy in multiple jurisdictions, using the same name and information, using aliases and false information, or using some combination of real and false information. Multiple filings clog up the bankruptcy court's docket, which slows down the whole process, including asset liquidation. Although multiple filings aren't criminal, they may still violate bankruptcy provisions, and they are often used to provide cover for a debtor trying to conceal assets.

Legal Consequences

Federal prosecutors can bring criminal charges for suspected bankruptcy fraud under 18 U.S.C. Chapter 9. Proof of fraud requires a showing that the defendant knowingly and fraudulently misrepresented a material fact. Bankruptcy fraud carries a sentence of up to five years in prison, or a fine of up to $250,000, or both. Even just *intending* to commit bankruptcy fraud may be punishable.

Victims of bankruptcy fraud may also seek civil remedies, according to the American Bankruptcy Institute.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 was meant in part to reduce the instances of bankruptcy fraud and abuse. Supreme Court case Ransom v. FIA Card Services addressed the "means test" which the Act imposed on someone filing for a Chapter 13 bankruptcy."

"Bankruptcy Fraud." *Wex,* Legal Information Institute, 17 July 2017, www.law.cornell.edu/wex/bankruptcy_fraud/.

Violations of the Foreign Corrupt Practices Act

As a byproduct of Watergate, federal officials at the Securities and Exchange Commission and the Internal Revenue Service uncovered many instances of bribes paid by major corporations to officials of foreign governments to win contracts with those governments. Congress responded in 1977 with the Foreign Corrupt Practices Act, which imposed a stringent requirement that the disposition of assets be accurately and fairly accounted for in a company's books and records. The act also made illegal the payment of bribes to foreign officials or to anyone who will transmit the money to a foreign official to assist the payor (the one offering and delivering the money) in getting business.

Violations of the Racketeering Influenced and Corrupt Organizations Act

In 1970 Congress enacted the Racketeering Influenced and Corrupt Organizations Act (RICO), aimed at ending organized crime's infiltration into legitimate business. The act tells courts to construe its language broadly "to effectuate its remedial purpose," and many who are not part of organized crime have been successfully prosecuted under the act. It bans a "pattern of racketeering," defined as the commission of at least two acts within ten years of any of a variety of already-existing crimes, including mail, wire, and securities fraud. The act thus makes many types of fraud subject to severe penalties.

Money Laundering

The term “money laundering” refers to the activities and financial transactions that are undertaken specifically to hide the true source of the money. In most cases, the money involved is earned from an illegal enterprise and the goal is to give that money the appearance of coming from a legitimate source.

Crimes dealing with or motivated by money make up the majority of criminal activity in the nation. Money laundering is a very complex crime involving intricate details, often involving numerous financial transactions and financial outlets throughout the world. According to the IRS, money laundering is the means by which criminals evade paying taxes on illegal income by concealing the source and the amount of profit. Money laundering is in effect tax evasion in progress.

When no other crimes could be pinned to Al Capone, the Internal Revenue Service obtained a conviction for tax evasion. As the astonished Capone left the courthouse he said, “This is preposterous. You can’t tax illegal income!” But the fact is income from whatever source derived (legal or illegal) is taxable income.

Had the money laundering statutes been on the books in the 1930’s, Capone would also have been charged with money laundering. However, since October 1986, with the passage of the Money Laundering Control Act, organized crime members and many others have been charged and convicted of both tax evasion and money laundering. (https://www.irs.gov/uac/overview-money-laundering)

Cyber Crime

Computer crime generally falls into four categories: (1) theft of money, financial instruments, or property; (2) misappropriation of computer time; (3) theft of programs; and (4) illegal acquisition of information. The main federal statutory framework for many computer crimes is the Computer Fraud and Abuse Act (CFAA; see Table 8 “Summary of Provisions of the Computer Fraud and Abuse Act”). Congress only prohibited computer fraud and abuse where there was a federal interest, as where computers of the government were involved or where the crime was interstate in nature.

The Supreme Court recently reviewed the scope of CFAA to address the question of whether a person who accesses information in a computer system with intent to misuse the information violates CFAA. In *Van Buren v. U.S.*, 593 U.S. ___ (2021), the Court held that CFAA does not criminalize such behavior, but instead only criminalizes unauthorized access – that is, access beyond what the user’s credentials permit them to access under section (a)(2) of CFAA. 18 U.S.C. § 1030.

Table 8 Summary of Provisions of Computer Fraud and Abuse Act (CFAA)

Obtaining national security information	Sec. (a)(1)	10 years maximum (20 years second offense)
Trespassing in a government computer	Sec. (a)(3)	1 year (5)
Compromising the confidentiality of a computer	Sec. (a)(2)	1 year (10)
Accessing a computer to defraud and obtain value	Sec. (a)4	5 years (10)

Intentional access and reckless damage	(a)(5)(A)(ii)	5 years (20)
Trafficking in passwords	(a)(6)	1 year (10)

Cyber fraud, Hacking, Cyber theft

Cyber fraud refers to any online intentional action used to commit a crime, such as identity theft, credit fraud or theft, cyber bullying, harassment, hacking etc. Cyber fraud is a growing threat with many instances occurring with individuals or entities in other countries, who commit fraud in the United States. Due to the world wide nature of the problem and that sophisticated individuals can hide behind a myriad of phony IP (internet provider) addresses, tracking and catching such individuals is very difficult.

However, prosecution is not an impossibility as was seen with the 2016 conviction of the internet hacker Guccifer. Hacker Guccifer Pleads Guilty

Cyber terrorism

Cyber terrorism is a more specific form of cyber fraud by using the internet to shut down areas of critical national infrastructure for political, ideological or religious purposes. And this is not merely hacking into a government website, but using online computer systems to hack into and effect water treatment plants, nuclear reactors, railways, airports, governmental operations, etc. (https://leb.fbi.gov/2011/november/cyber-terror)

The Nature of the Criminal Act

To be guilty of a crime, you must have acted. Mental desire or intent to do so is insufficient. But what constitutes an act? This question becomes important when someone begins to commit a crime, or does so in association with others, or intends to do one thing but winds up doing something else.

Attempt

It is not necessary to commit the intended crime to be found guilty of a criminal offense. An *attempt* to commit the crime is punishable as well, though usually not as severely. For example, Brett points a gun at Ashley, intending to shoot her dead. He pulls the trigger but his aim is off, and he misses her heart by four feet. He is guilty of an attempt to murder. Suppose, however, that earlier in the day, when he was preparing to shoot Ashley, Brett had been overheard in his apartment muttering to himself of his intention, and that a neighbor called the police. When they arrived, he was just snapping his gun into his shoulder holster.

At that point, courts in most states would not consider him guilty of an attempt because he had not passed beyond the stage of *preparation*. After having buttoned his jacket he might have reconsidered and put the gun away. Determining when the accused has passed beyond mere preparation and taken an actual step toward *perpetrating* the crime is often difficult and is usually for the jury to decide.

Conspiracy

Under both federal and state laws, it is a separate offense to work with others toward the commission of a crime. When two or more people combine to carry out an unlawful purpose, they are engaged in a conspiracy.

The law of conspiracy is quite broad, especially when it is used by prosecutors in connection with white-collar crimes. Many people can be swept up in the net of conspiracy, because it is unnecessary to show that the actions they took were sufficient to constitute either the crime or an attempt.

Usually, to establish a conspiracy, the prosecution needs to show only (1) an agreement and (2) a single overt act in furtherance of the conspiracy. Thus if three people agree to rob a bank, and if one of them goes to a store to purchase a gun to be used in the holdup, the three can be convicted of conspiracy to commit robbery. Even the purchase of an automobile to be used as the getaway car could support a conspiracy conviction. The act of any one of the conspirators is imputed to the other members of the conspiracy. It does not matter, for instance, that only one of the bank robbers fired the gun that killed a guard. All can be convicted of murder. That is so even if one of the conspirators was stationed as a lookout several blocks away and even if he specifically told the others that his agreement to cooperate would end "just as soon as there is shooting."

Agency and Corporations

A person can be guilty of a crime if he acts through another. Again, the usual reason for "imputing" the guilt of the actor to another is that both were engaged in a conspiracy. But imputation of guilt is not limited to a conspiracy. The agent may be innocent even though he participates. A corporate officer directs a junior employee to take a certain bag and deliver it to the officer's home. The employee reasonably believes that the officer is entitled to the bag. Unbeknownst to the employee, the bag contains money that belongs to the company, and the officer wishes to keep it. This is not a conspiracy. The employee is not guilty of larceny, but the officer is, because the agent's act is imputed to him. Since intent is a necessary component of crime, an agent's intent cannot be imputed to his principal if the principal did not share the intent.

The company president tells her sales manager, "Go make sure our biggest customer renews his contract for next year"—by which she meant, "Don't ignore our biggest customer." Standing before the customer's purchasing agent, the sales manager threatens to tell the purchasing agent's boss that the purchasing agent has been cheating on his expense account, unless he signs a new contract. The sales manager could be convicted of blackmail, but the company president could not.

Can a corporation be guilty of a crime? For many types of crimes, the guilt of individual employees may be imputed to the corporation. Thus the antitrust statutes explicitly state that the corporation may be convicted and fined for violations by employees. This is so even though the shareholders are the ones who ultimately must pay the price—and who may have had nothing to do with the crime nor the power to stop it. The law of corporate criminal responsibility has been changing in recent years. The tendency is to hold the corporation liable under criminal law if the act has been directed by a responsible officer or group within the corporation (the president or board of directors).

Defenses to Criminal Liability

In General

The mens rea requirement depends on the nature of the crime and all the circumstances surrounding the act. In general, though, the requirement means that the accused must in some way have intended the criminal consequences of his act. Suppose, for example, that Charlie gives Gabrielle a poison capsule to swallow. That is the act. If Gabrielle dies, is Charlie guilty of murder? The answer depends on what his state of mind was. Obviously, if he gave it to her intending to kill her, the act was murder.

What if he gave it to her knowing that the capsule was poison but believing that it would only make her mildly ill? The act is still murder, because we are all liable for the consequences of any intentional act that may cause harm to others. But suppose that Gabrielle had asked Harry for aspirin, and he handed her two pills that he reasonably believed to be aspirin (they came from the aspirin bottle and looked like aspirin) but that turned out to be poison, the act would not be murder, because he had neither intent nor a state of knowledge from which intent could be inferred.

Not every criminal law requires criminal intent as an ingredient of the crime. Many regulatory codes dealing with the public health and safety impose strict requirements. Failure to adhere to such requirements is a violation, whether or not the violator had mens rea.

Excuses That Limit or Overcome Responsibility

Mistake of Fact and Mistake of Law

Ordinarily, ignorance of the *law* is not an excuse. If you believe that it is permissible to turn right on a red light but the city ordinance prohibits it, your belief, even if reasonable, does not excuse your violation of the law. Under certain circumstances, however, ignorance of law will be excused. If a statute imposes criminal penalties for an action taken without a license, and if the government official responsible for issuing the license formally tells you that you do not need one (though in fact you do), a conviction for violating the statute cannot stand. In rare cases, a lawyer's advice, contrary to the statute, will be held to excuse the client, but usually the client is responsible for his attorney's mistakes. Otherwise, as it is said, the lawyer would be superior to the law.

Ignorance or mistake of *fact* more frequently will serve as an excuse. If you take a coat from a restaurant, believing it to be yours, you cannot be convicted of larceny if it is not. Your honest mistake of fact negates the requisite intent. In general, the rule is that a mistaken belief of fact will excuse criminal responsibility if (1) the belief is honestly held, (2) it is reasonable to hold it, and (3) the act would not have been criminal if the facts were as the accused supposed them to have been.

Impossibility

What if a defendant is accused of attempting a crime that is factually impossible? For example, suppose that men believed they were raping a drunken, unconscious woman, and were later accused of attempted rape, but defended on the grounds of factual impossibility because the woman was actually dead at the time sexual intercourse took place? Or suppose that a husband intended to poison his wife with strychnine in her coffee, but put sugar in the coffee instead? The "mens rea" or criminal intent was there, but the act itself was not criminal (rape requires a live victim, and murder by poisoning requires the use of poison). States are divided on this, but thirty-seven states have ruled out factual impossibility as a defense to the crime of attempt.

Legal impossibility is different, and is usually acknowledged as a valid defense. If the defendant completes all of his intended acts, but those acts do not fulfill all the required elements of a crime, there could be a successful "impossibility" defense. If Barney (who has poor sight), shoots at a tree stump, thinking it is his neighbor, Ralph, intending to kill him, has he committed an attempt? Many courts would hold that he has not. But the distinction between factual impossibility and legal impossibility is not always clear, and the trend seems to be to punish the intended attempt.

Entrapment

One common technique of criminal investigation is the use of an undercover agent or decoy—the policeman who poses as a buyer of drugs from a street dealer or the elaborate "sting" operations in which ostensibly stolen goods are "sold" to underworld "fences." Sometimes these methods are the only way by which certain kinds of crime can be rooted out and convictions secured.

But a rule against entrapment limits the legal ability of the police to play the role of criminals. The police are permitted to use such techniques to detect criminal activity; they are not permitted to do so to instigate crime. The distinction is usually made between a person who intends to commit a crime and one who does not. If the police provide the former with an opportunity to commit a criminal act—the sale of drugs to an undercover agent, for example—there is no defense of entrapment. But if the police knock on the door of one not known to be a drug user and persist in a demand that he purchase drugs from them, finally overcoming his will to resist, a conviction for purchase and possession of drugs can be overturned on the ground of entrapment.

Lack of Capacity

A further defense to criminal prosecution is the lack of mental capacity to commit the crime. Infants and children are considered incapable of committing a crime; under common law any child under the age of seven could not be prosecuted for any act. That age of incapacity varies from state to state and is now usually defined by statutes. Likewise, insanity or mental disease or defect can be a complete defense. Intoxication can be a defense to certain crimes, but the mere fact of drunkenness is not ordinarily sufficient.

Immunity

Immunity basically prevents the state from filing charges against an individual related to the commission of a crime. Immunity is granted because the state wants the individual to serve as a witness in the case against someone else.

Immunity can be complete, referred to as transactional immunity, relating to any charges arising out of a specific event (with the exception of perjury- if the person lies about the event), or it can be limited to not allowing the state to use statements you make against you – known as use immunity. With use immunity the state may still prosecute you, they just cannot use your own statements against you at trial.

How immunity works in federal cases
https://www.whitecollarcrimeresources.com/how-immunity-works-in-federal-criminal-cases.html

Statute of Limitations

The statute of limitations provides for a defense so a person does not have to fear prosecution for some crimes, especially minor crimes (misdemeanors) for the rest of his or her life. Most states limit misdemeanors to a one year to three years statute of limitations, however some are longer and some shorter, especially for really minor crimes. For serious crimes, such as felonies, states have longer statutes of limitations and some states, such as Maryland, have no statute of limitations. A chart of statute of limitations by state for various felonies and misdemeanors can be found at http://criminal.findlaw.com/criminal-law-basics/time-limits-for-charges-state-criminal-statutes-of-limitations.html.

Other Excuses: Duress, Consent, Necessity, Defense of Self, etc.

A number of other circumstances can limit or excuse criminal liability. These include duress (a gun pointed at one's head by a masked man who apparently is unafraid to use the weapon and who demands that you help him rob a store), honest consent of the "victim" (the quarterback who is tackled), adherence to the requirements of legitimate public authority lawfully exercised (a policeman directs a towing company to remove a car parked in a tow-away zone), the proper exercise of domestic authority (a parent may spank a child, within limits), necessity (breaking into a house to call an ambulance for an auto accident), and defense of self, others, property, and habitation. Each of these excuses is a complex subject in itself.

Criminal Procedure and Constitutional Safeguards

Criminal Procedure

The procedure for criminal prosecutions is complex. Procedures will vary from state to state. A criminal case begins with an arrest if the defendant is caught in the act or fleeing from the scene; if the defendant is not caught, a warrant for the defendant's arrest will issue. The warrant is issued by a judge or a magistrate upon receiving a complaint detailing the charge of a specific crime against the accused. It is not enough for a police officer to go before a judge and say, "I'd like you to arrest Bonnie because I think she's just murdered Clyde." She must supply enough information to satisfy the magistrate that there is probable cause (reasonable grounds) to believe that the accused committed the crime. The warrant will be issued to any officer or agency that has power to arrest the accused with warrant in hand.

The accused will be brought before the magistrate for a preliminary hearing. The purpose of the hearing is to determine whether there is sufficient reason to hold the accused for trial. If so, the accused can be sent to jail or be permitted to make bail. **Bail** is a sum of money paid to the court to secure the defendant's attendance at trial. If he fails to appear, he forfeits the money. Constitutionally, bail can be withheld only if there is reason to believe that the accused will flee the jurisdiction.

Once the arrest is made, the case is in the hands of the prosecutor. In the fifty states, prosecution is a function of the district attorney's office. These offices are usually organized on a county-by-county basis. In the federal system, criminal prosecution is handled by the office of the US attorney, one of whom is appointed for every federal district.

Following the preliminary hearing, the prosecutor must either file **an information** (a document stating the crime of which the person being held is accused) or ask the grand jury for an indictment. The grand jury consists of twenty-three people who sit to determine whether there is sufficient evidence to warrant a prosecution. It does not sit to determine guilt or innocence. The indictment is the grand jury's formal declaration of charges on which the accused will be tried. If indicted, the accused formally becomes a defendant.

The defendant will then be **arraigned**, that is, brought before a judge to answer the accusation in the indictment. The defendant may plead guilty or not guilty. If he pleads not guilty, the case will be tried before either a judge (known as a **bench trial**) or a jury of 6-12 citizens. A defendant cannot be convicted unless the judge or jury finds the defendant guilty beyond a reasonable doubt. Most states require a unanimous jury verdict, however prior to 2020, two states did not. The Supreme Court held in *Ramos v. Louisiana* that a non-unanimous jury violated the sixth amendment right of the defendant. *Ramos v. Louisiana*, 590 U.S. 1390 (2020).

The defendant might have pleaded guilty to the offense or to a lesser charge (often referred to as a **"lesser included offense"**—simple larceny, for example, is a lesser included offense of robbery because the defendant may not have used violence but nevertheless stole from the victim). Such a plea is usually arranged through plea bargaining with the prosecution. In return for the plea, the prosecutor promises to recommend to the judge that the sentence be limited. The judge most often, but not always, goes along with the prosecutor's recommendation.

The defendant is also permitted to file a plea of **nolo contendere** (no contest) in prosecutions for certain crimes. In so doing, he neither affirms nor denies his guilt. He may be sentenced as though he had pleaded guilty, although usually a nolo plea is the result of a plea bargain. Why plead nolo? In some offenses, such as violations of the antitrust laws, the statutes provide that private plaintiffs may use a conviction or a guilty plea as proof that the defendant violated the law. This enables a plaintiff to prove liability without putting on witnesses or evidence and reduces the civil trial to a hearing about the damages to plaintiff. The nolo plea permits the defendant to avoid this, so that any plaintiff will have to not only prove damages but also establish civil liability.

Following a guilty plea or a verdict of guilt, the judge will impose a sentence after presentencing reports are written by various court officials (often, probation officers). Permissible sentences are spelled out in statutes, though these frequently give the judge a range within which to work (e.g., twenty years to life). The judge may sentence the defendant to imprisonment, a fine, or both, or may decide to suspend sentence (i.e., the defendant will not have to serve the sentence as long as he stays out of trouble).

Sentencing usually comes before appeal. As in civil cases, the defendant, now convicted, has the right to take at least one appeal to higher courts, where issues of procedure and constitutional rights may be argued, as well as errors of law.

Table 9 Summary of Constitutional Criminal Protections

Fourth Amendment	Fifth Amendment	Sixth Amendment	Eighth Amendment
Right Against Unreasonable Searches or Seizures of Persons or Property	Right Against Self-Incrimination at Trial or during Custodial Interrogation	Right to Speedy Trial	Prohibition of Cruel and Unusual Punishment
Warrant Requirement supported by "Probable Cause"	Right of Due Process	Right to Cross Examine Accusers	Prohibition of Excessive Fines
	Right Against Double Jeopardy	Right to Counsel	Prohibition of Unreasonable Bail

Constitutional Safeguards

Search and Seizure

The rights of those accused of a crime are spelled out in four of the ten constitutional amendments that make up the Bill of Rights (Amendments Four, Five, Six, and Eight). For the most part, these amendments have been held to apply to both the federal and the state governments. The Fourth Amendment says in part that "the right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated." Therein, individuals are entitled to a reasonable expectation of privacy in their person, houses, etc. from governmental intrusion. Although there are numerous and tricky exceptions to the general rule, ordinarily the police may not break into a person's house or confiscate his papers or arrest him unless they have a warrant to do so. This means, for instance, that a policeman cannot simply stop you on a street corner and ask to see what is in your pockets (a power the police enjoy in many other countries), nor can your home be raided without probable cause to believe that you have committed a crime.

Table 10 Fourth Amendment Warrant Exceptions

Exception	Description
Plain View	Police that view potential contraband in "plain view" need not obtain a warrant to seize the illegal object. *U.S. v. Gordon*, 741 F. 3d 64, 71 (10th cir. 2014).
Exigency	Searches incident to pursue a fleeing suspect, protect individuals threatened with imminent harm, or to prevent immediate destruction of evidence. *Carpenter v. U.S.*, 138 S. Ct. 2206, 2223 (2018)
Community Caretaking	Search to protect "the safety of the general public who might be endangered" in certain circumstances. *U.S. v. Bute*, 43 F.3d 531, 535 (10th cir. 1994) (limiting this exception to searches of automobiles)
Incident to Arrest	Search "only the space within an arrestee's 'immediate control,' meaning 'the area from within which he might gain possession of a weapon or destructible evidence.'" *Arizona v. Gant*, 556 U.S. 332 (2009).
Terry search	"Stop and Frisk" incident to a reasonable, articulable suspicion of criminal activity particularized to the defendant the time of the seizure. *U.S. v. Curry*, 965 F. 3d 313 (4th cir. 2020)
Inventory search	"Police may, without a warrant, impound and search a motor vehicle so long as they do so in conformance with the standardized procedures of the local police department and in furtherance of a community caretaking purpose, such as promoting public safety or the efficient flow of traffic." Such a search is valid to produce an inventory to protect the owner's property while in police custody, to assure against claims against the police of lost property, and protect the police from danger that might be posed by property in the vehicle. *U.S. v. Johnson*, 889 F. 3d 112 (9th cir. 2018).
Consent	A person can consent to a police search of their person or property and thereby waive any right to object later under the fourth amendment to the search. *U.S. v. DaCruz-Mendes*, 970 F.3d 904, 908 (8th cir. 2020) ("The encounter is considered consensual so long as a reasonable person would feel free to terminate the encounter or refuse to answer questions") .

In evaluating whether a particular warrantless search is "reasonable" under the fourth amendment, courts have formulated various rules based on what the reasonable expectations of privacy are within society – a concept that changes with the times. Generally, courts are more likely to expect a warrant for the search of a person's home or its curtilage than they might for the search of a person's car incident to a traffic stop or arrest of the driver. Police activity in the public street – such as a police lip reader that watched a suspect while he made a phone call in a public payphone on a street corner or police investigation of an open field for narcotics– are less likely to require a warrant or even be considered a search. *Katz v. U.S.*, 389 U.S. 347 (1967); *Oliver v. U.S.*, 466 U.S. 170 (1984).

However, numerous cases demonstrate that these general principles give way to unexpected exceptions. In 2021, The Fourth Circuit *en banc* held that recorded aerial surveillance *en masse* of persons outside in Baltimore City by the police department violated the fourth amendment when that data was subsequently used by the police department to "deduce information from the whole of individuals' movements" without a warrant. *Leaders of a Beautiful Struggle v. Balt. Police Dep't*, No. 20-1495 (4th cir. 2021 *en banc*). The Supreme Court held that, while visual surveillance of a home that is otherwise not a trespass does not violate a fourth amendment right, street-based infrared surveillance of the exteriors of homes requires a warrant. *Kyllo v. U.S.*, 533 U.S. 27 (2001). The lesson of these myriad cases is that there is tremendous litigation on the validity of searches that lack a warrant, and myriad rules that have been developed on what constitutes a reasonable search under the circumstances.

What if the police do search or seize unreasonably? The courts have devised a remedy for the use at trial of the fruits of an unlawful search or seizure. Evidence that is unconstitutionally seized is excluded from the trial. This is the so-called **exclusionary rule**, first made applicable in federal cases in 1914 and brought home to the states in 1961. The exclusionary rule is highly controversial, and there are numerous exceptions to it. But it remains generally true that the prosecutor may not use evidence willfully taken by the police in violation of constitutional rights generally, and most often in the violation of Fourth Amendment rights. (The fruits of a coerced confession are also excluded.)

Double Jeopardy

The Fifth Amendment prohibits the government from prosecuting a person twice for the same offense. The amendment says that no person shall be "subject for the same offense to be twice put in jeopardy of life or limb." If a defendant is acquitted, the government may not appeal. If a defendant is convicted and his conviction is upheld on appeal, he may not, thereafter, be re-prosecuted for the same crime.

Double jeopardy does not prevent a state government and the federal government or two separate state governments (like Maryland and Virginia) from trying the same individual for the same crime. That is because each state and the federal government are separate and sovereign entities. So, if a defendant committed an act that was a violation of both state and federal law, he or she could be tried by both the state government and the federal government for the same crime. Or, where a crime crosses multiple state lines, such as a kidnapping, each state can try the defendant for a violation of that state's laws. However, many times multiple prosecutions do not occur due to conserving judicial resources where one state has already received a conviction.

Self-Incrimination

The Fifth Amendment is also the source of a person's right against self-incrimination (no person "shall be compelled in any criminal case to be a witness against himself"). The debate over the limits of this right has given rise to an immense amount of literature and case law. In broadest outline, the right against self-incrimination means that the prosecutor may not call a defendant to the witness stand during trial and may not comment to the jury on the defendant's failure to take the stand. Moreover, a defendant's confession must be excluded from evidence if it was not voluntarily made (e.g., if the police beat the person into giving a confession). In *Miranda v. Arizona*, 384 U.S. 436 (1966), the Supreme Court ruled that a confession may not be admissible if the police have not first advised a suspect of his constitutional rights, including the right to have a lawyer present to advise him during the questioning. However, like most areas of the law there are exceptions to this rule. These so-called Miranda warnings have prompted scores of follow-up cases that have made this branch of jurisprudence especially complex.

Speedy Trial

The Sixth Amendment tells the government that it must try defendants speedily. How long a delay is too long depends on the circumstances in each case. In 1975, Congress enacted the Speedy Trial Act to give priority to criminal cases in federal courts. It requires all criminal prosecutions to go to trial within seventy-five days (though the law lists many permissible reasons for delay).

Cross-Examination

The Sixth Amendment also says that the defendant shall have the right to confront witnesses against him. No testimony is permitted to be shown to the jury unless the person making it is present and subject to cross-examination by the defendant's counsel.

Assistance of Counsel

The Sixth Amendment guarantees criminal defendants the right to have the assistance of defense counsel. During the eighteenth century and before, the British courts frequently refused to permit defendants to have lawyers in the courtroom during trial. The right to counsel is much broader in this country, as the result of Supreme Court decisions that require the state to pay for a lawyer for indigent defendants in most criminal cases. Notification of this right is included in the standard *Miranda* warnings read to defendants at arrest or interrogation.

Cruel and Unusual Punishment

Punishment under the common law was frequently horrifying. Death was a common punishment for relatively minor crimes. In many places throughout the world, punishments still persist that seem cruel and unusual, such as the practice of stoning someone to death. The guillotine, famously in use during and after the French Revolution, is no longer used, nor are defendants put in stocks for public display and humiliation. In pre-Revolutionary America, an unlucky defendant who found himself convicted could face brutal torture before death.

The Eighth Amendment banned these actions with the words that "cruel and unusual punishments [shall not be] inflicted." Virtually all such punishments either never were enacted or have been eliminated from the statute books in the United States. Nevertheless, the Eighth Amendment has become a source of controversy, first with the Supreme Court's ruling in 1972 that the death penalty, as haphazardly applied in the various states, amounted to cruel and unusual punishment. *Furman v. Georgia*, 408 U.S. 238 (1972) (Georgia subsequently enacted a new statute for the death penalty which was reviewed and approved by the Court in *Gregg)*. Later Supreme Court opinions have made it easier for states to administer the death penalty. *Gregg v. Georgia*, 428 U.S. 153 (1976). As of 2010, there were 3,300 defendants on death row in the United States. There are 19 states and the District of Columbia that have subsequently abolished the death penalty. Thirty-one states and the federal government currently allow for the death penalty. Under federal law only certain homicide offenses and treason qualify for the death penalty. https://deathpenaltyinfo.org/states-and-without-death-penalty

Of course, no corporation is on death row, and no corporation's charter has ever been revoked by a US state, even though some corporations have repeatedly been indicted and convicted of criminal offenses.

Adding to the complexity is that states may provide further or additional protections to criminal defendants that are greater than those defined by the federal constitution. For example, while the death penalty is not automatically a violation of the Eighth Amendment, some states have made this practice illegal, including Maryland. *Bellard v. State*, 452 Md. 467 (2017); 2013 Md. Laws 2298-99 (Vol. III, Ch. 156, S.B. 276). While random drug testing of student athletes may not offend the fourth amendment, such practice does violate the state constitution of Washington which affords fewer exceptions to the warrant requirement than its federal counterpart. *York v. Wahkiakum School Dist.*, 178 P.3d 995 (Wash. 2008). The fifth amendment right against self-incrimination requires the criminal defendant voluntarily confess, but under Maryland law, the state has the burden to demonstrate that the confession was actually voluntary. *Winder v. State*, 765 A.2d 97, 113 (Md. 2001). As the reader can imagine, there are numerous other wrinkles, exceptions, and rules of law that vary from state to state as to the rights of criminal defendants in addition to those found in the federal constitution. However, states are not free to provide criminal defendants with fewer protections; the federal constitution establishes a "floor" or minimum rights of all accused of or prosecuted for a crime. *Cooper v. California*, 386 U.S. 58 (1967); *Oregon v. Hass*, 420 U.S. (1975).

Presumption of Innocence

The most important constitutional right in the US criminal justice system is the presumption of innocence. The Supreme Court has repeatedly cautioned lower courts in the United States that juries must be properly instructed that the defendant is innocent until proven guilty. This is the origin of the "beyond all reasonable doubt" standard of proof and is an instruction given to juries in each criminal case.

The Fifth Amendment notes the right of "due process" in federal proceedings, and the Fourteenth Amendment requires that each state provide "due process" to defendants, which includes the right to be informed of charges against you; the right to counsel; the right to remain silent; the right to confront your accusers and cross-exam witnesses against you; and the right to trial by jury in many instances.

Common Law Contracts Introduction

The Role of Contracts in Modern Society

The contract is probably the most familiar legal concept in our society because it is so central to the essence of our political, economic, and social life. In common parlance, the idea of a contract is used interchangeably with agreement, bargain, undertaking, or deal. Whatever the word, the concept it embodies is our notion of freedom to pursue our own lives together with others. Contract is central because it is the means by which a free society orders what would otherwise be a jostling, frenetic anarchy.

So commonplace is the concept of contract—and our freedom to make contracts with each other—that it is difficult to imagine a time when contracts were rare, when people's everyday associations with one another were not freely determined. Yet in historical terms, it was not so long ago that contracts were rare, entered into if at all by very few: that affairs should be ordered based on mutual assent was mostly unknown.

In primitive societies and in feudal Europe, relationships among people were largely fixed; traditions spelled out duties that each person owed to family, tribe, or manor. People were born into an ascribed position—a status (not unlike the caste system still existing in India)—and social mobility was limited. Sir Henry Maine, a nineteenth-century British historian, wrote that "the movement of the progressive societies has…been a movement from status to contract" (180–82). This movement was not accidental—it developed with the emerging industrial order. From the fifteenth to the nineteenth century, England evolved into a booming mercantile economy, with flourishing trade, growing cities, an expanding monetary system, the commercialization of agriculture, and mushrooming manufacturing. With this evolution, contract law was created of necessity.

Contract law did not develop according to a conscious plan, however. It was a response to changing conditions, and the judges who created it frequently resisted, preferring the imagined quieter pastoral life of their forefathers. Not until the nineteenth century, in both the United States and England, did a full- fledged law of contracts arise together with, and help create, modern capitalism.

Modern capitalism, indeed, would not be possible without contract law. So it is that in planned economies, like those of the former Soviet Union and precapitalistic China, the contract did not determine the nature of an economic transaction. That transaction was first set forth by the state's planning authorities; only thereafter were the predetermined provisions set down in a written contract. Modern capitalism has demanded new contract regimes in Russia and China; the latter adopted its Revised Contract Law in 1999.

Contract law may be viewed economically as well as culturally. In an Economic Analysis of Law, Judge Richard A. Posner (a former University of Chicago law professor) suggests that contract law performs three significant economic functions. First, it helps maintain incentives for individuals to exchange goods and services efficiently. Second, it reduces the costs of economic transactions because its very existence means that the parties need not go to the trouble of negotiating a variety of rules and terms already spelled out. Third, the law of contracts alerts the parties to troubles that have arisen in the past, thus making it easier to plan the transactions more intelligently and avoid potential pitfalls.

The Definition of Contract

As usual in the law, the legal definition of contract is formalistic. The Restatement (Second) of Contracts, Section 1 says, "A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." Restat 2d of Contracts § 1; *see also County Commr's for Carroll County v. Forty West Bldrs., Inc.*, 178 Md. App. 328, 941 A.2d 1181 (2008). Similarly, the Uniform Commercial Code says, "'Contract' means the total legal obligation which results from the parties' agreement as affected by this Act and any other applicable rules of law." Md. Code Ann., Com. Law, § 1-201(11) (LexisNexis 2021). As operational definitions, these two are circular; in effect, a contract is defined as an agreement that the law will hold the parties to.

Most simply, a contract is a legally enforceable promise. This implies that not every promise or agreement creates a binding contract; if every promise did, the simple definition set out in the preceding sentence would read, "A contract is a promise." But—again—a contract is not simply a promise: it is a legally enforceable promise. The law takes into account the way in which contracts are made, by whom they are made, and for what purposes they are made. For example, in many states, a wager is unenforceable, even though both parties "shake" on the bet.

Overview of the Contracts Materials

Although contract law has many wrinkles and nuances, it consists of four principal inquiries, each of which will be taken up in subsequent sections of the Contracts Unit:

1) Did the parties create a valid contract? Four elements are necessary for a valid contract:

   a. Mutual assent (i.e., offer and acceptance)

   b. Real assent (no duress, undue influence, misrepresentation, mistake, or incapacity)

   c. Consideration

   d. Legality

2) What does the contract mean, and is it in the proper form to carry out this meaning? Sometimes contracts need to be in writing (or evidenced by some writing), or they can't be enforced. Sometimes it isn't clear what the contract means, and a court has to figure that out.

3) Do persons other than the contracting parties have rights or duties under the contract? Can the right to receive a benefit from the contract be assigned, and can the duties be delegated so that a new person is responsible? Can persons not a party to the contract sue to enforce its terms?

4) How do contractual duties terminate, and what remedies are available if a party has breached the contract?

Together, the answers to these four basic inquiries determine the rights and obligations of contracting parties.

Sources of Contract Law

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The most important sources of contract law are state case law and state statutes (though there are also many federal statutes governing how contracts are made by and with the federal government).

Case Law

Law made by judges is called case law. Because contract law was made up in the common-law courtroom by individual judges as they applied rules to resolve disputes before them, it grew over time to formidable proportions. By the early twentieth century, tens of thousands of contract disputes had been submitted to the courts for resolution, and the published opinions, if collected in one place, would have filled dozens of bookshelves. Clearly this mass of material was too unwieldy for efficient use. A similar problem also had developed in the other leading branches of the common law.

Disturbed by the profusion of cases and the resulting uncertainty of the law, a group of prominent American judges, lawyers, and law teachers founded the American Law Institute (ALI) in 1923 to attempt to clarify, simplify, and improve the law. One of the ALI's first projects, and ultimately one of its most successful, was the drafting of the Restatement of the Law of Contracts, completed in 1932. A revision— the Restatement (Second) of Contracts—was undertaken in 1964 and completed in 1979. Hereafter, references to "the Restatement" pertain to the Restatement (Second) of Contracts. The Restatements— others exist in the fields of torts, agency, conflicts of laws, judgments, property, restitution, security, and trusts—are detailed analyses of the decided cases in each field. These analyses are made with an eye to discerning the various principles that have emerged from the courts, and to the maximum extent possible, the Restatements declare the law as the courts have determined it to be.

The Restatement (Second) of Contracts won prompt respect in the courts and has been cited in innumerable cases. The Restatements are not authoritative, in the sense that they are not actual judicial precedents; but they are nevertheless weighty interpretive texts, and judges frequently look to them for guidance. They are as close to "black letter" rules of law as exist anywhere in the American common-law legal system.

Common law, case law (the terms are synonymous), governs contracts for the sale of real estate and services. "Services" refer to acts or deeds (like plumbing, drafting documents, driving a car) as opposed to the sale of property.

Statutory Law

Because of the historical development of the English legal system, contracts for the sale of goods came to be governed by a different body of legal rules. In its modern American manifestation, that body of rules is an important statute: the Uniform Commercial Code (UCC), especially Article 2, which deals with the sale of goods. The UCC will be covered in more detail in Unit 3, but we will briefly review its relevance to contract law here.

History of the UCC

Before the UCC was written, commercial law varied, sometimes greatly, from state to state. This first proved a nuisance and then a serious impediment to business as the American economy became nationwide during the twentieth century. Although there had been some uniform laws concerned with commercial deals—including the Uniform Sales Act, first published in 1906—few were widely adopted and none nationally. As a result, the law governing sales of goods, negotiable instruments, warehouse receipts, securities, and other matters crucial to doing business in an industrial market economy was a crazy quilt of untidy provisions that did not mesh well from state to state.

The UCC is a model law developed by the ALI and the National Conference of Commissioners on Uniform State Laws; it has been adopted in one form or another by the legislatures in all fifty states, the District of Columbia, and the American territories. It is a "national" law not enacted by Congress—it is not federal law but uniform state law. The UCC is now a basic law of relevance to every business and business lawyer in the United States, even though it is not entirely uniform because different states have adopted it at various stages of its evolution—an evolution that continues still.

Organization of the UCC

The UCC consists of nine major substantive articles; each deals with separate though related subjects. All references to the UCC in this section will be to the Maryland Annotated Code, Commercial Law Article – Maryland's adoption of the UCC.

The articles are as follows:

- Article 1: General Provisions
- Article 2: Sales
- Article 2A: Leases
- Article 3: Commercial Paper
- Article 4: Bank Deposits and Collections
- Article 4A: Funds Transfers
- Article 5: Letters of Credit
- Article 6: Bulk Transfers
- Article 7: Warehouse Receipts, Bills of Lading, and Other Documents of Title
- Article 8: Investment Securities
- Article 9: Secured Transactions

Article 2 deals only with the sale of goods, which the UCC defines as “all things…which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid.” Md. Code Ann., Com. Law § 2-105. The only contracts and agreements covered by Article 2 are those relating to the present or future sale of goods.

Type of Contract	Source of Law: Common Law	Source of Law: UCC
Real Estate	✓	
Services	✓	
Sale of Goods		✓

Figure 5 Contract Sources of Law

Basic Classification of Contracts

Some contracts are written, some oral; some are explicit, some not. Because contracts can be formed, expressed, and enforced in a variety of ways, a taxonomy of contracts has developed that is useful in grouping together like legal consequences. In general, contracts are classified along four different dimensions: explicitness, mutuality, enforceability, and degree of completion.

Explicitness is the degree to which the agreement is manifest to those not party to it.

Mutuality takes into account whether promises are given by two parties or only one.

Enforceability is the degree to which a given contract is binding.

Completion considers whether the contract is yet to be performed or whether the obligations have been fully discharged by one or both parties.

Formal Contracts v. Informal Contracts

Contracts may be either "formal" or "informal." Formal contracts are those under seal or record - that is, acknowledgments of debt entered on the records of a court, and contracts in writing and under seal (all contracts under seal are written). These types of contracts are limited in use today. Informal or simple contracts are also known as "parol contracts" and include all contracts not under seal or of record- and represent the vast majority of all contracts.

Explicitness

Express Contract

An express contract is one in which the terms are spelled out directly. The parties to an express contract, whether it is written or oral, are conscious that they are making an enforceable agreement. *See Cnty Commr's of Caroline Cnty v. J. Roland Dashiel & Sons. Inc.*, 358 Md. 83, 747 A.2d 600 (2000). For example, an agreement to purchase your neighbor's car for $5,500 and to take title next Monday is an express contract.

Implied Contract (Implied in Fact)

An implied contract is one that is inferred from the actions of the parties. When parties have not discussed terms, an implied contract exists if it is clear from the conduct of both parties that they intended there be one. A delicatessen patron who asks for a turkey sandwich to go has made a contract and is obligated to pay when the sandwich is made. By ordering the food, the patron is implicitly agreeing to the price, whether posted or not. Another example is you stop by the local newsstand, grab a paper and put $1 on the counter and walk away – your agreement to purchase the paper was implied by your conduct.

The distinction between express and implied contracts received a degree of notoriety in the so-called palimony cases, in which one member of an unmarried couple seeks a division of property after a long- standing live-together relationship has broken up. When a married couple divorces, their legal marriage contract is dissolved, and financial rights and obligations are spelled out in a huge body of domestic relations statutes and judicial decisions. No such laws exist for unmarried couples. However, about one-third of the states recognize common-law marriage, under which two people are deemed to be married if they live together with the intent to be married, regardless of their failure to have obtained a license or gone through a ceremony. Although there is no actual contract of marriage (no license), their behavior implies that the parties intended to be treated as if they were married.

Quasi-Contract

A quasi-contract (implied in law) is—unlike both express and implied contracts, which embody an actual agreement of the parties—an obligation said to be "imposed by law" in order to avoid unjust enrichment of one person at the expense of another. A quasi-contract is not a contract at all; it is a fiction that the courts created to prevent injustice. Suppose, for example, that the local lumberyard mistakenly delivers a load of lumber to your house, where you are repairing your deck. It was a neighbor on the next block who ordered the lumber, but you are happy to accept the load for free; since you never talked to the lumberyard, you figure you need not pay the bill. Although it is true there is no contract, the law implies a contract for the value of the material: of course you will have to pay for what you got and took. The existence of this implied contract does not depend on the intention of the parties.

Two legal theories used to recover under quasi-contract are: unjust enrichment and quantum meruit. These legal theories are similar with some distant differences.

Unjust enrichment requires that the defendant received a benefit at the expense of the plaintiff and equity (and good conscience) require restitution. As in our prior example of the lumberyard delivering a truck load of lumber to your house instead of your neighbor's and you try to keep the wood for free. Unjust enrichment would require that you pay the lumberyard.

Quantum meruit requires that the plaintiff establish that he or she rendered services to the defendant in good faith, the defendant accepted the services, and expectation of compensation by the plaintiff (the services were not gratuitous) for the reasonable value of the services. An example would be, you go to pave a driveway but arrive at the wrong house. The homeowner sees you in the driveway, waves and acknowledges you and allows you to pave his driveway without telling you that you are at the wrong house. The homeowner's acknowledgement and acceptance of the service, knowing that you expected to be paid, would result in a claim for the reasonable value of your services and materials under a theory of quantum meruit.

When parties to a contract seek to redress grievances in court – where an express contract exists, the parties cannot resort to seeking remedy in quasi contract- in the hopes of reaping more damages. "The general rule is that no quasi-contractual claim can arise when a contract exists between the parties concerning the same subject matter on which the quasi-contractual claim rests. The reason for this rule is not difficult to discern. When parties enter into a contract they assume certain risks with an expectation of a return. Sometimes, their expectations are not realized, but they discover that under the contract they have assumed the risk of having those expectations defeated. As a result, they have no remedy under the contract for restoring their expectations. In desperation, they turn to quasi-contract for recovery. This the law will not allow." *Cnty. comm'rs of Caroline Cnty*, 358 Md. at 96, 747 A.2d at 607.

Mutuality

Bilateral Contract

The typical contract is one in which the parties make mutual promises. Each is both promisor and promisee; that is, each pledges to do something, and each is the recipient of such a pledge. This type of contract is called a bilateral contract.

So, if you promise to pay your friend $500 if he promises to sell you his watch next week- you have a bilateral contract. A promise for a promise. If your friend sells his watch tomorrow to someone else, you have a right to sue for breach of contract.

Unilateral Contract

Mutual promises are not necessary to constitute a contract. Unilateral contracts, in which one party performs an act in exchange for the other party's promise, are equally valid. An offer of a reward—for catching a criminal or for returning a lost cat—is an example of a unilateral contract: there is an offer on one side, and the other side accepts by taking the action requested.

So, if you promise to pay your friend $500 when he paints your house, you have unilateral contract. You have made a promise to pay. Your friend has not made a promise to paint your house. If he paints your house, you owe him $500. If he chooses not to paint your house, you do not owe him $500. He has not breached your agreement and you cannot sue him. You just need to find another house painter.

Table 11 Types of Contracts

Contract Type	Nature of Agreement	Example
Bilateral Contract	A promise exchanged for a promise.	I promise to pay you $50, if you promise to sell me your watch.
Unilateral Contract	A promise exchanged for performance.	I promise to pay you $50, if you mow my lawn on Sunday.

Enforceability

Void

Not every agreement between two people is a binding contract. An agreement that is lacking one of the legal elements of a contract is said to be a void contract—that is, not a contract at all. An agreement that is illegal—for example, a promise to commit a crime in return for a money payment—is void. Neither party to a void "contract" may enforce it.

Voidable

By contrast, a voidable contract is one that may become unenforceable by one party but can be enforced by the other. For example, a minor (any person under eighteen, in most states) may "avoid" a contract with an adult; the adult may not enforce the contract against the minor if the minor refuses to carry out the bargain. But the adult has no choice if the minor wishes the contract to be performed. (A contract may be voidable by both parties if both are minors.)

Ordinarily, the parties to a voidable contract are entitled to be restored to their original condition. Suppose you agree to buy your seventeen-year-old neighbor's car. He delivers it to you in exchange for your agreement to pay him next week. He has the legal right to terminate the deal and recover the car, in which case you will of course have no obligation to pay him. If you have already paid him, he still may legally demand a return to the status quo ante (previous state of affairs). You must return the car to him; he must return the cash to you.

A voidable contract remains a valid contract until it is voided. Thus a contract with a minor remains in force unless the minor decides he or she does not wish to be bound by it. When the minor reaches majority, he or she may "ratify" the contract—that is, agree to be bound by it—in which case the contract will no longer be voidable and will thereafter be fully enforceable.

One exception to the voidable rule for minors is for contracts for necessaries. Necessaries include food, clothing, shelter- items necessary for basic survival. Minors may disaffirm these contracts, but they are required to pay the fair market value for the goods.

Unenforceable

An unenforceable contract is one that some rule of law bars a court from enforcing. For example, Tom owes Pete money, but Pete has waited too long to collect it and the statute of limitations has run out. The contract for repayment is unenforceable and Pete is out of luck, unless Tom makes a new promise to pay or actually pays part of the debt. (However, if Pete is holding collateral as security for the debt, he is entitled to keep it; not all rights are extinguished because a contract is unenforceable.) A debt becomes unenforceable, too, when the debtor declares bankruptcy.

Promissory Estoppel

A promise or what seems to be a promise is usually enforceable only if it is otherwise embedded in the elements necessary to make that promise a contract. Those elements are mutual assent, real assent, consideration, capacity, and legality. Sometimes, though, people say things that seem like promises, and on which another person relies. In the early twentieth century, courts began, in some circumstances, to recognize that insisting on the existence of the traditional elements of contract to determine whether a promise is enforceable could work an injustice where there has been reliance. Thus developed the equitable doctrine of promissory estoppel, which has become an important adjunct to contract law.

The Restatement (Second) of Contracts puts it this way: “A promise which the promisor should reasonably expect to induce action or forbearance on the party of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.” Restat 2d of Contracts, § 90. To be “estopped” means to be prohibited from denying now the validity of a promise you made before.

In applying the language of Section 90, Maryland courts have developed a four-part test

1. a clear and definite promise;
2. where the promisor has a reasonable expectation that the offer will induce action or forbearance on the part of the promisee;
3. which does induce actual and reasonable action or forbearance by the promisee; and
4. causes a detriment which can only be avoided by the enforcement of the promise.

Pavel Enters. v. A. S. Johnson Co., 342 Md. 143, 166, 674 A.2d 521, 532 (1996).

So, assume you orally agree to sell your farm in Maryland to John, who currently works and lives in Florida. You include a stipulation that John must quit his job and move to Maryland by the end of July. John does this and then you change your mind and refuse to sell him the farm. Technically, your agreement is unenforceable as a contract for the sale of land (the farm) must be in writing under the Statute of Frauds. However, since John has so changed his position to his detriment based on your promise and it was reasonable and foreseeable he would do so, a court may enforce your promise to sell John the farm under the doctrine of promissory estoppel.

Degree of Completion

An agreement consisting of a set of promises is called an executory contract before any promises are carried out. Most executory contracts are enforceable. John makes an agreement to buy wheat from Humphrey for payment of $1,000. Once Humphrey delivers the wheat to John the contract is called a partially executed contract: one side (Humphrey) has performed by delivering the wheat, the other side (John) has not performed as he has not yet made payment. When John pays for the wheat, the contract is fully performed. A contract that has been carried out fully by both parties is called an executed contract.

Terminology: Suffixes Expressing Relationships

Although not really part of the taxonomy of contracts (i.e., the orderly classification of the subject), an aspect of contractual—indeed, legal—terminology should be highlighted here. Suffixes (the end syllables of words) in the English language are used to express relationships between parties in legal terminology.

Here are examples:

• Offeror. One who makes an offer.

• Offeree. One to whom an offer is made.

• Promisor. One who makes a promise.

• Promisee. One to whom a promise is made.

• Obligor. One who makes and has an obligation.

• Obligee. One to whom an obligation is made.

• Transferor. One who makes a transfer.

• Transferee. One to whom a transfer is made.

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Contract Formation

Contract formation focuses on four main areas, which we will review in detail:

1. Offer and Acceptance

2. Real Assent

3. Consideration

4. Legality

If you have all four elements, then you have a contract that the law will enforce. We start our look at contract formation with Offer and Acceptance.

Offer and Acceptance – The Agreement

The Significance of Agreement

The core of a legal contract is the agreement between the parties. This is not a necessary ingredient; in Communist nations, contracts were (or are, in the few remaining Communist countries) routinely negotiated between parties who had the terms imposed on them. But in the West, and especially in the United States, agreement is of the essence. That is not merely a matter of convenience; it is at the heart of our philosophical and psychological beliefs. As the great student of contract law Samuel Williston put it, "It was a consequence of the emphasis laid on the ego and the individual will that the formation of a contract should seem impossible unless the wills of the parties concurred. Accordingly we find at the end of the eighteenth century, and the beginning of the nineteenth century, the prevalent idea that there must be a "meeting of the minds" (a new phrase) in order to form a contract" (Williston 368).

Although agreements may take any form, including unspoken conduct between the parties, they are usually structured in terms of an offer and an acceptance. These two components will be the focus of our discussion. Note, however, that not every agreement, in the broadest sense of the word, need consist of an offer and an acceptance, and that it is entirely possible, therefore, for two persons to reach agreement without forming a contract. For example, people may agree that the weather is pleasant or that it would be preferable to go out for Chinese food rather than to see a foreign film; in neither case has a contract been formed. One of the major functions of the law of contracts is to sort out those agreements that are legally binding—those that are contracts—from those that are not.

The Objective Test

In interpreting agreements, courts generally apply an objective standard (outwardly, as an independent observer would interpret; not subjectively as the parties involved believed). The Restatement (Second) of Contracts, Section 3 defines *agreement* as a "manifestation of mutual assent by two or more persons to one another." Restat 2d of Contracts, § 3. The distinction between objective and subjective standards crops up occasionally when one person claims he spoke in jest.

The vice president of a company that manufactured punchboards, used in gambling, testified to the Washington State Game Commission that he would pay $100,000 to anyone who found a "crooked board." Barnes, a bartender, who had purchased two boards that were crooked some time before, brought one to the company office and demanded payment. The company refused, claiming that the statement was made in jest (the audience at the commission hearing had laughed when the offer was made). The court disagreed, holding that it was reasonable to interpret the pledge of $100,000 as a means of promoting punchboards:

"[I]f the jest is not apparent and a reasonable hearer would believe that an offer was being made, then the speaker risks the formation of a contract which was not intended. It is the objective manifestations of the offeror that count and not secret, unexpressed intentions. If a party's words or acts, judged by a reasonable standard, manifest an intention to agree in regard to the matter in question, that agreement is established, and it is immaterial what may be the real but unexpressed state of the party's mind on the subject." *Barnes v. Treece*, 549 P.2d 1152, 1155 (Wash. Ct. App. 1976).

The Offer

Offer and acceptance may seem to be straightforward concepts, as they are when two people meet face-to-face. But in a commercial society, the ways of making offers and accepting them are nearly infinite. A retail store advertises its merchandise in the newspaper. A seller makes his offer by mail or over the Internet. A telephone caller states that his offer will stand for ten days. An offer leaves open a crucial term. An auctioneer seeks bids. An offeror gives the offeree a choice. All these situations can raise tricky questions, as can corresponding situations involving acceptances.

The Definition of Offer

The Restatement defines offer as "the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it." Restat 2d of Contracts § 24.

Two key elements are implicit in that definition: the offer must be communicated, and it must be definite. Before considering these requirements, we examine the threshold question of whether an offer was intended. Let us look at proposals that may look like, but are not, offers.

Proposals That Are Not Offers

Advertisements

Most advertisements, price quotations, and invitations to bid are not construed as offers. A notice in the newspaper that a bicycle is on sale for $800 is normally intended only as an invitation to the public to come to the store to make a purchase. Similarly, a statement that a seller can "quote" a unit price to a prospective purchaser is not, by itself, of sufficient definiteness to constitute an offer; quantity, time of delivery, and other important factors are missing from such a statement. Frequently, in order to avoid construction of a statement about price and quantity as an offer, a seller or buyer may say, "Make me an offer." Such a statement obviously suggests that no offer has yet been made. This principle usually applies to invitations for bids (e.g., from contractors on a building project). Many forms used by sales representatives as contracts indicate that by signing, the customer is making an offer to be accepted by the home office and is not accepting an offer made by the sales representative.

Although advertisements, price quotations, and the like are generally not offers, the facts in each case are important. Under the proper circumstances, an advertised statement can be construed as an offer, as shown in the well-known *Lefkowitz v. Great Minn, Surplus Store*, 86 N.W.2d 689 (Minn. 1957), in which the offended customer acted as his own lawyer and pursued an appeal to the Minnesota Supreme Court against a Minneapolis department store that took back its advertised offer.

In *Lefkowitz*, the store advertised a fur stole for $1.00 that was valued at $139.50. The ad said "First Come First Served." Mr. Lefkowitz went to purchase the stole, and was the first purchaser at the store on the day of the sale. The store refused his purchase stating that the store had a house rule that the sale was intended for women only. This was not communicated in the ad. The store argued in court that the offer was unilateral and could be revoked at any time, including when Mr. Lefkowitz appeared at the store to purchase the fur stole. The court rejected this argument and held that the offer to sell the stole was definite, clear and explicit - leaving nothing for negotiation. In affirming the trial court's judgment for Mr. Lefkowitz, the court held that the buyer was entitled to performance of the contract having been the first person at the store to purchase the article. As to the house rule of sales only to women, the court rejected this argument as it was not part of the advertisement and once Mr. Lefkowitz was at the store to accept the offer, the seller could not add arbitrary conditions to it. *Id.* at 691-692.

Despite the common-law rule that advertisements are normally to be considered invitations rather than offers, legislation and government regulations may offer redress. For many years, retail food stores have been subject to a rule, promulgated by the Federal Trade Commission (FTC), that goods advertised as "specials" must be available and must be sold at the price advertised. It is unlawful for a retail chain not to have an advertised item in each of its stores and in sufficient quantity, unless the advertisement specifically states how much is stocked and which branch stores do not carry it. 16 C.F.R. § 238.3 (2021). Many states have enacted consumer protection statutes that parallel the FTC rule.

Invitations to Bid

Invitations to bid are also not generally construed as offers. An auctioneer does not make offers but solicits offers from the crowd: "May I have an offer?—$500? $450? $450! I have an offer for $450. Do I hear $475? May I have an offer?"

Communication

A contract is an agreement in which each party assents to the terms of the other party. Without mutual assent there cannot be a contract, and this implies that the assent each person gives must be with reference to that of the other. If Toni places several alternative offers on the table, only one of which can be accepted, and invites Sandy to choose, no contract is formed if Sandy says merely, "I accept your terms." Sandy must specify which offer she is assenting to.

From this general proposition, it follows that no contract can be legally binding unless an offer is in fact communicated to the offeree. If you write an e-mail to a friend with an offer to sell your car for a certain sum and then get distracted and forget to send it, no offer has been made. If your friend coincidentally e- mails you the following day and says that she wants to buy your car and names the same sum, no contract has been made. Her e-mail to you is not an acceptance, since she did not know of your offer; it is, instead, an offer or an invitation to make an offer. Nor would there have been a contract if you had sent your communication and the two e-mails crossed in cyberspace. Both e-mails would be offers, and for a valid contract to be formed, it would still be necessary for one of you to accept the other's offer. An offer is not effective until it is received by the offeree (and that's also true of a revocation of the offer, and a rejection of the offer by the offeree).

The requirement that an offer be communicated does not mean that every term must be communicated. You call up your friend and offer to sell him your car. You tell him the price and start to tell him that you will throw in the snow tires but will not pay for a new inspection, and that you expect to keep the car another three weeks. Impatiently, he cuts you off and says, "Never mind about all that; I'll accept your offer on whatever terms you want." You and he have a contract.

These principles apply to unknown offers of reward. An offer of a reward constitutes a unilateral contract that can be made binding only by performing the task for which the reward is offered. Suppose that Bonnie posts on a tree a sign offering a reward for returning her missing dog. If you saw the sign, found the dog, and returned it, you would have fulfilled the essentials of the offer. But if you chanced upon the dog, read the tag around its neck, and returned it without ever having been aware that a reward was offered, then you have not responded to the offer, even if you acted in the hope that the owner would reward you. There is no contractual obligation.

In many states, a different result follows from an offer of a reward by a governmental entity. Commonly, local ordinances provide that a standing reward of, say, $1,000 will be paid to anyone providing information that leads to the arrest and conviction of arsonists. To collect the reward, it is not necessary for a person who does furnish local authorities with such information to know that a reward ordinance exists. In contract terms, the standing reward is viewed as a means of setting a climate in which people will be encouraged to act in certain ways in the expectation that they will earn unknown rewards. It is also possible to view the claim to a reward as noncontractual; the right to receive it is guaranteed, instead, by the local ordinance.

Although a completed act called for by an unknown private offer does not give rise to a contract, partial performance usually does. Suppose Apex Bakery posts a notice offering a one-week bonus to all bakers who work at least six months in the kitchen. Charlene works two months before discovering the notice on the bulletin board. Her original ignorance of the offer will not defeat her claim to the bonus if she continues working, for the offer serves as an inducement to complete the performance called for.

Definiteness

The common law reasonably requires that an offer spell out the essential proposed terms with sufficient definiteness—certainty of terms that enables a court to order enforcement or measure damages in the event of a breach. Thus a supposed promise to sell "such coal as the promisor may wish to sell" is not an enforceable term because the seller, the coal company, undertakes no duty to sell anything unless it wishes to do so. Essential terms certainly include price and the work to be done. But not every omission is fatal; for example, as long as a missing term can be fixed by referring to some external standard—such as "no later than the first frost"—the offer is sufficiently definite.

In major business transactions involving extensive negotiations, the parties often sign a preliminary "agreement in principle" before a detailed contract is drafted. These preliminary agreements may be definite enough to create contract liability even though they lack many of the terms found in a typical contract. For example, in a famous 1985 case, a Texas jury concluded that an agreement made "in principle" between the Pennzoil Company and the Getty Oil Company and not entirely finished was binding and that Texaco had unlawfully interfered with their contract. As a result, Texaco was held liable for over $10 billion, which was settled for $3 billion after Texaco went into bankruptcy. *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. Ct. App. 1987).

Offers that state alternatives are definitive if each alternative is definite. David offers Sheila the opportunity to buy one of two automobiles at a fixed price, with delivery in two months and the choice of vehicle left to David. Sheila accepts. The contract is valid. If one of the cars is destroyed in the interval before delivery, David is obligated to deliver the other car. Sometimes, however, what appears to be an offer in the alternative may be something else. Charles makes a deal to sell his business to Bernie. As part of the bargain, Charles agrees not to compete with Bernie for the next two years, and if he does, to pay $25,000. Whether this is an alternative contract depends on the circumstances and intentions of the parties. If it is, then Charles is free to compete as long as he pays Bernie $25,000. On the other hand, the intention might have been to prevent Charles from competing in any event; hence a court could order payment of the $25,000 as damages for a breach and still order Charles to refrain from competition until the expiration of the two-year period.

The UCC Approach to Definiteness

The UCC is generally more liberal in its approach to definiteness than is the common law—at least as the common law was interpreted in the heyday of classical contract doctrine. Section 2-204(3) of the UCC states the rule: "Even though one or more terms are left open, a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy."

The drafters of the UCC sought to give validity to as many contracts as possible and grounded that validity on the intention of the parties rather than on formalistic requirements. As the official comment to Section 2-204(3) notes, "If the parties intend to enter into a binding agreement, this subsection recognizes that agreement as valid in law, despite missing terms, if there is any reasonably certain basis for granting a remedy.… Commercial standards on the point of 'indefiniteness' are intended to be applied." Md. Code Ann., Com. Law, § 2-204(3) cmt. Other sections of the UCC spell out rules for filling in such open provisions as price, performance, and remedies. Md Code Ann., Com. Law, §§ 2-305 through 2-310.

Duration of Offer

An offer need not be accepted on the spot. Because there are numerous ways of conveying an offer and numerous contingencies that may be part of the offer's subject matter, the offeror might find it necessary to give the offeree considerable time to accept or reject the offer. By the same token, an offer cannot remain open forever, so that once given, it never lapses and cannot be terminated. The law recognizes seven ways by which the offer can expire (besides acceptance, of course):

- revocation,
- rejection by the offeree,
- counteroffer,
- acceptance with counteroffer,
- lapse of time,
- death or insanity of a person or destruction of an essential term, and
- illegality.

We will examine each of these in turn.

Revocation

People are free to make offers and, in general, to revoke them.

The general rule, both in common law and under the UCC, is that the offeror may revoke his or her offer at any time before acceptance, even if the offer states that it will remain open for a specified period of time. *See Hall v. Prince George's Co. Democratic Central Comm.*, 431 Md. 108, 64 A.3d 210 (2013).

Neil offers Arlene his car for $5,000 and promises to keep the offer open for ten days. Two days later, Neil calls Arlene to revoke the offer. The offer is terminated, and Arlene's acceptance thereafter, though within the ten days, is ineffective. But if Neil had sent his revocation (the taking back of an offer before it is accepted) by mail, and if Arlene, before she received it, had telephoned her acceptance, there would be a contract, since revocation is effective only when the offeree actually receives it. There is an exception to this rule for offers made to the public through newspaper or like advertisements. The offeror may revoke a public offering by notifying the public by the same means used to communicate the offer. If no better means of notification is reasonably available, the offer is terminated even if a particular offeree had no actual notice.

Revocation may be communicated indirectly. If Arlene had learned from a friend that Neil had sold his car to someone else during the ten day period, she would have had sufficient notice. Any attempt to accept Neil's offer would have been futile.

Irrevocable Offers

Not every type of offer is revocable. One type of offer that cannot be revoked is the option contract (the promisor explicitly agrees for consideration to limit his right to revoke). Arlene tells Neil that she cannot make up her mind in ten days but that she will pay him $25 to hold the offer open for thirty days. Neil agrees. Arlene has an option to buy the car for $5,000; if Neil should sell it to someone else during the thirty days, he will have breached the contract with Arlene. Note that the transactions involving Neil and Arlene consist of two different contracts. One is the promise of a thirty-day option for the promise of $25. It is this contract that makes the option binding and is independent of the original offer to sell the car for $5,000. The offer for the car can be accepted and made part of an independent contract during the option period.

Partial performance of a unilateral contract creates an option. Although the option is not stated explicitly, it is recognized by law in the interests of justice. Otherwise, an offeror could induce the offeree to go to expense and trouble without ever being liable to fulfill his or her part of the bargain. Before the offeree begins to carry out the contract, the offeror is free to revoke the offer. But once performance begins, the law implies an option, allowing the offeree to complete performance according to the terms of the offer. If, however, after a reasonable time, the offeree does not fulfill the terms of the offer, then it may be revoked.

If you hire your neighbor to paint your house, and he comes over and puts up painters tape and paints half your house, you cannot revoke your offer because performance has begun. However, if he stops painting, goes home and does not come back. After a reasonable period of time- which the courts would determine, if he never comes back, you can revoke the contract. You would be liable for the cost of the services he did provide, but can sue for any additional costs you have expended in finding a replacement painter.

Revocability under the UCC

The UCC changes the common-law rule for offers by merchants. Under Section 2-205, a firm offer (a written and signed promise by a merchant to hold an offer to buy or sell goods for some period of time) is irrevocable. Md. Code Ann., Com. Law § 2-205. That is, an option is created, but no consideration is required. The offer must remain open for the time period stated or, if no time period is given, for a reasonable period of time, which may not exceed three months.

Irrevocability by Law

By law, certain types of offers may not be revoked (statutory irrevocability), despite the absence of language to that effect in the offer itself. One major category of such offers is that of the contractor submitting a bid to a public agency. The general rule is that once the period of bidding opens, a bidder on a public contract may not withdraw his or her bid unless the contracting authority consents. The contractor who purports to withdraw is awarded the contract based on the original bid and may be sued for damages for nonperformance.

Rejection by the Offeree

Rejection (a manifestation of refusal to agree to the terms of an offer) of the offer is effective when the offeror receives it. A subsequent change of mind by the offeree cannot revive the offer. Donna calls Chuck to reject Chuck's offer to sell his lawn mower. Chuck is then free to sell it to someone else. If Donna changes her mind and calls Chuck back to accept after all, there still is no contract, even if Chuck has made no further effort to sell the lawn mower. Having rejected the original offer, Donna, by her second call, is not accepting but making a new offer to buy. Suppose Donna had written Chuck to reject, but on changing her mind decided to call to accept before the rejection letter arrived. In that case, the offer would have been accepted.

Counteroffer

A counteroffer, a response that varies the terms of an offer, is a rejection. Jones offers Smith a small parcel of land for $10,000 and says the offer will remain open for one month. Smith responds ten days later, saying he will pay $5,000. Jones's original offer has thereby been rejected. If Jones now declines Smith's counteroffer, may Smith bind Jones to his original offer by agreeing to pay the full $10,000? He may not, because once an original offer is rejected, all the terms lapse. However, an inquiry by Smith as to whether Jones would consider taking less is not a counteroffer and would not terminate the offer.

Acceptance with Counteroffer

This is not really an acceptance at all but is a counteroffer: an acceptance that changes the terms of the offer is a counteroffer and terminates the offer. The common law imposes a mirror image rule: the acceptance must match the offer in all its particulars or the offer is rejected. *See Pavel Enters.*, 342 Md. 143, 674 A.2d 521

(1996). However, if an acceptance that request a change or an addition to the offer that does not require the offeror's assent, then the acceptance is valid.

The broker at Friendly Real Estate offers you a house for $320,000. You accept but include in your acceptance "the vacant lot next door." Your acceptance is a counteroffer, which serves to terminate the original offer. If, instead, you had said, "It's a deal, but I'd prefer it with the vacant lot next door," then there is a contract because you are not demanding that the broker abide by your request. If you had said, "It's a deal, and I'd also like the vacant lot next door," you have a contract, because the request for the lot is a separate offer, not a counteroffer rejecting the original proposal.

The UCC and Counteroffers

The UCC is more liberal than the common law in allowing contracts to be formed despite counteroffers and in incorporating the counteroffers into the contracts. This UCC provision is necessary because the use of routine forms for contracts is very common, and if the rule were otherwise, much valuable time would be wasted by drafting clauses tailored to the precise wording of the routine printed forms. A buyer and a seller send out documents accompanying or incorporating their offers and acceptances, and the provisions in each document rarely correspond precisely. Indeed, it is often the case that one side's form contains terms favorable to it but inconsistent with terms on the other side's form. Section 2-207 of the UCC attempts to resolve this "battle of the forms" by providing that additional terms or conditions in an acceptance operate as such unless the acceptance is conditioned on the offeror's consent to the new or different terms. The new terms are construed as offers but are automatically incorporated in any contract between merchants for the sale of goods unless "(a) the offer expressly limits acceptance to the terms of the offer; (b) [the terms] materially alter it; or (c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received." Md. Code Ann., Com. Law § 2-207.

An example of terms that become part of the contract without being expressly agreed to are clauses providing for interest payments on overdue bills. Examples of terms that would materially alter the contract and hence need express approval are clauses that negate the standard warranties that sellers give buyers on their merchandise. Frequently, parties use contract provisions to prevent the automatic introduction of new terms. A typical seller's provision is as follows:

Any modification of this document by the Buyer, and all additional or different terms included in Buyer's purchase order or any other document responding to this offer, are hereby objected to. BY ORDERING THE GOODS HERE FOR SHIPMENT, BUYER AGREES TO ALL THE TERMS AND CONDITIONS CONTAINED ON BOTH SIDES OF THIS DOCUMENT.

Section 2-207 of the UCC, liberalizing the mirror image rule, is pervasive, covering all sorts of contracts, from those between industrial manufacturers to those between friends.

Lapse of Time

Offers are not open-ended; they lapse after some period of time. An offer may contain its own specific time limitation—for example, "until close of business today." *See Amer. Medicinal Spirits Co. v. Baltimore*, 165 Md. 128, 166 A. 407 (1933) ("If acceptance id made in the manner and within the period fixed by the offer, the offer necessarily expires." *Id.* at 133, 166 A. at 409.)

In the absence of an expressly stated time limit, the common-law rule is that the offer expires at the end of a "reasonable" time. *See Barnes v. Euster*, 240 Md. 603, 214 A.2d 807 (1965). Such a period is a factual question in each case and depends on the particular circumstances, including the nature of the service or property being contracted for, the manner in which the offer is made, and the means by which the acceptance is expected to be made. Whenever the contract involves a speculative transaction—the sale of securities or land, for instance—the time period will depend on the nature of the security and the risk involved. In general, the greater the risk to the seller, the shorter the period of time.

Karen offers to sell Gary a block of oil stocks that are fluctuating rapidly hour by hour. Gary receives the offer an hour before the market closes; he accepts by fax two hours after the market has opened the next morning and after learning that the stock has jumped up significantly. The time period has lapsed if Gary was accepting a fixed price that Karen set, but it may still be open if the price is market price at time of delivery. (Under Section 41 of the Restatement, an offer made by mail is "seasonably accepted if an acceptance is mailed at any time before midnight on the day on which the offer is received.")

For unilateral contracts, both the common law and the UCC require the offeree to notify the offeror that he has begun to perform the terms of the contract. Without notification, the offeror may, after a reasonable time, treat the offer as having lapsed.

Death or Insanity of the Offeror

The death or insanity of the offeror prior to acceptance terminates the offer; the offer is said to die with the offeror. (Notice, however, that the death of a party to a *contract* does not necessarily terminate the contract: the estate of a deceased person may be liable on a contract made by the person before death.)

Destruction of Subject Matter Essential to the Offer

Destruction of something essential to the contract also terminates the offer. You offer to sell your car, but the car is destroyed in an accident before your offer is accepted; the offer is terminated.

Postoffer Illegality

A statute making unlawful the object of the contract will terminate the offer if the statute takes effect after the offer was made. Thus an offer to sell a quantity of herbal weight-loss supplements will terminate if the Food and Drug Administration outlaws the sale of such supplements.

The Acceptance

To result in a legally binding contract, an offer must be accepted by the offeree. "A contract if formed when a unrevoked offer made by one person is accepted by another." *Prince George's Co. v. Silverman*, 58 Md. App. 41, 57, 472 A.2d 104, 112 (1984). Just as the law helps define and shape an offer and its duration, so the law governs the nature and manner of acceptance. The Restatement defines acceptance of an offer as "a manifestation of assent to the terms thereof made by the offeree in a manner invited or required by the offer." Restat 2d of Contracts, § 24. The assent may be either by the making of a mutual promise or by performance or partial performance. If there is doubt about whether the offer requests a return promise or a return act, the Restatement, Section 32, provides that the offeree may accept with either a promise or performance. Restat 2d of Contracts, § 23. The UCC also adopts this view; under Section 2-206(1)(a), "an offer to make a contract shall be construed as inviting acceptance in any manner and by any medium reasonable in the circumstances" unless the offer unambiguously requires a certain mode of acceptance. Md. Code Ann., Com. Law, § 2-206(1)(a).

Who May Accept?

The identity of the offeree is usually clear, even if the name is unknown. The person to whom a promise is made is ordinarily the person whom the offeror contemplates will make a return promise or perform the act requested. But this is not invariably so. A promise can be made to one person who is not expected to do anything in return. The consideration necessary to weld the offer and acceptance into a legal contract can be given by a third party. Under the common law, whoever is invited to furnish consideration to the offeror is the offeree, and only an offeree may accept an offer. A common example is sale to a minor. George promises to sell his automobile to Bartley, age seventeen, if Bartley's father will promise to pay $3,500 to George. Bartley is the promisee (the person to whom the promise is made) but not the offeree; Bartley cannot legally accept George's offer. Only Bartley's father, who is called on to pay for the car, can accept, by making the promise requested. And notice what might seem obvious: a *promise* to perform as requested in the offer is itself a binding acceptance.

When Is Acceptance Effective?

As noted previously, an offer, a revocation of the offer, and a rejection of the offer are not effective until received. The same rule does not always apply to the acceptance.

Instantaneous Communication

Of course, in many instances the moment of acceptance is not in question: in face-to-face deals or transactions negotiated by telephone, the parties extend an offer and accept it instantaneously during the course of the conversation. But problems can arise in contracts negotiated through correspondence.

Stipulations as to Acceptance

One common situation arises when the offeror stipulates the mode of acceptance (e.g., return mail, fax, or carrier pigeon). If the offeree uses the stipulated mode, then the acceptance is deemed effective when sent. Even though the offeror has no knowledge of the acceptance at that moment, the contract has been formed. Moreover, according to the Restatement, Section 60, if the offeror says that the offer can be accepted only by the specified mode, that mode must be used. (It is said that "the offeror is the master of the offer.") Restat 2d of Contracts, § 60.

If the offeror specifies no particular mode, then acceptance is effective when transmitted, as long as the offeree uses a reasonable method of acceptance. It is implied that the offeree can use the same means used by the offeror or a means of communication customary to the industry.

The "Mailbox Rule"

The use of the postal service is customary, so acceptances are considered effective when mailed, regardless of the method used to transmit the offer. Indeed, the so-called mailbox rule has a lineage tracing back more than one hundred years to the English courts. *Adams v. Lindsell*, 1 Barnewall & Alderson 681 (K.B. 1818).

The mailbox rule may seem to create particular difficulties for people in business, since the acceptance is effective even though the offeror is unaware of the acceptance, and even if the letter is lost and never arrives. But the solution is the same as the rationale for the rule. In contracts negotiated through correspondence, there will always be a burden on one of the parties. If the rule were that the acceptance is not effective until received by the offeror, then the offeree would be on tenterhooks, rather than the other way around, as is the case with the present rule. As between the two, it seems fairer to place the burden on the offeror, since he or she alone has the power to fix the moment of effectiveness. All the offeror need do is specify in the offer that acceptance is not effective until received.

In all other cases—that is, when the offeror fails to specify the mode of acceptance and the offeree uses a mode that is not reasonable—acceptance is deemed effective only when received.

Acceptance "Outruns" Rejection

When the offeree sends a rejection first and then later transmits a superseding acceptance, the "effective when received" rule also applies. Suppose a seller offers a buyer two cords of firewood and says the offer will remain open for a week. On the third day, the buyer writes the seller, rejecting the offer. The following evening, the buyer rethinks his firewood needs, and on the morning of the fifth day, he sends an e-mail accepting the seller's terms. The previously mailed letter arrives the following day. Since the letter had not yet been received, the offer had not been rejected. For there to be a valid contract, the e-mailed acceptance must arrive before the mailed rejection. If the e-mail were hung up in cyberspace, although through no fault of the buyer, so that the letter arrived first, the seller would be correct in assuming the offer was terminated—even if the e-mail arrived a minute later. In short, where "the acceptance outruns the rejection" the acceptance is effective. See Figure 7.

	When Sent	When Recieved
1. Offer		✓
2. Revocation of Offer		✓
3. Rejection		✓
4. Acceptance	If reasonable or by specified mode	If unreasonable or mode not specified or after rejection sent

Figure 6 When Is Communication Effective?

Electronic Communications

Electronic communications have, of course, become increasingly common. Many contracts are negotiated by e-mail, accepted and "signed" electronically. Generally speaking, this does not change the rules. The Uniform Electronic Transactions Act (UETA) was promulgated (i.e., disseminated for states to adopt) in 1999. It is one of a number of uniform acts, like the Uniform Commercial Code. As of 2017, forty-seven states, the District of Columbia and the US Virgin Islands had adopted the statute. The introduction to the act provides that "the purpose of the UETA is to remove barriers to electronic commerce by validating and effectuating electronic records and signatures" (National Conference of Commissioners on Uniform State Laws 1).

In general, the UETA provides the following:

1. A record or signature may not be denied legal effect or enforceability solely because it is in electronic

2. A contract may not be denied legal effect or enforceability solely because an electronic record was used in its formati
3. If a law requires a record to be in writing, an electronic record satisfies the law.
4. If a law requires a signature, an electronic signature satisfies the law.

The UETA, though, doesn't address all the problems with electronic contracting. Clicking on a computer screen may constitute a valid acceptance of a contractual offer, but only if the offer is clearly communicated. In *Specht v. Netscape Communications Corp*., 306 F.3d 17 (2d Cir. 2002), customers who had downloaded a free online computer program complained that it effectively invaded their privacy by inserting into their machines "cookies"; they wanted to sue, but the defendant said they were bound to arbitration. They had clicked on the Download button, but hidden below it were the licensing terms, including the arbitration clause. The federal court of appeals held that there was no valid acceptance. The court said, "We agree with the district court that a reasonably prudent Internet user in circumstances such as these would not have known or learned of the existence of the license terms before responding to defendants' invitation to download the free software, and that defendants therefore did not provide reasonable notice of the license terms. In consequence, the plaintiffs' bare act of downloading the software did not unambiguously manifest assent to the arbitration provision contained in the license terms." *Id.* at 20.

If a faxed document is sent but for some reason not received or not noticed, the emerging law is that the mailbox rule does not apply. A court would examine the circumstances with care to determine the reason for the nonreceipt or for the offeror's failure to notice its receipt. A person has to have fair notice that his or her offer has been accepted, and modern communication makes the old-fashioned mailbox rule—that acceptance is effective upon dispatch—problematic. See, for example, *Clow Water Systems Co. v. National Labor Relations Board*, 92 F.3d 441 (6th Cir. 1996) ("If the parties, expressly or by conduct, agree to a method of communication, and use the agreed-upon method, we will not require actual knowledge of the communication on the part of the recipient. If the parties did not agree to the method of communication utilized, and if there is no pattern of conduct reflecting acquiescence to the method of communication utilized, we will not impute notice of the communication to the recipient." *Id.* at 445.)

Silence as Acceptance

General Rule: Silence Is Not Acceptance

Ordinarily, for there to be a contract, the offeree must make some positive manifestation of assent to the offeror's terms. The offeror cannot usually word his offer in such a way that the offeree's failure to respond can be construed as an acceptance.

Exceptions

The Restatement (Second) of Contracts, Section 69, gives three situations, however, in which silence can operate as an acceptance.

1. The first occurs when the offeree avails himself of services proffered by the offeror, even though he could have rejected them and had reason to know that the offeror offered them expecting compensation.
2. The second situation occurs when the offer states that the offeree may accept without responding and the offeree, remaining silent, intends to accept.
3. The third situation is that of previous dealings, in which only if the offeree intends not to accept is it reasonable to expect him to say so. Restat 2d of Contracts § 69; *see also Cochran v. Norkunas*, 398 Md. 1, 919 A.2d 700 (2007).

As an example of the first type of acceptance by silence, assume that a carpenter happens by your house and sees a collapsing porch. He spots you in the front yard and points out the deterioration. “I’m a professional carpenter,” he says, “and between jobs. I can fix that porch for you. Somebody ought to.” You say nothing. He goes to work. There is an implied contract, with the work to be done for the carpenter’s usual fee.

To illustrate the second situation, suppose that a friend has left her car in your garage. The friend sends you a letter in which she offers you the car for $4,000 and adds, “If I don’t hear from you, I will assume that you have accepted my offer.” If you make no reply, with the intention of accepting the offer, a contract has been formed.

In the third situation, if you have a standing order with your local grocery store to deliver two dozen eggs to your restaurant each Monday. And, one Monday the store delivers the eggs as per your prior dealings but you had decided on Sunday that you did not need eggs this week- but did not inform the grocery store of your decision, your failure to reject them will constitute an acceptance.

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Consideration

This section continues our inquiry into whether the parties created a valid contract. Previously, we saw that the first requisite of a valid contract is an agreement: offer and acceptance. In this section, we assume that agreement has been reached and concentrate on one of its crucial aspects: the existence of consideration. Which of the following, if any, is a contract?

1. Betty offers to give a book to Lou. Lou accepts.

2. Betty offers Lou the book in exchange for Lou's promise to pay $25.00. Lou accepts.

3. Betty offers to give Lou the book if Lou promises to pick it up at Betty's house. Lou agrees.

In American law, only the second situation is a binding contract, because only that contract contains consideration, a set of mutual promises in which each party agrees to give up something to the benefit of the other. *See Shimp v. Shimp*, 287 Md. 372, 412 A.2d 1228 (1980); *Pettiford v. Next Generation Trust Ser.*, 467 Md. 624, 652, 226 A.3d 15, 31 (2020) (where no return performance on promise was bargained for there was no consideration).

The question of what constitutes a binding contract has been answered differently throughout history and in other cultures. For example, under Roman law, a contract without consideration was binding if certain formal requirements were met. And in the Anglo-American tradition, the presence of a seal—the wax impression affixed to a document—was once sufficient to make a contract binding without any other consideration. The seal is no longer a substitute for consideration, although in some states it creates a presumption of consideration; in 49 states, the UCC abolished the seal on contracts for the sale of goods. (Louisiana has not adopted UCC Article 2.) The affixing of a seal to a writing evidencing a contract for sale or an offer to buy or sell goods does not constitute the writing a sealed instrument and the law with respect to sealed instruments does not apply to such a contract or offer. Md. Code Ann., Com. Law § 2-203.

Whatever its original historical purposes, and however apparently arcane, the doctrine of consideration serves some still-useful purposes. It provides objective evidence for asserting that a contract exists; it distinguishes between enforceable and unenforceable bargains; and it is a check against rash, unconsidered action, against thoughtless promise making (Fuller 799).

A Definition of *Consideration*

Consideration is said to exist when the promisor receives some benefit for his promise and the promisee gives up something in return; it is the bargained-for price; you pay for what you get. That may seem simple enough. But as with much in the law, the complicating situations are never very far away. The "something" that is promised or delivered cannot be just anything, such as a feeling of pride, warmth, amusement, or friendship; it must be something known as a legal detriment—an act, forbearance, or a promise of such from the promisee. The detriment need not be an actual detriment; it may in fact be a benefit to the promisee, or at least not a loss. The detriment to one side is usually a legal benefit to the other, but the detriment to the promisee need not confer a tangible benefit on the promisor; the promisee can agree to forego something without that something being given to the promisor. Whether consideration is legally sufficient has nothing to do with whether it is morally or economically adequate to make the bargain a fair one. Moreover, legal consideration need not even be certain; it can be a promise contingent on an event that may never happen. Consideration is a legal concept, and it centers on the giving up of a legal right or benefit.

Consideration has two elements. The first, as just outlined, is whether the promisee has incurred a legal detriment—given up something, paid some "price," though it may be, for example, the promise to do something, like paint a house. The second element is whether the legal detriment was bargained for: did the promisor specifically intend the act, forbearance, or promise in return for his promise? Applying this two-pronged test to the three examples given at the outset of the chapter, we can easily see why only in the second is there legally sufficient consideration. In the first, Lou incurred no legal detriment; he made no pledge to act or to forbear from acting, nor did he in fact act or forbear from acting. In the third example, what might appear to be such a promise is not really so. Betty made a promise on a condition that Lou comes to her house; the intent clearly is to make a gift.

Legal Sufficiency

As suggested above, what is required in contract is the exchange of a legal detriment and a legal benefit; if that happens, the consideration is said to have legal sufficiency.

Actual versus Legal Detriment

Suppose Phil offers George $500 if George will quit smoking for one year. Is Phil's promise binding? Because George is presumably benefiting by making and sticking to the agreement—surely his health will improve if he gives up smoking—how can his act be considered a legal detriment? The answer is that there is forbearance on George's part: George is legally entitled to smoke, and by contracting not to, he suffers a loss of his legal right to do so. This is a legal detriment; consideration does not require an actual detriment.

Adequacy of Consideration

Scrooge offers to buy Caspar's motorcycle, worth $700, for $10 and a shiny new fountain pen (worth $5). Caspar agrees. Is this agreement supported by adequate consideration? Yes, because both have agreed to give up something that is theirs: Scrooge, the cash and the pen; Caspar, the motorcycle. Courts are not generally concerned with the economic adequacy of the consideration but instead with whether it is present. As Judge Richard A. Posner puts it, "To ask whether there is consideration is simply to inquire whether the situation is one of exchange and a bargain has been struck. To go further and ask whether the consideration is adequate would require the court to do what…it is less well equipped to do than the parties—decide whether the price (and other essential terms) specified in the contract are reasonable." In short, "courts do not inquire into the adequacy of consideration." Richard A. Posner, *Economic Analysis of Law* (New York: Aspen, 1973), 46.

Of course, normally, parties to contracts will not make such a one-sided deal as Scrooge and Caspar's. But there is a common class of contracts in which nominal consideration—usually one dollar—is recited in printed forms. Usually these are option contracts, in which "in consideration of one dollar in hand paid and receipt of which is hereby acknowledged" one party agrees to hold open the right of the other to make a purchase on agreed terms. The courts will enforce these contracts if the dollar is intended "to support a short-time option proposing an exchange on fair terms." Restat 2d of Contracts, § 87(b). If, however, the option is for an unreasonably long period of time and the underlying bargain is unfair (the Restatement gives as an example a ten-year option permitting the optionee to take phosphate rock from a widow's land at a per-ton payment of only one-fourth the prevailing rate), then the courts are unlikely to hold that the nominal consideration makes the option irrevocable.

Because the consideration on such option contracts is nominal, its recital in the written instrument is usually a mere formality, and it is frequently never paid; in effect, the recital of nominal consideration is false. Nevertheless, the courts will enforce the contract—precisely because the recital became a formality and nobody objects to the charade. Moreover, it would be easy enough to upset an option based on nominal consideration by falsifying oral testimony that the dollar was never paid or received. In a contest between oral testimonies where the incentive to lie is strong and there is a written document clearly incorporating the parties' agreement, the courts prefer the latter. However, as the case of *Board of Control of Eastern Mich. Univ. v. Burgess*, 206 N.W.2d 256 (Mich. 1973) demonstrates, the state courts are not uniform on this point, and it is a safe practice always to deliver the consideration, no matter how nominal. In *Burgess*, the option contract called for a nominal consideration of $1.00 which was not paid or tendered, as such the court held the option contract was not valid. *Id.* at 258-59.

Applications of the Legal Sufficiency Doctrine

This section discusses several common circumstances where the issue of whether the consideration proffered (offered up) is adequate.

Threat of Litigation: Covenant Not to Sue

Because every person has the legal right to file suit if he or she feels aggrieved, a promise to refrain from going to court is sufficient consideration to support a promise of payment or performance. In *Dedeaux v. Young*, 170 So.2d 561 (Miss. 1965), Dedeaux purchased property and promised to make certain payments to Young, the broker. But Dedeaux thereafter failed to make these payments, and Young threatened suit; had he filed papers in court, the transfer of title could have been blocked. To keep Young from suing, Dedeaux promised to pay a 5 percent commission if Young would stay out of court. Dedeaux later resisted paying on the ground that he had never made such a promise and that even if he had, it did not amount to a contract because there was no consideration from Young. The court disagreed, holding that the evidence supported Young's contention that Dedeaux had indeed made such a promise and upholding Young's claim for the commission because "a request to forbear to exercise a legal right has been generally accepted as sufficient consideration to support a contract." If Young had had no grounds to sue—for example, if he had threatened to sue a stranger, or if it could be shown that Dedeaux had no obligation to him originally— then there would have been no consideration because Young would not have been giving up a legal right.

A promise to forebear suing in return for settlement of a dispute is called a covenant not to sue (*covenant* is another word for agreement).

Accord and Satisfaction Generally

Frequently, the parties to a contract will dispute the meaning of its terms and conditions, especially the amount of money actually due. When the dispute is genuine (and not the unjustified attempt of one party to avoid paying a sum clearly due), it can be settled by the parties' agreement on a fixed sum as the amount due. This second agreement, which substitutes for the disputed first agreement, is called an accord, and when the payment or other term is discharged, the completed second contract is known as an accord and satisfaction. A suit brought for an alleged breach of the original contract could be defended by citing the later accord and satisfaction.

An accord is a contract and must therefore be supported by consideration. Suppose Jan owes Andy $7,000, due November 1. On November 1, Jan pays only $3,500 in exchange for Andy's promise to release Jan from the remainder of the debt. Has Andy (the promisor) made a binding promise? He has not, because there is no consideration for the accord. Jan incurred no detriment; she received something (release of the obligation to pay the remaining $3,500), but she gave up nothing. But if Jan and Andy agreed that Jan would pay the $3,500 on October 25, then there would be consideration; Jan incurred a legal detriment by obligating herself to make a payment earlier than the original contract required her to. If Jan paid the $3,500 on November 11 and gave Andy something else agreed to—a pen, a keg of beer, a peppercorn—the required detriment would also be present.

Let's take a look at some examples of the accord and satisfaction principle. The dispute that gives rise to the parties' agreement to settle by an accord and satisfaction may come up in several typical ways: where there is an:

1. unliquidated debt;
2. a disputed debt;
3. an "in-full-payment check" for less than what the creditor claims is due;
4. unforeseen difficulties that give rise to a contract modification or a novation;
5. a composition among creditors;
6. a preexisting duty; or
7. illusory promises.

But no obligation ever arises—and no real legal dispute can arise—where a person promises a benefit if someone will do that which he has a preexisting obligation to, or where a person promises a benefit to someone not to do that which the promisee is already disallowed from doing, or where one makes an illusory promise.

Settling an Unliquidated Debt

An unliquidated debt is one that is uncertain in amount. Such debts frequently occur when people consult professionals in whose offices precise fees are rarely discussed, or where one party agrees, expressly or by implication, to pay the customary or reasonable fees of the other without fixing the exact amount. It is certain that a debt is owed, but it is not certain how much. (A liquidated debt, on the other hand, is one that is fixed in amount, certain. A debt can be liquidated by being written down in unambiguous terms—"IOU $100"—or by being mathematically ascertainable—$1 per pound of ice ordered and 60 pounds delivered; hence the liquidated debt is $60.)

Typically, when parties to a unliquidated debt agree to settle for a set amount, the parties enter into a written release whereby the parties agree to a specific sum in settlement of all claims, counterclaims, damages, etc. from either side relating to the matter underlying the debt.

Here is how the matter plays out: Assume a patient goes to the hospital for a gallbladder operation. The cost of the operation has not been discussed beforehand in detail, although the cost in the metropolitan area is normally around $8,000. After the operation, the patient and the surgeon agree on a bill of $6,000. The patient pays the bill; a month later the surgeon sues for another $2,000. Who wins? The patient: he has forgone his right to challenge the reasonableness of the fee by agreeing to a fixed amount payable at a certain time. The agreement liquidating the debt is an accord and is enforceable. If, however, the patient and the surgeon agreed on an $8,000 fee before the operation, and if the patient arbitrarily refused to pay this liquidated debt unless the surgeon agreed to cut her fee in half, then the surgeon would be entitled to recover the other half in a lawsuit, because the patient would have given no consideration—given up nothing, "suffered no detriment"—for the surgeon's subsequent agreement to cut the fee.

Settling a Disputed Debt

A **disputed debt** arises where the parties *did* agree on (liquidated) the price or fee but subsequently get into a dispute about its fairness, and then settle. When this dispute is settled, the parties have given consideration to an agreement to accept a fixed sum as payment for the amount due. Assume that in the gallbladder case the patient agrees in advance to pay $8,000. Eight months after the operation and as a result of nausea and vomiting spells, the patient undergoes a second operation; the surgeons discover a surgical sponge embedded in the patient's intestine. The patient refuses to pay the full sum of the original surgeon's bill; they settle on $6,000, which the patient pays. This is a binding agreement because subsequent facts arose to make legitimate the patient's quarrel over his obligation to pay the full bill. As long as the dispute is based in fact and is not trumped up, as long as the promisee is acting in good faith, then consideration is present when a disputed debt is settled.

The "In-Full-Payment" Check Situation

To discharge his liquidated debt for $8,000 to the surgeon, the patient sends a check for $6,000 marked "payment in full." The surgeon cashes it. There is no dispute. May the surgeon sue for the remaining $2,000? This may appear to be an accord: by cashing the check, the surgeon seems to be agreeing with the patient to accept the $6,000 in full payment. But consideration is lacking. Because the surgeon is owed more than the face amount of the check, she causes the patient no legal detriment by accepting the check. If the rule were otherwise, debtors could easily tempt hard-pressed creditors to accept less than the amount owed by presenting immediate cash. The key to the enforceability of a "payment in full" legend is the character of the debt. If unliquidated, or if there is a dispute, then "payment in full" can serve as accord and satisfaction when written on a check that is accepted for payment by a creditor. But if the debt is liquidated and undisputed, there is no consideration when the check is for a lesser amount. (However, it is arguable that if the check is considered to be an agreement modifying a sales contract, no consideration is necessary.) Md Code Ann., Com. Law § 2-209(1) ("an agreement modifying a contracts within this Title {Article 2 Sales] needs no consideration to be binding").

Unforeseen Difficulties

An unforeseen difficulty arising after a contract is made may be resolved by an accord and satisfaction, too. Difficulties that no one could foresee can sometimes serve as catalyst for a further promise that may appear to be without consideration but that the courts will enforce nevertheless. Suppose Peter contracts to build Jerry a house for $390,000. While excavating, Peter unexpectedly discovers quicksand, the removal of which will cost an additional $10,000. To ensure that Peter does not delay, Jerry promises to pay Peter $10,000 more than originally agreed. But when the house is completed, Jerry reneges on his promise. Is Jerry liable? Logically perhaps not: Peter incurred no legal detriment in exchange for the $10,000; he already contracted to build the house. But most courts would allow Peter to recover on the theory that the original contract was terminated, or modified, either by mutual agreement or by an implied condition that the original contract would be discharged if unforeseen difficulties developed. In short, the courts will enforce the parties' own mutual recognition that the unforeseen conditions had made the old contract unfair. The parties either modified their original contract (which requires consideration at common law) or ended their original contract and made a new one (called a novation).

It is a question of fact whether the new circumstance is new and difficult enough to make a preexisting obligation into an unforeseen difficulty. Obviously, if Peter encounters only a small pocket of quicksand— say two gallons' worth—he would have to deal with it as part of his already-agreed-to job. If he encounters as much quicksand as would fill an Olympic-sized swimming pool, that's clearly unforeseen, and he should get extra to deal with it. Someplace between the two quantities of quicksand there is enough of the stuff so that Peter's duty to remove it is outside the original agreement and new consideration would be needed in exchange for its removal. In fact, Peter's contract probably explicitly addressed what would be considered a "differing site condition", which are those site conditions that are substantively different from what the parties believed them to be at the time of contracting.

Creditors' Composition

A creditors' composition may give rise to debt settlement by an accord and satisfaction. It is an agreement whereby two or more creditors of a debtor consent to the debtor's paying them pro rata shares of the debt due in full satisfaction of their claims. A composition agreement can be critically important to a business in trouble; through it the business might manage to stave off bankruptcy. Even though the share accepted is less than the full amount due and is payable after the due date so that consideration appears to be lacking, courts routinely enforce these agreements. The promise of each creditor to accept a lesser share than that owed in return for getting something is taken as consideration to support the promises of the others. A debtor has $3,000 on hand. He owes $3,000 each to A, B, and C. Creditors A, B, and C agree to accept $1,000 each and discharge the debtor. Each creditor gave up $2,000 but in return at least received something, the $1,000. Without the composition, one might have received the entire amount owed her, but the others would have received nothing.

Preexisting Duty

Not amenable to settlement by an accord and satisfaction is the situation where a party has a **preexisting duty** and he or she is offered a benefit to discharge it. *State Constr. Corp. v. Slone Assocs.*, 385 F. Supp. 3d 449 (D. Md. 2019). When the only consideration offered the promisor is an act or promise to act to carry out a preexisting duty, there is no valid contract.

As *Denney v. Reppert*, 432 S.W.2d 647 (Ky. 1968), makes clear, the promisee suffers no legal detriment in promising to undertake that which he is already obligated to do. Where a person is promised a benefit not to do that which he is already disallowed from doing, there is no consideration. David is sixteen years old; his uncle promises him $50 if he will refrain from smoking. The promise is not enforceable: legally, David already must refrain from smoking, so he has promised to give up nothing to which he had a legal right. As noted previously, the difficulty arises where it is unclear whether a person has a preexisting obligation or whether such unforeseen difficulties have arisen as to warrant the recognition that the parties have modified the contract or entered into a novation. What if Peter insists on additional payment for him to remove one wheelbarrow full of quicksand from the excavation? Surely that's not enough "unforeseen difficulty." How much quicksand is enough?

Illusory Promises

Not every promise is a pledge to do something. Sometimes it is an illusory promise, where the terms of the contract really bind the promisor to give up nothing, to suffer no detriment. For example, Lydia offers to pay Juliette $10 for mowing Lydia's lawn. Juliette promises to mow the lawn if she feels like it. May Juliette enforce the contract? No, because Juliette incurred no legal detriment; her promise is illusory, since by doing nothing she still falls within the literal wording of her promise. The doctrine that such bargains are unenforceable is sometimes referred to as the rule of mutuality of obligation: if one party to a contract has not made a binding obligation, neither is the other party bound. The illusory promise presents a special problem in agreements for exclusive dealing, outputs, and needs contracts.

Exclusive Dealing Agreement

In an exclusive dealing agreement, one party (the franchisor) promises to deal solely with the other party (the franchisee)—for example, a franchisor-designer agrees to sell all of her specially designed clothes to a particular department store (the franchisee). In return, the store promises to pay a certain percentage of the sales price to the designer. On closer inspection, it may appear that the store's promise is illusory: it pays the designer only if it manages to sell dresses, but it may sell none. The franchisor-designer may therefore attempt to back out of the deal by arguing that because the franchisee is not obligated to do anything, there was no consideration for her promise to deal exclusively with the store.

Courts, however, have upheld exclusive dealing contracts on the theory that the franchisee has an obligation to use reasonable efforts to promote and sell the product or services. This obligation may be spelled out in the contract or implied by its terms. In the classic statement of this concept, Judge Benjamin N. Cardozo, then on the New York Court of Appeals, in upholding such a contract, declared: It is true that [the franchisee] does not promise in so many words that he will use reasonable efforts to place the defendant's endorsements and market her designs. We think, however, that such a promise is fairly to be implied. The law has outgrown its primitive stage of formalism when the precise word was the sovereign talisman, and every slip was fatal. It takes a broader view today. A promise may be lacking, and yet the whole writing may be "instinct with an obligation," imperfectly expressed.…His promise to pay the defendant one-half of the profits and revenues resulting from the exclusive agency and to render accounts monthly was a promise to use reasonable efforts to bring profits and revenues into existence. *Otis F. Wood v. Lucy, Lady Duff-Gordon*, 118 N.E. 214, 215 (N. Y. 1917).

The UCC follows the same rule. In the absence of language specifically delineating the seller's or buyer's duties, an exclusive dealing contract imposes "an obligation by the seller to use best efforts to supply the goods and by the buyer to use best efforts to promote their sale." Md. Code Ann., Com. Law § 2-306(2).

Outputs Contracts and Requirements Contracts

A similar issue arises with outputs contracts and needs contracts. In an outputs contract, the seller—say a coal company—agrees to sell its entire yearly output of coal to an electric utility. Has it really agreed to produce and sell any coal at all? What if the coal-mine owner decides to shut down production to take a year's vacation—is that a violation of the agreement? Yes. The law imposes upon the seller here a duty to produce and sell a reasonable amount. Similarly, if the electric utility contracted to buy all its requirements of coal from the coal company—a requirements contract—could it decide to stop operation entirely and take no coal? No, it is required to take a reasonable amount.

Promises Enforceable without Consideration

For a variety of policy reasons, courts will enforce certain types of promises even though consideration may be absent. Some of these are governed by the UCC; others are part of the established common law.

Promises Enforceable without Consideration at Common Law

Past Consideration

Ordinarily, past consideration is not sufficient to support a promise. By past consideration, the courts mean an act that could have served as consideration if it had been bargained for at the time but that was not the subject of a bargain. For example, Mrs. Ace's dog Fluffy escapes from her condo at dusk. Robert finds Fluffy, sees Mrs. Ace, who is herself out looking for her pet, and gives Fluffy to her. She says, "Oh, thank you for finding my dear dog. Come by my place tomorrow morning and I'll give you $50 as a reward." The next day Robert stops by Mrs. Ace's condo, but she says, "Well, I don't know. Fluffy soiled the carpet again last night. I think maybe a $25 reward would be plenty." Robert cannot collect the $50. Even though Mrs. Ace might have a moral obligation to pay him and honor her promise, there was no consideration for it. Robert incurred no legal detriment; his contribution— finding the dog—was paid out before her promise, and his past consideration is invalid to support a contract. There was no bargained-for exchange.

However, a valid consideration, given in the past to support a promise, can be the basis for another, later contract under certain circumstances. *Reece v. Reece*, 239 Md. 649 (1965) (past services performed at the request of the promisor are sufficient legal consideration to support a present promise to pay). These occur when a person's duty to act for one reason or another has become no longer binding. If the person then makes a new promise based on the unfulfilled past duty, the new promise is binding without further consideration. Three types of cases follow.

Promise Revived after Statute of Limitations Has Passed

A statute of limitations is a law requiring a lawsuit to be filed within a specified period of years. For example, in many states a contract claim must be sued on within six years; if the plaintiff waits longer than that, the claim will be dismissed, regardless of its merits. When the time period set forth in the statute of limitations has lapsed, the statute is said to have "run." If a debtor renews a promise to pay or acknowledges a debt after the running of a statute of limitations, then under the common law the promise is binding, although there is no consideration in the usual sense. In many states, this promise or acknowledgment must be in writing and signed by the debtor. Also, in many states, the courts will imply a promise or acknowledgment if the debtor makes a partial payment after the statute has run. However, when the creditor does an act discharging the debtor in whole or in part, the pre-existing liability is released and cannot form sufficient consideration for a new promise to pay the old debt. *Ingersoll v. Martin*, 58 Md. 67, 77 (1882).

Voidable Duties

Some promises that might otherwise serve as consideration are voidable by the promisor, for a variety of reasons, including infancy, fraud, duress, or mistake. But a voidable contract does not automatically become void, and if the promisor has not avoided the contract but instead thereafter renews his promise, it is binding. For example, Mr. Melvin sells his bicycle to Seth, age 13. Seth promises to pay Mr. Melvin $100. Seth may repudiate the contract, but he does not. When he turns 18, he renews his promise to pay $100. This promise is binding. (However, a promise made up to the time he turned 18 would not be binding, since he would still have been a minor.)

Promissory Estoppel

As previously discussed, promissory estoppel represents another type of promise that the courts will enforce without consideration. Simply stated, promissory estoppel means that the courts will stop the promisor from claiming that there was no consideration. The doctrine of promissory estoppel is invoked in the interests of justice when three conditions are met:

(1) the promise is one that the promisor should reasonably expect to induce the promisee to take action or forbear from taking action of a definite and substantial character;
(2) the action or forbearance is taken; and
(3) injustice can be avoided only by enforcing the promise.

The complete phraseology is "promissory estoppel with detrimental reliance."

Timko served on the board of trustees of a school. He recommended that the school purchase a building for a substantial sum of money, and to induce the trustees to vote for the purchase, he promised to help with the purchase and to pay at the end of five years the purchase price less the down payment. At the end of four years, Timko died. The school sued his estate, which defended on the ground that there was no consideration for the promise. Timko was promised or given nothing in return, and the purchase of the building was of no direct benefit to him (which would have made the promise enforceable as a unilateral contract). The court ruled that under the three-pronged promissory estoppel test, Timko's estate was liable. *Estate of Timko v. Oral Roberts Evangelistic Assn.*, 215 N.W.2d 750 (Mich. Ct. App. 1974).

Cases involving pledges of charitable contributions have long been troublesome to courts. Recognizing the necessity to charitable institutions of such pledges, the courts have also been mindful that a mere pledge of money to the general funds of a hospital, university, or similar institution does not usually induce substantial action but is, rather, simply a promise without consideration. When the pledge does prompt a charitable institution to act, promissory estoppel is available as a remedy. In about one-quarter of the states, another doctrine is available for cases involving simple pledges: the "mutual promises" theory, whereby the pledges of many individuals are taken as consideration for each other and are binding against each promisor. This theory was not available to the plaintiff in *Timko* because his was the only promise.

Moral Obligation

The Restatement allows, under some circumstances, the enforcement of past-consideration contracts. It provides as follows in Section 86, "Promise for Benefit Received": A promise made in recognition of a benefit previously received by the promisor from the promisee is binding to the extent necessary to prevent injustice. A promise is not binding under Subsection (1) if the promisee conferred the benefit as a gift or for other reasons the promisor has not been unjustly enriched; or to the extent that its value is disproportionate to the benefit. Restat 2d of Contracts, § 86.

Promises Enforceable without Consideration by Statute

We have touched on several common-law exceptions to the consideration requirement. Some also are provided by statute.

Under the UCC

The UCC permits one party to discharge, without consideration, a claim or right arising out of an alleged breach of contract by the other party. This is accomplished by delivering to the other party a signed written waiver or renunciation. Md Code Ann., Com Law, § 1-107. This provision applies to any contract governed by the UCC and is not limited to the sales provisions of Article 2.

The UCC also permits a party to discharge the other side without consideration when there is no breach, and it permits parties to modify their Article 2 contract without consideration. Md. Code Ann., Com. Law §§ 2-209(4), 2-209(1). The official comments to the UCC section add the following: "However, modifications made thereunder must meet the test of good faith imposed by this Act. The effective use of bad faith to escape performance on the original contract terms is barred, and the extortion of a "modification" without legitimate commercial reason is ineffective as a violation of the duty of good faith." *Id* at cmt. 2.

Seller agrees to deliver a ton of coal within seven days. Buyer needs the coal sooner and asks Seller to deliver within four days. Seller agrees. This promise is binding even though Seller received no additional consideration beyond the purchase price for the additional duty agreed to (the duty to get the coal to Buyer sooner than originally agreed). Per section 2-209(1), modification of an existing contract, changing the delivery times would not require new consideration. Md. Code Ann., Com. Law § 2-209. The UCC allows a merchant's firm offer, signed, in writing, to bind the merchant to keep the offer to buy or sell open without consideration. Md. Code Ann., Com. Law § 2-205. This is the UCC's equivalent of a common-law option, which, as you recall, does require consideration.

Section 1-308 [formerly 1-207] of the UCC allows a party a reservation of rights while performing a contract; however, this section does not apply to an accord and satisfaction, which is covered under section 3-311. Md. Code Ann., Com. Law §§ 1-308, 3-311. Section 1-308 raises a difficult question when a debtor issues an in-full-payment check in payment of a disputed debt. As noted earlier in this section, because under the common law the creditor's acceptance of an in-full- payment check in payment of a disputed debt constitutes an accord and satisfaction, the creditor cannot collect an amount beyond the check. But what if the creditor, in cashing the check, reserves the right (under Section 1-308) to sue for an amount beyond what the debtor is offering? The courts are split on the issue: regarding the sale of goods governed by the UCC, some courts allow the creditor to sue for the unpaid debt notwithstanding the check being marked "paid in full," and others do not. Maryland requires an explicit statement that the payment is tendered in full and complete satisfaction of a disputed claim **AND** no dissent or dissatisfaction by the party accepting the payment. *Weston Bldrs & Developers, Inc. v. McBerry, LLC*, 167 Md. App. 24, 79, 891 A.2d 430, 461 (2005).

Bankruptcy

Bankruptcy is, of course, federal statutory law. The rule here regarding a promise to pay after the obligation is discharged is similar to that governing statutes of limitations. Traditionally, a promise to repay debts after a bankruptcy court discharged them makes the debtor liable once again. This traditional rule gives rise to potential abuse; after undergoing the rigors of bankruptcy, a debtor could be badgered by creditors into reaffirmation, putting him in a worse position than before, since he must wait six years before being allowed to avail himself of bankruptcy again.

The federal Bankruptcy Act includes certain procedural protections to ensure that the debtor knowingly enters into a reaffirmation of his debt. 11 U.S.C. § 524 (2021). Among its provisions, the law requires the debtor to have reaffirmed the debt before the debtor is discharged in bankruptcy; he then has sixty days to rescind his reaffirmation. If the bankrupt party is an individual, the law also requires that a court hearing be held at which the consequences of his reaffirmation must be explained, and reaffirmation of certain consumer debts is subject to court approval if the debtor is not represented by an attorney.

Fuller, Lon L. "Consideration and Form." *Columbia Law Review,* vol. 41, 1941, pp. 799-824.

Legality

We have discussed the requirements of agreement, assent, and consideration. We now turn to the requirement of legality of the underlying bargain. The basic rule is that courts will not enforce an illegal bargain. (The term *illegal bargain* is better than *illegal contract* because a contract is by definition a legal agreement, but the latter terminology prevails in common usage.) Why should this be? Why should the courts refuse to honor contracts made privately by people who presumably know what they are doing—for example, a wager on the World Series or a championship fight? Two reasons are usually given. One is that refusal to enforce helps discourage unlawful behavior; the other is that honoring such contracts would demean the judiciary.

Are these reasons valid? Yes and no, in the opinion of one contracts scholar:

> [D]enying relief to parties who have engaged in an illegal transaction…helps to effectuate the public policy involved by discouraging the conduct that is disapproved. Mere denial of contractual and quasi-contractual remedy [however] rarely has a substantial effect in discouraging illegal conduct. A man who is hired to perform a murder is not in the least deterred by the fact that the courts are not open to him to collect his fee. Such a man has other methods of enforcement, and they are in fact more effective than legal process. The same is true in varying degrees where less heinous forms of illegal conduct are involved. Even in the matter of usury it was found that mere denial of enforcement was of little value in the effort to eliminate the loan shark. And restraints of trade were not curbed to an appreciable extent until contracts in restraint of trade were made criminal. In most instances, then, the protection of the good name of the judicial institution must provide the principal reason for the denial of a remedy to one who has trafficked in the forbidden. This is, moreover, a very good reason. The first duty of an institution is to preserve itself, and if the courts to any appreciable extent busied themselves with "justice among thieves," the community…would be shocked and the courts would be brought into disrepute" (Havighurst 1145).

Strictly enforced, the rule prohibiting courts from ordering the parties to honor illegal contracts is harsh. It means that a promisee who has already performed under the contract can neither obtain performance of the act for which he bargained nor recover the money he paid or the value of the performance he made. The court will simply leave the parties where it finds them, meaning that one of the parties will have received an uncompensated benefit.

Not surprisingly, the severity of the rule against enforcement has led courts to seek ways to moderate its impact, chiefly by modifying it according to the principle of restitution. In general, restitution requires that one who has conferred a benefit or suffered a loss should not unfairly be denied compensation.

Pursuing this notion, the courts have created several exceptions to the general rule. Thus a party who is excusably ignorant that his promise violates public policy and a party who is not equally in the wrong may recover. Likewise, when a party "would otherwise suffer a forfeiture that is disproportionate in relation to the contravention of public policy involved," restitution will be allowed. Restatement (Second) of Contracts, Section 197(b). Other exceptions exist when the party seeking restitution withdraws from the transaction contemplated in the contract before the illegal purpose has been carried out and when "allowing the claim would put an end to a continuing situation that is contrary to the public interest." Restatement (Second) of Contracts, Section 197(b). An example of the latter situation occurs when two bettors place money in the hands of a stakeholder. If the wager is unlawful, the loser of the bet has the right to recover his money from the stakeholder before it is paid out to the winner.

Though by and large courts enforce contracts without considering the worth or merits of the bargain they incorporate, freedom of contract can conflict with other public policies. Tensions arise between the desire to let people pursue their own ends and the belief that certain kinds of conduct should not be encouraged. Thus a patient may agree to be treated by an herbalist, but state laws prohibit medical care except by licensed physicians. Law and public policies against usury, gambling, obstructing justice, bribery, corrupt influence, perjury, restraint of trade, impairment of domestic relations, and fraud all significantly affect the authority and willingness of courts to enforce contracts.

In this section, we will consider two types of illegality: (1) that which results from a bargain that violates a statute and (2) that which the courts deem contrary to public policy, even though not expressly set forth in statutes.

Agreements in Violation of Statute

Any bargain that violates the criminal law—including statutes that govern extortion, robbery, embezzlement, forgery, some gambling, licensing, and consumer credit transactions—is illegal. Thus determining whether contracts are lawful may seem to be an easy enough task. Clearly, whenever the statute itself explicitly forbids the making of the contract or the performance agreed upon, the bargain (such as a contract to sell drugs) is unlawful. But when the statute does not expressly prohibit the making of the contract, courts examine a number of factors in determining its validity, such as a contract involving the apparently innocent sale of a jewelry manufacturing firm whose real business was making marijuana-smoking paraphernalia. *Bovard v. American Horse Enterprises*, 201 Cal. App. 3d 832 (Cal. Ct. App. 1988) (the court declared the contract void on public policy grounds based on statutory law making the use, possession and distribution of marijuana illegal, even though the manufacturer of the paraphernalia was not technically illegal when the contract was entered into). And, contracts failing to contain necessary statutory language will not necessarily be deemed void, as the courts can impliedly incorporate the necessary statutory language into the statute. *Roger's Refrigeration Co. v. Pulliam's Garage, Inc.*, 66 Md. App. 675, 505 A.2d 878 (1986). However, the safest course of action is to make sure a contract complies with any and all statutory requirements.

Types of Bargains Made Illegal by Statute

Usury

A usury statute is one that sets the maximum allowable interest that may be charged on a loan; usury is charging illegal interest rates. Md. Code Ann., Com. Law §§ 12-102 thru 12-114. Formerly, such statutes were a matter of real importance because the penalty levied on the lender—ranging from forfeiture of the interest, or of both the principal and the interest, or of some part of the principal—was significant. But usury laws, like Sunday contract laws, have been relaxed to accommodate an ever-more-frenzied consumer society. There are a number of transactions to which the laws do not apply, varying by state: small consumer loans, pawn shop loans, payday loans, and corporate loans. In *Marquette v. First Omaha Service Corp.*, 439 U.S. 299 (1978), the Supreme Court ruled that a national bank could charge the highest interest rate allowed in its home state to customers living anywhere in the United States, including states with restrictive interest caps. Thus it was that in 1980 Citibank moved its credit card headquarters from cosmopolitan New York City to the somewhat less cosmopolitan Sioux Falls, South Dakota. South Dakota recently abolished its usury laws, and so, as far as credit-card interest rates, the sky was the limit. That appealed to Citibank and a number of other financial institutions, and to the state: it became a major player in the US financial industry, garnering many jobs.

Licensing Statutes

To practice most professions and carry on the trade of an increasing number of occupations, states require that providers of services possess licenses—hairdressers, doctors, plumbers, real estate brokers, and egg inspectors are among those on a long list. As sometimes happens, though, a person may contract for the services of one who is unlicensed either because he is unqualified and carrying on his business without a license or because for technical reasons (e.g., forgetting to mail in the license renewal application) he does not possess a license at the moment. Robin calls Paul, a plumber, to install the pipes for her new kitchen. Paul, who has no license, puts in all the pipes and asks to be paid. Having discovered that Paul is unlicensed, Robin refuses to pay. May Paul collect?

To answer the question, a three-step analysis is necessary. First, is a license required? Some occupations may be performed without a license (e.g., lawn mowing). Others may be performed with or without certain credentials, the difference lying in what the professional may tell the public. (For instance, an accountant need not be a certified public accountant to carry on most accounting functions.) Let us assume that the state requires everyone who does any sort of plumbing for pay to have a valid license.

The second step is to determine whether the licensing statute explicitly bars recovery by someone who has performed work while unlicensed. Some do; many others contain no specific provision on the point. Statutes that do bar recovery must of course govern the courts when they are presented with the question. If the statute is silent, courts must, in the third step of the analysis, distinguish between "regulatory" and "revenue" licenses. A regulatory license is intended to protect the public health, safety, and welfare. To obtain these licenses, the practitioner of the art must generally demonstrate his or her abilities by taking some sort of examination, like the bar exam for lawyers or the medical boards for doctors. A plumber's or electrician's licensing requirement might fall into this category. A revenue license generally requires no such examination and is imposed for the sake of raising revenue and to ensure that practitioners register their address so they can be found if a disgruntled client wants to serve them legal papers for a lawsuit. Some revenue licenses, in addition to requiring registration, require practitioners to demonstrate that they have insurance. A license to deliver milk, open to anyone who applies and pays the fee, would be an example of a revenue license. (In some states, plumbing licenses are for revenue purposes only.)

Generally speaking, failure to hold a regulatory license bars recovery, but the absence of a revenue or registration license does not—the person may obtain the license and then move to recover.

Bargains Made Illegal by the Common Law

Public policy is expressed by courts as well as legislatures. In determining whether to enforce a contract where there is no legislative dictate, courts must ordinarily balance the interests at stake. To strike the proper balance, courts must weigh the parties' expectations, the forfeitures that would result from denial of enforcement, and the public interest favoring enforcement against these factors: the strength of the policy, whether denying enforcement will further the policy, the seriousness and deliberateness of the violation, and how direct the connection is between the misconduct and the contractual term to be enforced. Restat 2d of Contracts, § 178.

Types of Bargains Made Illegal by Common Law

Common-Law Restraint of Trade

One of the oldest public policies evolved by courts is the common-law prohibition against restraint of trade. From the early days of industrialism, the courts took a dim view of ostensible competitors who agreed among themselves to fix prices or not to sell in each other's territories. Since 1890, with the enactment of the Sherman Act, the law of restraint of trade has been absorbed by federal and state antitrust statutes. But the common-law prohibition still exists. Though today it is concerned almost exclusively with promises not to compete in sales of businesses and employment contracts, it can arise in other settings. For example, George's promise to Arthur never to sell the parcel of land that Arthur is selling to him is void because it unreasonably restrains trade in the land.

The general rule is one of reason: not every restraint of trade is unlawful; only unreasonable ones are. In Maryland, an agreement in restraint of trade that is unlimited or unreasonable is void. *Donovan v. Scuderi*, 51 Md. App. 217, 443 A.2d 121 (1982). As the Restatement puts it, "Every promise that relates to business dealings or to a professional or other gainful occupation operates as a restraint in the sense that it restricts the promisor's future activity. Such a promise is not, however, unenforceable, unless the restraint that it imposes is unreasonably detrimental to the smooth operation of a freely competitive private economy." Restat 2d of Contracts, § 186(a). An agreement that restrains trade will be construed as unreasonable unless it is ancillary to a legitimate business interest and is no greater than necessary to protect the legitimate interest. Restraint- of-trade cases usually arise in two settings: (1) the sale of a business and an attendant agreement not to compete with the purchasers and (2) an employee's agreement not to compete with the employer should the employee leave for any reason.

Sale of a Business

A first common area where a restraint-of-trade issue may arise is with the sale of a business. Regina sells her lingerie store to Victoria and promises not to establish a competing store in town for one year. Since Victoria is purchasing Regina's goodwill (the fact that customers are used to shopping at her store), as well as her building and inventory, there is clearly a property interest to be protected. And the geographical limitation ("in town") is reasonable if that is where the store does business. But if Regina had agreed not to engage in any business in town, or to wait ten years before opening up a new store, or not to open up a new store anywhere within one hundred miles of town, she could avoid the noncompetition terms of the contract because the restraint in each case (nature, duration, and geographic area of restraint) would have been broader than necessary to protect Victoria's interest. Whether the courts will uphold an agreement not to compete depends on all the circumstances of the particular case.

In Maryland, such agreements will be strictly construed and will be held valid where they are reasonable in terms of time and place. *Checket-Columbia Co. v. Lipman*, 201 Md. 494, 94 A.2d 433 (1953); *see also ICENY USA. LLC v. M&M's, LLC*, 421 F. Supp. 3d 204 (D. Md. 2019). However, where these agreements were unlimited as to time, but restricted to a reasonable area, such as a town, city or county, courts have upheld them. *Guerand v. Dandelet*, 32 Md. 561 (1870); *Griffin v. Guy*, 172 Md. 510, 192 A. 359 (1937).

Employment Noncompete Agreements

A second common restraint-of-trade issue arises with regard to noncompete agreements in employment contracts. As a condition of employment by the research division of a market research firm, Bruce, a product analyst, is required to sign an agreement in which he promises, for a period of one year after leaving the company, not to "engage, directly or indirectly, in any business competing with the company and located within fifty miles of the company's main offices." The principal reason recited in the agreement for this covenant not to compete is that by virtue of the employment, Bruce will come to learn a variety of internal secrets, including client lists, trade or business secrets, reports, confidential business discussions, ongoing research, publications, computer programs, and related papers. Is this agreement a lawful restraint of trade?

Here both the property interest of the employer and the extent of the restraint are issues. Certainly an employer has an important competitive interest in seeing that company information not walk out the door with former employees. Nevertheless, a promise by an employee not to compete with his or her former employer is scrutinized carefully by the courts, and an injunction (an order directing a person to stop doing what he or she should not do) will be issued cautiously, partly because the prospective employee is usually confronted with a contract of adhesion (take it or leave it) and is in a weak bargaining position compared to the employer, and partly because an injunction might cause the employee's unemployment. *See Allegis Group, Inc. v. Jordan*, 951 F.3d 203 (4th Cir. 2020) (non-compete agreement in incentive clause for highly paid employees was narrowly tailored in protecting corporate interest and not and undue hardship as participation in the incentive plan was voluntary); *Bindagraphics, Inc. v. Fox Grp., Inc.*, 377 F. Supp. 3d 565 (D. Md. 2019) (non-solicitation agreement for one year was found to be overly broad where is prevented former employee from soliciting prospective customers and passive sales to customers employee did not solicit).

Many courts are not enthusiastic about employment noncompete agreements. In Maryland, for employees earning less than $15.00 per hour or $31,200 per year, "[a] noncompete or conflict of interest provision in an employment contract or a similar document or agreement that restricts the ability of an employee to enter into employment with a new employer or to become self-employed in the same or similar business or trade shall be null and void as being against the public policy of the State." Md. Code Ann., Lab. & Employ. § 3-716 (Lexis 2021). Other states are less stingy, and employers have attempted to avoid the strictures of no-enforcement state rulings by providing that their employment contracts will be interpreted according to the law of a state where noncompetes are favorably viewed.

"Under Maryland law, whether a restrictive covenant is enforceable depends upon the unique language of the covenant at issue, and the specific facts of the case." *Aerotek, Inc. v. Obercian*, 377 F .Supp. 3d 539, 546 (D. Md. 2019) (citing *Holloway v. Faw, Casson & Co.*, 319 Md. 324, 572 A.2d 510, 515 (Md. 1990), *Ruhl v. F.A. Bartlett Tree Expert Co.*, 245 Md. 118, 225 A.2d 288, 291 (Md. 1967)). "To be enforceable, a restrictive covenant must satisfy the following four requirements: (1) the employer must have a legally protected interest; (2) the restrictive covenant must be no wider in scope and duration than is reasonably necessary to protect the employer's interest; (3) the covenant cannot impose an undue hardship on the employee; and (4) the covenant cannot violate public policy." *Id.* (citing Silver v. Goldberger, 231 Md. 1, 188 A.2d 155, 158 (Md. 1963)).

If a covenant not to compete is ruled unlawful, the courts can pursue one of three courses by way of remedy. A court can refuse to enforce the entire covenant, freeing the employee to compete thenceforth. The court could delete from the agreement only that part that is unreasonable and enforce the remainder (the "blue pencil" rule). *Id.* at 546. (Maryland courts follow the "blue pencil" rule.) In some states, the courts have moved away from this rule and have actually taken to rewriting the objectionable clause themselves. Since the parties intended that there be some form of restriction on competition, a reasonable modification would achieve a more just result. *Raimondo v. Van Vlerah*, 325 N.E.2d 544, 548 (Ohio 1975) (reversing a lower appellate court decision and directing the trial court to construct a reasonable covenant between the parties in terms of time and distance).

Unconscionable Contracts

Courts may refuse to enforce unconscionable contracts, those that are very one-sided, unfair, the product of unequal bargaining power, or oppressive; a court may find the contract divisible and enforce only the parts that are not unconscionable. *Aerotek, Inc.*, 377 F.Supp 3d at 553.

The common-law rule is reflected in Section 208 of the Restatement: "If a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term, or may so limit the application of any unconscionable term as to avoid any unconscionable result." Restat 2d of Contracts, § 208.

And the UCC (a statute, not common law) provides a similar rule in Section 2-302(1): "If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result." Md. Code Ann., Com. Law, § 2-302(1).

Unconscionable is not defined in the Restatement or the UCC, but cases have given gloss to the meaning, *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir 1965), a well-known early interpretation of the section by the DC Court of Appeals ("when a party of little bargaining power, and hence little real choice, signs a commercially unreasonable contract with little or no knowledge of its terms, it is hardly likely that his consent, or even an objective manifestation of his consent, was ever given to all the terms.")

Unconscionability may arise procedurally or substantively. A term is procedurally unconscionable if it is imposed upon the “weaker” party because of fine or inconspicuous print, unexpected placement in the contract, lack of opportunity to read the term, lack of education or sophistication that precludes understanding, or lack of equality of bargaining power. Substantive unconscionability arises where the affected terms are oppressive and harsh, where the term deprives a party of any real remedy for breach. Most often—but not always—courts find unconscionable contracts in the context of consumer transactions rather than commercial transactions. In the latter case, the assumption is that the parties tend to be sophisticated businesspeople able to look out for their own contract interests.

“Contracts of adhesion that are "drafted unilaterally by the dominant party and then presented on a 'take-it-or-leave-it basis'" are procedurally unconscionable.” *Aerotek*, 377 F. Supp. 3d at 553 (citing *Walther v. Sovereign Bank*, 386 Md. 412, 430, 872 A.2d 735, 746 (2005)). “The fact that a contract is one of adhesion does not mean that either it or any of its terms are invalid or unenforceable.” *Id.* (citing *Meyer v. State Farm Fire & Cas. Co.*, 85 Md. App. 83, 90, 582 A.2d 275, 278 (1990)). Rather, “a contract of adhesion will be held invalid only if it is also substantively unconscionable.” *Id.* (citing *Walther*, at 430, 872 A.2d at 746-47).”

Exculpatory Clauses

The courts have long held that public policy disfavors attempts to contract out of tort liability. Exculpatory clauses that exempt one party from tort liability to the other for harm caused intentionally or recklessly are unenforceable without exception. A contract provision that exempts a party from tort liability for negligence is unenforceable under two general circumstances: (1) when it “exempts an employer from liability to an employee for injury in the course of his employment” or (2) when it exempts one charged with a duty of public service and who is receiving compensation from liability to one to whom the duty is owed. Restat 2d of Contracts, §195.

Exculpatory clauses will generally be held valid “as long as [its] language . . . clearly and specifically indicates the intent to release the defendant from liability for personal injury caused by the defendant's negligence.” *Seigneur v. National Fitness Institute, Inc.*, 132 Md. App. 271, 280, 752 A.2d 631, 636 (2000). In Maryland, “three exceptions have been identified where the public interest will render an exculpatory clause unenforceable. They are: (1) when the party protected by the clause intentionally causes harm or engages in acts of reckless, wanton, or gross negligence; (2) when the bargaining power of one party to the contract is so grossly unequal so as to put that party at the mercy of the other's negligence; and (3) when the transaction involves the public interest.” *Id.* at 282-83, 752 A.2d at 637.

In Maryland, exculpatory clauses in certain situations are made invalid by statute. *See* Md. Code Ann., Real Prop. § 8-105 (exculpatory clauses in property leases against public policy).

Obstructing the Administration of Justice or Violating a Public Duty

It is well established under common law that contracts that would interfere with the administration of justice or that call upon a public official to violate a public duty are void and unenforceable. Examples of such contracts are numerous: to conceal or compound a crime, to pay for the testimony of a witness in court contingent on the court’s ruling, to suppress evidence by paying a witness to leave the state, or to destroy documents. Thus, in an unedifying case in Arkansas, a gambler sued a circuit court judge to recover $1,675 allegedly paid to the judge as protection money, and the Arkansas Supreme Court affirmed the dismissal of the suit, holding, “The law will not aid either party to the alleged illegal and void contract…‘but will leave them where it finds them, if they have been equally cognizant of the illegality.’” *Womack v. Maner*, 301 S.W.2d 438, 439 (Ark. 1957). Also in this category are bribes, agreements to obstruct or delay justice (jury tampering, abuse of the legal process), and the like.

The types of contracts or bargains that might be found illegal are innumerable, limited only by the ingenuity of those who seek to overreach.

Effect of Illegality and Exceptions

The general rule is this: courts will not enforce illegal bargains. The parties are left where the court found them, and no relief is granted: it's a hands-off policy. The illegal agreement is void, and that a wrongdoer benefited to the other's detriment does not matter. *State of Maryland v. Strickland*, 42 Md. App. 357, 362, 400 A.2d 451, 454 (1979) ("A basic principle of contract law is that agreements to commit a crime are illegal, void. Without question, courts will not order damages for breach of such a contract. Parties of that ilk are left where they are found, to stew in their own juice.")

For example, suppose a specialty contractor, statutorily required to have a license, constructs a waterslide for Plaintiff, when the contractor knew or should have known he was unlicensed. Plaintiff discovers the impropriety and refuses to pay the contractor $80,000 remaining on the deal. The contractor will not get paid. *Pacific Custom Pools, Inc. v. Turner Construction*, 94 Cal. Rptr. 2d 756 (Cal. App. Div. 2000). In another example, a man held himself out to be an architect in a jurisdiction requiring that architects pass a test to be licensed. He was paid $80,000 to design a house costing $900,000. The project was late and over budget, and the building violated relevant easement building-code rules. The unlicensed architect was not allowed to keep his fee. *Ransburg v. Haase*, 586 N.E.2d 1295 (Ill. App. Ct. 1992).

Exceptions

As always in the law, there are exceptions. Of relevance here are situations where a court might permit one party to recover: party withdrawing before performance, party protected by statute, party not equally at fault, excusable ignorance, and partial illegality.

Party Withdrawing before Performance

Samantha and Carlene agree to bet on a soccer game and deliver their money to the stakeholder. Subsequently, but before the payout, Carlene decides she wants out; she can get her money from the stakeholder. Ralph hires Jacob for $5,000 to arrange a bribe of a juror. Ralph has a change of heart before Jacob completes the act; he can get his money from Jacob. *See Harrington v. Bochenski*, 140 Md. 24, 31, 116 A. 836, 839 (1922) (party entered into contract to purchase alcohol, upon discovering contract was illegal, buyer was able to recover money as seller had not performed yet).

Party Protected by Statute

An airline pilot, forbidden by federal law from working overtime, nevertheless does so; she would be entitled to payment for the overtime worked. Securities laws forbid the sale or purchase of unregistered offerings—such a contract is illegal; the statute allows the purchaser rescission (return of the money paid). An attorney (apparently unwittingly) charged his client beyond what the statute allowed for procuring for the client a government pension; the client could get the excess from the attorney.

Party Not Equally at Fault

One party induces another to make an illegal contract by undue influence, fraud, or duress; the victim can recover the consideration conveyed to the miscreant if possible.

Excusable Ignorance

A woman agrees to marry a man not knowing that he is already married; bigamy is illegal, the marriage is void, and she may sue him for damages. A laborer is hired to move sealed crates, which contain marijuana; it is illegal to ship, sell, or use marijuana, but the laborer is allowed payment for his services.

Partial Illegality

A six-page employment contract contains two paragraphs of an illegal noncompete agreement. The illegal part is thrown out, but the legal parts are enforceable. *See State Farm Mut. Auto Ins. Co. v. Nationwide Mut. Ins. Co.*, 307 Md. 631, 516 A.2d 586 (1986) (household exclusion in auto insurance policy found to be against public policy – that provision only was unenforceable).

The Statute of Frauds

The general rule is this: a contract need not be in writing to be enforceable. An oral agreement to pay a high-fashion model $2 million to pose for photographs is as binding as if the language of the deal were printed on vellum and signed in the presence of twenty bishops. For three centuries, however, a large exception grew up around the Statute of Frauds, first enacted in England in 1677 under the formal name "An Act for the Prevention of Frauds and Perjuries." The Statute of Frauds requires that some contracts be evidenced by a writing, signed by the party to be bound. The English statute's two sections dealing with contracts read as follows:

"[Sect. 4]…no action shall be brought

1. whereby to charge any executor or administrator upon any special promise, to answer damages out of his own estate;
2. or whereby to charge the defendant upon any special promise to answer for the debt, default or miscarriages of another person;
3. or to charge any person upon any agreement made upon consideration of marriage;
4. or upon any contract or sale of lands, tenements or hereditaments, or any interest in or concerning them;
5. or upon any agreement that is not to be performed within the space of one year from the making thereof;

unless the agreement upon which such action shall be brought, or some memorandum or note thereof, shall be in writing, and signed by the party to be charged therewith, or some other person thereunto by him lawfully authorized.

[Sect. 17]…no contract for the sale of any goods, wares and merchandizes, for the price of ten pounds sterling or upwards, shall be allowed to be good, except the buyer shall accept part of the goods so sold, and actually receive the same, or give something in earnest to bind the bargain or in part of payment, or that some note or memorandum in writing of the said bargain be made and signed by the parties to be charged by such contract, or their agents thereunto lawfully authorized."

As may be evident from the title of the act and its language, the general purpose of the law is to provide evidence, in areas of some complexity and importance, that a contract was actually made. To a lesser degree, the law serves to caution those about to enter a contract and "to create a climate in which parties often regard their agreements as tentative until there is a signed writing." Restat 2d of Contracts, Ch. 5, statutory note. Notice, of course, that this is a *statute*; it is a legislative intrusion into the common law of contracts. The name of the act is somewhat unfortunate: insofar as it deals with fraud at all, it does not deal with fraud as we normally think of it. It tries to avoid the fraud that occurs when one person attempts to impose on another a contract that never was agreed to.

The Statute of Frauds has been enacted in form similar to the seventeenth-century act in every state but New Mexico, where judicial decisions have given it legal effect, and Louisiana. *See* Md. Code Ann., Com. Law § 2-201 and Md. Code Ann., Cts. & Jud. Proc. § 5-901. With minor exceptions in Minnesota, Wisconsin, North Carolina, and Pennsylvania, the laws all embrace the same categories of contracts that are required to be in writing.

Statute of Frauds	UCC Sales of Contracts
1. Promises to Pay Debt of Another 2. Agreements of Executor or Administrator 3. Marriage Promises 4. Sale of Land 5. Contracts Not to be Performed Within One Year	1. Sale of Goods for $500 or More 2. Sale of Securities 3. Other Sales Exceedings $5000

Figure 7 Contracts Required to Be in Writing

One overall exception to the enforcement of the Statute of Frauds is promissory estoppel. The doctrine of promissory estoppel can be used to enforce an agreement when one party has partially fulfilled their portion of the agreement. As previously discussed, promissory estoppel requires four elements:

- First, there must be a promise made between the parties.
- Second, one of the parties must rely on the promise to their detriment.
- Third, the non- relying party must have reasonably expected the other party to rely on the promise.
- Finally, there must be an injustice in allowing the non-relying party to escape from enforcement of the promise.

The focus of promissory estoppel is that it would be unjust to allow one party to breach the oral contract after the other party has already fulfilled their portion of the agreement. Promissory estoppel is derived from the court's equitable power to grant relief even when there may not be a written agreement.

Types of Contracts Required in Writing and the Exceptions

Promises to Pay the Debt of Another

The rule: a promise to pay the debt of another person must be evidenced by some writing if it is a "collateral promise of suretyship (or 'guaranty')." A collateral promise is one secondary or ancillary to some other promise. A surety or guarantor (the terms are essentially synonymous) is one who promises to perform upon the default of another. Consider this:

A and B agree to pay C. Here, both A and B are making a direct promise to pay C. Although A is listed first, both are promising to pay C. Now consider this:

B agrees to pay C ***IF*** A does not.

Here it is clear that there must be another agreement somewhere for A to pay C, but that is not contained in this promise. Rather, B is making an agreement with C that is *collateral*—on the side—to the promise A is making to C. Sometimes the other agreement somewhere for A to pay C is actually in the same document as B's promise to pay C if A does not. That does not make B's promise a direct promise as opposed to a collateral one.

Suppose Lydia wishes to purchase a coat at Miss Juliette's Fine Furs on credit. Juliette thinks Lydia's creditworthiness is somewhat shaky. So Lydia's friend Jessica promises Miss Juliette's that if the store will extend Lydia credit, Jessica will pay whatever balance is due should Lydia default. Jessica is a surety for Lydia, and the agreement is subject to the Statute of Frauds; an oral promise will not be enforceable.

Of course, if Jessica really *did* orally promise Miss Juliette's to pay in case Lydia didn't, it would be bad faith to lie about it. The proper course for Jessica is **not** to say, "Ha, ha, I promised, but it was only oral, so I'm not bound." Jessica should say, "I raise the Statute of Frauds as a defense."

Suppose Jessica very much wants Lydia to have the coat, so she calls the store and says, "Send Lydia the fur, and I will pay for it." This agreement does not create a suretyship, because Jessica is primarily liable: she is making a direct promise to pay. To fall within the Statute of Frauds, the surety must back the debt of another person to a third-party promisee (also known as the obligee of the principal debtor). The "debt," incidentally, need not be a money obligation; it can be any contractual duty. If Lydia promised to work as a cashier on Saturdays at Miss Juliette's in return for the coat, Jessica could become surety to that obligation by agreeing to work in Lydia's place if she failed to show up. Such a promise would need to be in writing to be enforceable.

The exception: the main purpose doctrine. The main purpose doctrine is a major exception to the surety provision of the Statute of Frauds. It holds that if the promisor's principal reason for acting as surety is to secure her own economic advantage, then the agreement is not bound by the Statute of Frauds writing requirement. Suppose, in the previous example, that Jessica is really the one who wants the fur coat but cannot, for reasons of prudence, let it be known that she bought one. So she proposes that Lydia "buy" it for her and that she will guarantee Lydia's payments. Since the main purpose of Jessica's promise is to advance her own interests, an oral agreement is binding. Normally, the main purpose rule comes into play when the surety desires a financial advantage to herself that cannot occur unless she provides some security. For example, the board chairman of a small company, who also owns all the voting stock, might guarantee a printer that if his company defaulted in paying the bill for desperately needed catalogs, he would personally pay the bill. If his main purpose in giving the guarantee was to get the catalogues printed in order to stave off bankruptcy, and thus to preserve his own interest in the company, he would be bound by an oral agreement. *Stuart Studio, Inc. v. National School of Heavy Equipment, Inc.*, 214 S.E.2d 192 (N.C. 1975).

Agreements of Executor or Administrator

The rule: the promise by an executor or administrator of an estate to answer personally for the debt or other duty of the deceased is analogous to the surety provision—it must be evidenced by some writing if it is to be enforced over an objection by the would-be obligor. For an agreement to be covered by the statute, there must have been an obligation before the decedent's death. Thus if the executor arranges for a funeral and guarantees payment should the estate fail to pay the fee, an oral contract is binding, because there was no preexisting obligation. If, however, the decedent made his own arrangements prior to passing and signed a note obligating his estate to pay, the executor's promise to guarantee payment would be binding only if written.

The exception: the main purpose exception to the surety provision applies to this section of the Statute of Frauds as well.

Contracts Affecting an Interest in Real Estate

The rule: almost all contracts involving an interest in real estate are subject to the Statute of Frauds. "An interest in land" is a broad description, including the sale, mortgaging, and leasing of real property (including homes and buildings); profits from the land; the creation of easements; and the establishment of other interests through restrictive covenants and agreements concerning use. Short-term leases, usually for a term of one year or less, are exempt from the provision.

The exception: the part performance doctrine. The name here is a misnomer, because it is a doctrine of reliance, and the acts taken in reliance on the contract are not necessarily partial performances under it. As in all such cases, the rationale is that it is unjust not to give the promisee specific performance if he or she acted in reasonable reliance on the contract and the promisor continued to manifest assent to its terms. An oral contract to sell land is not binding simply because the buyer paid the purchase price; payment is not by itself reliance, and if the seller refuses to transfer title, the buyer may recover the purchase price. However, if the buyer took possession and made improvements on the property, courts will usually say the case is out of the statute, and the party claiming an oral contract can attempt to prove the existence of the oral contract.

The One-Year Rule

The rule: any agreement that cannot be performed within one year from its making must be evidenced by some writing to be enforceable. The purpose of this part is perhaps more obvious than most of the statute's provisions: memories fade regarding the terms of oral contracts made long ago; people die; disputes are not uncommon. Notice the critical time frame is not how long it will take to perform the contract, but how long from the time it is made until performance is complete. If a contract is made on January 1 for a house to be constructed starting on June 1 and to be completed on February 1 of the next year, the performance will be completed in eight months from the time it was begun, but thirteen months from the time the contract was made. It falls within the statute.

The exception: the possibility test. The statute's one-year rule has been universally interpreted to mean a contract that is impossible to be fully performed within one year; if there is even the slightest chance of carrying out the agreement completely within the year, an oral contract is enforceable. Thus an oral agreement to pay a sum of money on a date thirteen months hence is within the statute and not enforceable, but one calling for payment "within thirteen months" would be enforceable, since it is possible under the latter contract to pay in less than a year. Because in many cases strict application of the statute would dictate harsh results, the courts often strain for an interpretation that finds it possible to perform the agreement within the year. Courts will even hold that because any person may die within the year, a contract without a fixed term may be fully performed in under a year and does not, therefore, fall within the statute.

Under the UCC

The rule: contracts for the sale of goods in an amount greater than $500 must be evidenced by some writing to be enforceable. Section 2-201 of the UCC requires all contracts for the sale of goods for the price of $500 or more to be in writing, but oral agreements for the sale of goods valued at less than $500 are fully enforceable without exception. *See* Md. Code Ann., Com. Law § 2-201.

Other Writing Requirements

In addition to these requirements, the UCC provides that agreements for the sale of securities (e.g., most stocks and bonds) usually need to be evidenced by a writing, and agreements for property not included in the sales or securities articles of the UCC that exceed $5,000 in value need to be so evidenced. Md. Code Ann., Com. Law, §§ 8-319, 1-206. Included here would be intangible property such as rights to royalties and to mortgage payments, and other rights created by contract. And in many states, other statutes require a writing for several different kinds of contracts. These include agreements to pay commissions to real estate brokers, to make a will, to pay debts already discharged in bankruptcy, to arbitrate rather than litigate, to make loans, and to make installment contracts.

Exceptions under the UCC

There are four exceptions to the UCC's Statute of Frauds requirement that are relevant here.

The Ten-Day-Reply Doctrine

This provides that, as between merchants, if an oral agreement is reached and one party sends the other a written statement confirming it, the other party has ten days to object in writing or the agreement is enforceable. Md. Code Ann., Com. Law, § 2-201(2).

"Specially Manufactured Goods"

This exception provides that a seller who has manufactured goods to the buyer's specifications or who has made "either a substantial beginning of their manufacture or commitments for their procurement" will not be stuck if the buyer repudiates, assuming that the goods are unsuitable for sale to others. Md. Code Ann., Com. Law, § 2-201(3)(a).

The "Admission" Exception

This exception arises—reasonably enough—when the party against whom enforcement is sought admits in testimony or legal papers that a contract was in fact made. Md. Code Ann., Com. Law, § 2- 201(3)(b). However, the admission will not permit enforcement of all claimed terms of the contract; enforcement is limited to the quantity of goods admitted.

The "Payment or Delivery and Acceptance" Exception

The UCC provides that an oral contract for goods in excess of $500 will be upheld if payment has already been made and accepted, or if the goods have been received and accepted. Md. Code Ann., Com. Law, § 2-20l(3)(c).

Sufficiency of the Required Writing

At Common Law

We have been careful not to say “the contract needs to be in writing.” We have said, “a contractual intention must be evidenced by some writing, signed by the party to be bound.” A signed contract is not required. What is required in most states, following the wording of the original statute, is that there be at least some memorandum or note concerning the agreement—a logical consequence of the statute’s purpose to evidence the making of the contract. The words need not appear in a formal document; they are sufficient in any form in a will, or on a check or receipt, or in longhand on the back of an envelope—so long as the document is signed by the party to be charged (i.e., the party being sued on the contract). Although the writing need not contain every term, it must recite the subject matter of the contract. It need not do so, however, in terms comprehensible to those who were not party to the negotiations; it is enough if it is understandable in context. In short, the parties (and the courts) must be able to ascertain the terms of the contract.

A written agreement to buy a parcel of land is usually sufficiently definitive if it refers to the parcel in such a way that it could be mistaken for no other—for example, “seller’s land in Tuscaloosa,” assuming that the seller owned only one parcel there. Beyond the subject matter, the essential terms of promises to be performed must be written out; all details need not be. If an essential term is missing, it cannot be enforced, unless it can be inferred or imposed by rule of law. A written contract for the sale of land containing every term but the time for payment, which the parties orally agreed would be upon delivery of the deed, is sufficient. (A contract that omitted the selling price would not be.)

The parties must be named in the writing in a manner sufficient to identify them. Their whole names need not be given if initials or some other reference makes it inescapable that the writing does concern the actual parties. Reference to the agent of a party identifies the party. Possession of the writing may even be sufficient: if a seller gives a memorandum of an oral agreement for the sale of his land, stating all the terms, to the buyer, the latter may seek specific performance even though the writing omits to name or describe him or his agent. Restat 2d of Contracts, § 207(f).

Consideration must be stated in writing, even if the consideration has already been given. Consequently, written contracts frequently contain such language as “for value received.” In most states, failure to refer to consideration already given is unnecessary: “the prevailing view is that error or omission in the recital of past events does not affect the sufficiency of a memorandum.” Restat 2d of Contracts, § 207(h).

Finally, the time of payment, delivery or performance must be included in the agreement so it can be determined when a party's performance begins and ends.

Under the UCC

In contracts for the sale of goods, the writing must be signed by the party to be charged, and the parties must be sufficiently identified. Md. Code Ann., Com. Law, § 2-210(1).

But consideration, including the selling price, need not be set forth for the memorandum to meet the requirements of the UCC (“a writing is not insufficient because it omits or incorrectly states a term agreed upon”), though obviously it makes sense to do so whenever possible. Md. Code Ann., Com. Law § 2-305 (open price term). By contrast, UCC Sections 1-206 and 3-319 concerning intangible personal property and investment securities require “a defined or stated price.” Md. Code Ann., Com. Law, §§ 1-206, 3-319.

Effect of Noncompliance and Exceptions; Oral Rescission

The basic rule is that contracts governed by the Statute of Frauds are unenforceable if they are not sufficiently written down. If the agreement contains several promises, the unenforceability of one will generally render the others unenforceable also.

The Statute of Frauds can work injustices. In addition to the exceptions already noted, there are some general exceptions.

Full Performance

First, certainly, if the contract has been performed fully by both sides, its unenforceability under the statute is moot. Having fulfilled its function (neither side having repudiated the contract), the agreement cannot be rescinded on the ground that it should have been, but was not, reduced to writing.

Detrimental Reliance

Second, some relief may be granted to one who has relied on an oral contract to her detriment (similar to the part performance doctrine mentioned already). For a partially performed contract unenforceable under the Statute of Frauds, restitution may be available. Suppose George agrees orally to landscape Arthur's fifteen acres, in return for which George is to receive title to one acre at the far end of the lot. George is not entitled to the acre if Arthur defaults, but he may recover for the reasonable value of the services he has performed up to the time of repudiation. Somewhat related, if one side has reasonably and foreseeably relied upon a promise in such a way that injustice can only be avoided by enforcing it, some courts will use promissory estoppel to preclude the necessity of a writing, but the connection between the alleged oral contract and the detrimental reliance must be convincing.

Oral Rescission

Third, most contracts required to be in writing may be rescinded orally. The new agreement is treated in effect as a modification of the old one, and since a complete rescission will not usually trigger any action the statute requires to be in writing, the rescission becomes effective in the absence of any signed memorandum.

Some agreements, however, may not be rescinded orally. Those that by their terms preclude oral rescission are an obvious class. Under the UCC, certain agreements for the sale of goods may not be orally rescinded, depending on the circumstances. For instance, if title has already passed to the buyer under a written agreement that satisfies the statute, the contract can be rescinded only by a writing. Contracts for the sale of land are another class of agreements that generally may not be orally rescinded. If title has already been transferred, or if there has been a material change of position in reliance on the contract, oral agreements to rescind are unenforceable. But a contract that remains wholly executory, even though enforceable because in writing, may be rescinded orally in most states.

Contract Modification

Fourth, contracts governed by the Statute of Frauds may be modified orally if the resulting contract, taken as a whole, falls outside the statute. The same rule applies under the UCC. Uniform Commercial Code, Section 2-209(3). Thus a written contract for the sale of a new bicycle worth $1,200 may be orally modified by substituting the sale of a used bicycle worth $450, but not by substituting the sale of a used bike worth $600. The modified contract effectively rescinds the original contract.

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Defenses to Contract Formation

For a contract to be valid, the offeror and the offeree must both agree to its terms and conditions. This agreement must be done voluntarily, knowingly and freely. If anyone of these element of assent is missing, the validity of the contract is called into question.

Table 12 Summary of Defenses to Contract Formation

Type of Defense	Description of Issue
Duress	Physical Threat
Undue Influence	Coercion
Misrepresentation	Fraudulent or non-fraudulent
Mistake	Unilateral or Mutual
Capacity	Minors, Mentally Ill or Intoxicated Persons

Duress

When a person is forced to do something against his or her will, that person is said to have been the victim of duress—compulsion. There are two types of duress: physical duress and duress by improper threat. A contract induced by physical violence is void.

Physical Duress

If a person is forced into entering a contract on threat of physical bodily harm, he or she is the victim of physical duress. "If conduct that appears to be a manifestation of assent by a party who does not intend to engage in that conduct is physically compelled by duress, the conduct is not effective as a manifestation of assent." Restat 2d of Contracts, § 174. Comment (a) to this section provides in part, "This Section involves an application of that principle to those *relatively rare situations in which actual physical force* has been used to compel a party to appear to assent to a contract.…The essence of this type of duress is that a party is compelled by physical force to do an act that he has no intention of doing. He is, it is sometimes said, 'a mere mechanical instrument.' The result is that there is no contract at all, or a 'void contract' as distinguished from a voidable one" (emphasis added). *Id.* at cmt. a.

The Restatement is undoubtedly correct that there are "relatively rare situations in which actual physical force" is used to compel assent to a contract.

Duress by Threat

The second kind of duress is *duress by threat*; it is more common than physical duress. Here the perpetrator threatens the victim, who feels there is no reasonable alternative but to assent to the contract. It renders the contract voidable. *U.S. for the Use of Trane Co. v. Bond*, 322 Md. 170, 179, 586 A.2d 734, 738 (1991) (when the … 'duress' consists only of threats, and does not go to the height of such bodily compulsion as turns the ostensible party into a mere machine, the contract is only voidable. (citing *Fairbanks v. Snow*, 13 N.E. 596, 598 (Mass.1887)).

First, the threat must be improper. Second, there must be no reasonable alternative. If, for example, a supplier threatens to hold up shipment of necessary goods unless the buyer agrees to pay more than the contract price, this would not be duress if the buyer could purchase identical supplies from someone else. Third, the test for inducement is subjective. It does not matter that the person threatened is unusually timid or that a reasonable person would not have felt threatened. The question is whether the threat in fact induced assent by the victim. Such facts as the victim's belief that the threatener had the ability to carry out the threat and the length of time between the threat and assent are relevant in determining whether the threat did prompt the assent.

There are many types of improper threats that might induce a party to enter into a contract: threats to commit a crime or a tort (e.g., bodily harm or taking of property), to instigate criminal prosecution, to instigate civil proceedings when a threat is made in bad faith, to breach a "duty of good faith and fair dealing under a contract with the recipient," or to disclose embarrassing details about a person's private life.

Jack buys a car from a local used-car salesman, Mr. Olson, and the next day realizes he bought a lemon. He threatens to break the windows in Olson's showroom if Olson does not buy the car back for $2,150, the purchase price. Mr. Olson agrees. The agreement is voidable, even though the underlying deal is fair, if Olson feels he has no reasonable alternative and is frightened into agreeing. Suppose Jack knows that Olson had tampered with his cars' odometers, a federal offense, and threatens to have Olson prosecuted if he will not repurchase the car. Even though Olson may be guilty, this threat makes the repurchase contract voidable, because it is a misuse for personal ends of a power (to go to the police). If these threats failed, suppose Jack then tells Olson, "I'm going to haul you into court and sue your pants off." If Jack means he will sue for his purchase price, this is not an improper threat, because everyone has the right to use the courts to gain what they think is rightfully theirs. But if Jack meant that he would fabricate damages done him by a (falsely) claimed odometer manipulation that would be an improper threat. Although Olson could defend against the suit, his reputation would suffer in the meantime from his being accused of odometer tampering.

A threat to breach a contract that induces the victim to sign a new contract could be improper. Suppose that as part of the original purchase price, Olson agrees to make all necessary repairs and replace all failed parts for the first ninety days. At the end of one month, the transmission dies, and Jack demands a replacement. Olson refuses to repair the car unless Jack signs a contract agreeing to buy his next car from Olson. Whether this threat is improper depends on whether Jack has a reasonable alternative; if a replacement transmission is readily available and Jack has the funds to pay for it, he might have an alternative in suing Olson in small claims court for the cost. But if Jack needs the car immediately and he is short on money, then the threat would be improper and the contract voidable. A threat to breach a contract is not necessarily improper, however. It depends on whether the new contract is fair and equitable because of unanticipated circumstances. If, for example, Olson discovers that he must purchase a replacement transmission at three times the anticipated cost, his threat to hold up work unless Jack agrees to pay for it might be reasonable.

Undue Influence

The Restatement (Second) of Contracts characterizes undue influence as "unfair persuasion." Restat 2d of Contracts, §177. It is a milder form of duress than physical harm or threats. The unfairness does not lie in any misrepresentation; rather, it occurs when the victim is under the domination of the persuader or is one who, in view of the relationship between them, is warranted in believing that the persuader will act in a manner detrimental to the victim's welfare if the victim fails to assent. It is the improper use of trust or power to deprive a person of free will and substitute instead another's objective. Usually the fact pattern involves the victim being isolated from receiving advice except from the persuader. Falling within this rule are situations where, for example, a child takes advantage of an infirm parent, a doctor takes advantage of an ill patient, or a lawyer takes advantage of an unknowledgeable client. *See Cook v. Hollyday*, 185 Md. 656, 45 A.2d 761 (1946) (attorney and brother-in-law of testatrix used undue influence in execution of will that was drafted heavily in favor of attorney and not heir at law). If there has been undue influence, the contract is voidable by the party who has been unfairly persuaded. Whether the relationship is one of domination and the persuasion is unfair is a factual question. The answer hinges on a host of variables, including "the unfairness of the resulting bargain, the unavailability of independent advice, and the susceptibility of the person persuaded." Restat 2d of Contracts, § 177(b).

Misrepresentation

The two types of misrepresentation are fraudulent and nonfraudulent. Within the former are fraud in the execution and fraud in the inducement. Within the latter are negligent misrepresentation and innocent misrepresentation.

Misrepresentation is a statement of fact that is not consistent with the truth. If misrepresentation is intentional, it is fraudulent misrepresentation; if it is not intentional, it is nonfraudulent misrepresentation, which can be either negligent or innocent.

In further taxonomy, courts distinguish between fraud in the execution and fraud in the inducement. **Fraud in the execution** is defined by the Restatement as follows: "If a misrepresentation as to the character or essential terms of a proposed contract induces conduct that appears to be a manifestation of assent by one who neither knows nor has reasonable opportunity to know of the character or essential terms of the proposed contract, his conduct is not effective as a manifestation of assent." Restat 2d of Contracts, § 163. For example, Alphonse and Gaston decide to sign a written contract incorporating terms to which they have agreed. It is properly drawn up, and Gaston reads it and approves it. Before he can sign it, however, Alphonse shrewdly substitutes a different version to which Gaston has not agreed. Gaston signs the substitute version. There is no contract. There has been fraud in the execution.

Fraud in the inducement is more common. It involves some misrepresentation about the subject of the contract that induces assent. Alphonse tells Gaston that the car Gaston is buying from Alphonse has just been overhauled—which pleases Gaston—but it has not been. This renders the contract voidable. *Western Md. Dairy Corp. v. Brown*, 169 Md. 257, 181 A. 468 (1935) (insurance company representative badgered plaintiff to sign release at hospital immediately following accident).

Fraudulent Misrepresentation

Necessary to proving fraudulent misrepresentation (usually just "fraud," though technically "fraud" is the crime and "fraudulent misrepresentation" is the civil wrong) is a misstatement of fact that is intentionally made and justifiably relied upon.

"The elements of a fraudulent misrepresentation claim are:

(1) that a representation made by the defendant was false; (2) that either its falsity was known to the defendant or the misrepresentation was made with such reckless indifference to truth as to impute knowledge to him; (3) that the misrepresentation was made for the purpose of defrauding the plaintiff; (4) that the plaintiff not only relied upon the misrepresentation but had the right to rely upon it with full belief in its truth, and that he would not have done the thing from which damage resulted if it had not been made; and (5) that the plaintiff suffered damage directly resulting from the misrepresentation." *Univ. Nursing Home, Inc. v. R.B. Brown & Assocs., Inc.*, 67 Md. App. 48, 61, 506 A.2d 268, 274 (1986)

Misstatement of Fact

Again, generally, any statement not in accord with the facts (a fact is something amenable to testing as true) is a misrepresentation. Falsity does not depend on intent. A typist's unnoticed error in a letter (inadvertently omitting the word "not," for example, or transposing numbers) can amount to a misrepresentation on which the recipient may rely (it is not fraudulent misrepresentation). A half-truth can amount to a misrepresentation, as, for example, when the seller of a hotel says that the income is from both permanent and transient guests but fails to disclose that the bulk of the income is from single-night stopovers by seamen using the hotel as a brothel. *Ikeda v. Curtis*, 261 P.2d 684 (Wash. 1951).

Concealment

Another type of misrepresentation is concealment. It is an act that is equivalent to a statement that the facts are to the contrary and that serves to prevent the other party from learning the true statement of affairs; it is hiding the truth. A common example is painting over defects in a building—by concealing the defects, the owner is misrepresenting the condition of the property. The act of concealment need not be direct; it may consist of sidetracking the other party from gaining necessary knowledge by, for example, convincing a third person who has knowledge of the defect not to speak. Concealment is always a misrepresentation.

Nondisclosure

A more passive type of concealment is nondisclosure. Although generally the law imposes no obligation on anyone to speak out, nondisclosure of a fact can operate as a misrepresentation under certain circumstances. This occurs, for example, whenever the other party has erroneous information, or, as *Reed v. King*, 145 Cal. App. 3d 261 (Cal. App. Div. 1983) shows, where the nondisclosure amounts to a failure to act in good faith, or where the party who conceals knows or should know that the other side cannot, with reasonable diligence, discover the truth. In reversing a dismissal by the trial court, the appellate court in *Reed* allowed a buyer in a real estate sales contract to have her case against the seller for rescission of the contract returned for trial where the seller failed to disclosure a multiple murder on the property 19 years earlier.

In a remarkable 1991 case out of New York, a New York City stockbroker bought an old house upstate (basically anyplace north of New York City) in the village of Nyack, north of New York City, and then wanted out of the deal when he discovered—the defendant seller had not told him—that the house was "haunted." *Stambovsky v. Ackley*, 169 A.D.2d 254 (N.Y. 1991). The court summarized the facts: "Plaintiff, to his horror, discovered that the house he had recently contracted to purchase was widely reputed to be possessed by poltergeists [ghosts], reportedly seen by defendant seller and members of her family on numerous occasions over the last nine years. Plaintiff promptly commenced this action seeking rescission of the contract of sale. Supreme Court reluctantly dismissed the complaint, holding that plaintiff has no remedy at law in this jurisdiction." *Id.* at 255-56. The high court of New York ruled he could rescind the contract because the house was "haunted as a matter of law": the defendant had promoted it as such on village tours and in *Reader's Digest*. She had concealed it, and no reasonable buyer's inspection would have revealed the "fact." *Id.* at 256.

Statement Made False by Subsequent Events

If a statement of fact is made false by later events, it must be disclosed as false. For example, in idle chatter one day, Alphonse tells Gaston that he owns thirty acres of land. In fact, Alphonse owns only twenty-seven, but he decided to exaggerate a little. He meant no harm by it, since the conversation had no import. A year later, Gaston offers to buy the "thirty acres" from Alphonse, who does not correct the impression that Gaston has. The failure to speak is a nondisclosure—presumably intentional, in this situation—that would allow Gaston to rescind a contract induced by his belief that he was purchasing thirty acres.

Statements of Opinion

An opinion, of course, is not a fact; neither is sales puffery. For example, the statements "In my opinion this apple is very tasty" and "These apples are the best in the county" are not facts; they are not expected to be taken as true. Reliance on opinion is hazardous and generally not considered justifiable.

If Jack asks what condition the car is in that he wishes to buy, Mr. Olson's response of "Great!" is not ordinarily a misrepresentation. As the Restatement puts it: "The propensity of sellers and buyers to exaggerate the advantages to the other party of the bargains they promise is well recognized, and to some extent their assertions must be discounted." Restat 2d of Contracts, § 168(d).

Vague statements of quality, such as that a product is "good," ought to suggest nothing other than that such is the personal judgment of the opinion holder. Despite this general rule, there are certain exceptions that justify reliance on opinions and effectively make them into facts. Merely because someone is less astute than the one with whom she is bargaining does not give rise to a claim of justifiable reliance on an unwarranted opinion. However, if the person is inexperienced and susceptible or gullible to blandishments, the contract can be voided, as illustrated in *Vokes v. Arthur Murray, Inc.*, 212 So.2d 906 (Fla. 1968) (dance studio falsely claimed elderly customer was getting better and had real talent to get her to purchase over $31,000 in dance lessons, when customer had no talent at dancing).

Misstatement of Law

Incorrect assertions of law usually do not give rise to any relief, but sometimes they do. An assertion that "the city repealed the sales tax" or that a court cleared title to a parcel of land is a statement of fact; if such assertions are false, they are governed by the same rules that govern misrepresentations of fact generally. An assertion of the legal consequences of a given set of facts is generally an opinion on which the recipient relies at his or her peril, especially if both parties know or assume the same facts. Thus, if there is a lien on a house, the seller's statement that "the courts will throw it out, you won't be bothered by it" is an opinion. A statement that "you can build a five-unit apartment on this property" is not actionable because, at common law, people are supposed to know what the local and state laws are, and nobody should rely on a layperson's statement about the law. However, if the statement of law is made by a lawyer or real estate broker, or some other person on whom a layperson may justifiably rely, then it may be taken as a fact and, if untrue, as the basis for a claim of misrepresentation.

Assertions of Intention

Usually, **assertions of intention** are not considered facts. The law allows considerable leeway in the honesty of assertions of intention. The Restatement talks in terms of "a misrepresentation of intention…consistent with reasonable standards of fair dealing." Restat 2d of Contracts, § 171(1). The right to misstate intentions is useful chiefly in the acquisition of land; the cases permit buyers to misrepresent the purpose of the acquisition so as not to arouse the suspicion of the seller that the land is worth considerably more than his asking price. To be a misrepresentation that will permit rescission, an assertion of intention must be false at the time made; that is, the person asserting an intention must not then have intended it. That later he or she does not carry out the stated intention is not proof that there was no intention at the time asserted. Moreover, to render a contract voidable, the false assertion of intention must be harmful in some way to other interests of the recipient. Thus, in the common example, the buyer of land tells the seller that he intends to build a residence on the lot, but he actually intends to put up a factory and lied because he knows that otherwise the seller will not part with it because her own home is on an adjacent lot. The contract is voidable by the seller. So a developer says, as regards the picturesque old barn on the property, "I'll sure try to save it," but after he buys the land he realizes it would be very expensive (and in the way), so he does not try to save it. No misrepresentation.

Intentionally Made Misrepresentation

Another element necessary to prove fraud is that the misrepresentation was intentionally made. A misrepresentation is intentionally made "if the maker intends his assertion to induce a party to manifest his assent and the maker (a) knows or believes that the assertion is not in accord with the facts, or (b) does not have the confidence that he states or implies in the truth of the assertion, or (c) knows that he does not have the basis that he states or implies for the assertion." Restat 2d of Contracts, § 162(1).

The question of intent often has practical consequences in terms of the remedy available to the plaintiff. If the misrepresentation is fraudulent, the plaintiff may, as an alternative to avoiding the contract, recover damages. Some of this is discussed later in this unit when we discuss contract remedies, where we see that some states would force the plaintiff to elect one of these two remedies, whereas other states would allow the plaintiff to pursue both remedies (although only one type of recovery would eventually be allowed). If the misrepresentation is not intentional, then the common law allowed the plaintiff only the remedy of rescission. But the Uniform Commercial Code (UCC), Section 2-721, allows both remedies in contracts for the sale of goods, whether the misrepresentation is fraudulent or not, and does not require election of remedies. Md. Code Ann., Com. Law § 2-721.

Reliance

The final element necessary to prove fraud is **reliance** by the victim. He or she must show that the misrepresentation induced assent—that is, he or she relied on it to their detriment. The reliance need not be solely on the false assertion; the defendant cannot win the case by demonstrating that the plaintiff would have assented to the contract even without the misrepresentation. It is sufficient to avoid the contract if the plaintiff weighed the assertion as one of the important factors leading him to make the contract, and he believed it to be true. The person who asserts reliance to avoid a contract must have acted in good faith and reasonably in relying on the false assertion. Thus if the victim failed to read documents given him that truly stated the facts, he cannot later complain that he relied on a contrary statement, as, for example, when the purchaser of a car dealership was told the inventory consisted of new cars, but the supporting papers, receipt of which he acknowledged, clearly stated how many miles each car had been driven. If Mr. Olson tells Jack that the car Jack is interested in is "a recognized classic," and if Jack doesn't care a whit about that but buys the car because he likes its tail fins, he will have no case against Mr. Olson when he finds out the car is not a classic: it didn't matter to him, and he didn't rely on it.

Ordinarily, the person relying on a statement need not verify it independently. However, if verification is relatively easy, or if the statement is one that concerns matters peculiarly within the person's purview, he or she may not be held to have justifiably relied on the other party's false assertion. Moreover, usually the rule of reliance applies to statements about past events or existing facts, not about the occurrence of events in the future.

Nonfraudulent Misrepresentation

Nonfraudulent misrepresentation may also be grounds for some relief. There are two types: negligent misrepresentation and innocent misrepresentation.

Negligent Misrepresentation

Where representation is caused by carelessness, it is **negligent misrepresentation**. To prove it, a plaintiff must show a negligent misstatement of fact that is material and justifiably relied upon.

"The principal elements of the tort of negligent misrepresentation … [are]:

(1) the defendant, owing a duty of care to the plaintiff, negligently asserts a false statement; (2) the defendant intends that his statement will be acted upon by the plaintiff; (3) the defendant has knowledge that the plaintiff will probably rely on the statement, which, if erroneous, will cause loss or injury; (4) the plaintiff, justifiably, takes action in reliance on the statement; and (5) the plaintiff suffers damage proximately caused by the defendant's negligence." *Martens Chevrolet, Inc. v. Seney*, 292 Md. 328, 336-37, 439 A.2d 534, 539 (1982)

Negligence

As an element of misrepresentation, "negligence" here means the party who makes the representation was careless. A potential buyer of rural real estate asks the broker if the neighborhood is quiet. The broker assures her it is. In fact, the neighbors down the road have a whole kennel of hunting hounds that bark a lot. The broker didn't know that; she just assumed the neighborhood was quiet. That is negligence: failure to use appropriate care. By not checking the neighborhood first or even in response to the question, the broker was negligent.

Misstatement of Fact

Whether a thing is a fact may be subject to the same general analysis used in discussing fraudulent misrepresentation. (A person could negligently conceal a fact, or negligently give an opinion, as in legal malpractice.)

Materiality

A **material misrepresentation** is one that "would be likely to induce a reasonable person to manifest his assent" or that "the maker knows…would be likely to induce the recipient to do so." Restat 2d of Contracts, § 162(2). An honestly mistaken statement that the house for sale was built in 1922 rather than 1923 would not be the basis for avoiding the contract because it is not material unless the seller knew that the buyer had sentimental or other reasons for purchasing a house built in 1922. *See Carozza v. Peacock Land Corp.*, 231 Md. 112, 121, 188 A.2d 917, 921 (1963) ("A fact is material if its existence or nonexistence is a matter to which a reasonable man would attach importance in determining his choice of action in the transaction, or the maker of the misrepresentation knows that its recipient is likely to regard the fact as important although a reasonable man would not so regard it."); *Snyder v. Herbert Greenbaum & Assoc., Inc.*, 38 Md. App. 144, 148, 380 A.2d 618, 621 (1977) ("In order for the misrepresentations to have this effect, not only must there be representations that are false, but the representations must be of facts, and the facts must be material to the contracting.")

Justifiable Reliance

The issues here for negligent misrepresentation are the same as those set out for fraudulent misrepresentation. Negligent misrepresentation implies culpability and is usually treated the same as fraudulent misrepresentation; if the representation is not fraudulent, however, it cannot be the basis for rescission unless it is also material. As with fraudulent misrepresentation, the plaintiff must have relied on the misrepresentation and that reliance must be justifiable- meaning it was reasonable for the plaintiff to have relied on the statement.

Innocent Misrepresentation

The elements necessary to prove innocent misrepresentation are, reasonably enough, based on what we have looked at so far, as follows: an innocent misstatement of fact that is material and justifiably relied upon. It is not necessary here to go over the elements in detail. The issues are the same as previously discussed, except now the misrepresentation is innocent. The plaintiffs purchased the defendants' eighteen-acre parcel on the defendants' representation that the land came with certain water rights for irrigation, which they believed was true. It was not true. The plaintiffs were entitled to rescission on the basis of innocent misrepresentation. *Lesher v. Strid*, 996 P.2d 988 (Or. Ct. App. 2000).

Remedies

Remedies will be taken up in more detail later in this unit, but it is worth noting the difference between remedies for fraudulent misrepresentation and remedies for nonfraudulent misrepresentation.

Fraudulent misrepresentation has traditionally given the victim the right to rescind the contract promptly (return the parties to the before-contract status) *or* affirm it and bring an action for damages caused by the fraud, but not both. *Merritt v. Craig*, 130 Md. App. 350, 746 A.2d 923 (2000). The UCC rejected the "election of remedies" doctrine; it allows cumulative damages, such that the victim can both return the goods and sue for damages. Md. Code Ann., Com. Law § 2-721. And this is the modern trend for fraudulent misrepresentation: victims may first seek damages, and if that does not make them whole, they may seek rescission. *Ehrman v. Mann*, 979 So.2d 1011 (Fla. Ct. App. 2008). In egregious cases of fraud where the defendant undertakes a pattern of such deceit, the rare civil remedy of punitive damages may be awarded against the defendant.

One further note: the burden of proof for fraudulent misrepresentation is that it must be proved not just "by a preponderance of the evidence," as in the typical civil case, but rather "by clear, cogent, and convincing evidence"; the fact finder must believe the claim of fraud is very probably true. *Kirkham v. Smith*, 23 P.3d 10, 13 (Wash. Ct. App. 2001).

The remedy for nonfraudulent misrepresentation is normally merely rescission of the contract since the offending party had no intent to commit fraud- damages would usually not be an appropriate remedy.

Mistake

In discussing fraud, we have considered the ways in which trickery by the other party makes a contract void or voidable. We now examine the ways in which the parties might "trick" themselves by making assumptions that lead them mistakenly to believe that they have agreed to something they have not. A mistake is "a belief about a fact that is not in accord with the truth." Restat 2d of Contracts, § 151.

Unilateral Mistake

Where one party makes a mistake, it is a unilateral mistake. The rule: ordinarily, a contract is not voidable because one party has made a mistake about the subject matter (e.g., the truck is not powerful enough to haul the trailer; the dress doesn't fit). *See Creamer v. Helferstay*, 294 Md. 107, 121, 448 A.2d 332, 339 (1982) ("absent intentional, culpable conduct, such as fraud, duress or undue influence, a unilateral mistake is ordinarily not a ground for relief from a contract.")

Exceptions

If one side *knows or should know* that the other has made a mistake, he or she may not take advantage of it. And, as the Court of Appeals of Maryland stated in *Creamer*, intentional, culpable conduct will be grounds to rescind a contract where the mistake is unilateral. *See id.*

A person who makes the mistake of not reading a written document will usually get no relief, nor will relief be afforded to one whose mistake is caused by negligence (a contractor forgets to add in the cost of insulation) unless the negligent party would suffer unconscionable hardship if the mistake were not corrected. Courts will allow the correction of drafting errors in a contract ("reformation") in order to make the contract reflect the parties' intention. *Sikora v. Vanderploeg*, 212 S.W.3d 277 (Tenn. Ct. App. 2006).

Mutual Mistake

In the case of mutual mistake—both parties are wrong about the subject of the contract—relief may be granted. The Restatement sets out three requirements for successfully arguing mutual mistake. The party seeking to avoid the contract must prove that

1. the mistake relates to a "basic assumption on which the contract was made",
2. the mistake has a material effect on the agreed exchange of performances, and
3. the party seeking relief does not bear the risk of the mistake. Restat 2d of Contracts, § 152

Basic assumption is probably clear enough. In the famous "cow case," the defendant sold the plaintiff a cow—Rose of Abalone—believed by both to be barren and thus of less value than a fertile cow (a promising young dairy cow in 2010 might sell for $1,800). Just before the plaintiff was to take Rose from the defendant's barn, the defendant discovered she was "large with calf"; he refused to go on with the contract. The court held this was a mutual mistake of fact—"a barren cow is substantially a different creature than a breeding one"—and ruled for the defendant. That she was infertile was "a basic assumption" of the contract. But—for example—that hay would be readily available to feed her inexpensively was not a basic assumption of the contract, and had hay been expensive, that would not have rescinded the contract. *See also Wheat v. Cross*, 31 Md. 99, 104 (1869) ("In a case where there is a mutual mistake of the parties as to the subject-matter of the contract, or the price or terms, going to show the want of a consensus ad idem [meeting of the minds], without which no contract can arise, such a defence [sic] may be made."); *Bartlett v. Dept. of Transp.*, 40 Md App. 47, 388 A.2d 930 (1978) (mistake in determining purchase price based on a price per acre deemed not material, but rather a computational error).

Material Effect on the Agreed-to Exchange of Performance

"Material effect on the agreed-to exchange of performance" means that because of the mutual mistake, there is a significant difference between the value the parties thought they were exchanging compared with what they would exchange if the contract were performed, given the standing facts. Again, in the cow case, had the seller been required to go through with the deal, he would have given up a great deal more than he anticipated, and the buyer would have received an unagreed-to windfall.

Party Seeking Relief Does Not Bear the Risk of the Mistake

Assume a weekend browser sees a painting sitting on the floor of an antique shop. The owner says, "That old thing? You can have it for $100." The browser takes it home, dusts it off, and hangs it on the wall. A year later a visitor, an expert in art history, recognizes the hanging as a famous lost El Greco worth $1 million. The story is headlined; the antique dealer is chagrined and claims the contract for sale should be voided because both parties mistakenly thought they were dickering over an "old, worthless" painting.

The contract is valid. The owner is said to bear the risk of mistake because he contracted with conscious awareness of his ignorance: he knew he didn't know what the painting's possible value might be, but he didn't feel it worthwhile to have it appraised. He gambled it wasn't worth much, and lost.

A party signing a contract is presumed to have read and understood the contents, and will be bound by the terms contained therein. Ignorance of the terms of the agreement or failing to read the "fine print" will not relieve the party from the enforcement of the contract. *Dynacorp Ltd. v. Aramatel Ltd.*, 208 Md. App. 403, 477, 56 A.3d 631, 675 (2012) (party held to forum selection clause in contract regardless of awareness of provision); *Western Md. Dairy Corp.*, 169 Md. at 263-64, 181 A. at 471-72 (where plaintiff was rushed into signing release at hospital without the time to read it and understand the contents, the release will be rescinded).

Capacity

A contract requires a meeting of minds. To enter into a valid contract, the parties must possess the mental capacity to consent to its terms. *Potter v. Musick*, 247 Md. 39, 40-41, 230 A.2d 91, 92 (1967). If someone lacks mental capacity to understand what he is assenting to—or that he is assenting to anything—it is unreasonable to hold him to the consequences of his act. At common law there are various classes of people who are presumed to lack the requisite capacity. These include infants (minors), the mentally ill, and the intoxicated.

Minors (or "Infants")

The general rule is this: minors (or more legalistically "infants") are in most states persons younger than eighteen years old; they can avoid their contracts, up to and within a reasonable time after reaching majority, subject to some exceptions and limitations. The rationale here is that infants do not stand on an equal footing with adults, and it is unfair to require them to abide by contracts made when they have immature judgment.

The words *minor* and *infant* are mostly synonymous, but not exactly, necessarily. In a state where the legal age to drink alcohol is twenty-one, a twenty-year-old would be a minor, but not an infant, because infancy is under eighteen. A seventeen-year-old may avoid contracts (usually), but an eighteen-year-old, while legally bound to his contracts, cannot legally drink alcohol. Strictly speaking, the better term for one who may avoid his contracts is *infant*, even though, of course, in normal speaking we think of an infant as a baby.

The age of majority (when a person is no longer an infant or a minor) was lowered in all states except Mississippi during the 1970s (to correspond to the Twenty-Sixth Amendment, ratified in 1971, guaranteeing the right to vote at eighteen) from twenty-one to either eighteen or nineteen. Maryland's legal age of majority is 18. Md. Code Ann., Gen. Provis. § 1-401 (LexisNexis 2021). Legal rights for those under twenty-one remain ambiguous, however. Although eighteen-year-olds may assent to binding contracts, not all creditors and landlords believe it, and they may require parents to cosign. For those under twenty-one, there are also legal impediments to holding certain kinds of jobs, signing certain kinds of contracts, marrying, leaving home, and drinking alcohol. There is as yet no uniform set of rules.

The exact day on which the disability of minority vanishes also varies. The old common-law rule put it on the day before the twenty-first birthday. Many states have changed this rule so that majority commences on the day of the eighteenth birthday. An infant's contract is voidable, not void. An infant wishing to avoid the contract need do nothing positive to disaffirm. The defense of infancy to a lawsuit is sufficient; although the adult cannot enforce the contract, the infant can (which is why it is said to be voidable, not void).

Exceptions and Complications

There are exceptions and complications here. We call out six of them.

Necessities

First, as an exception to the general rule, infants are generally liable for the reasonable cost of necessities (for the reason that denying them the right to contract for necessities would harm them, not protect them). At common law, a necessity was defined as food, medicine, clothing, or shelter. *Garay v. Overholtzer*, 332 Md. 339, 631 A.2d 429 (1993) (minor is liable for cost of medical care if parents cannot pay). In recent years, however, the courts have expanded the concept, so that in many states today, necessities include property and services that will enable the infant to earn a living and to provide for those dependent on him. If the contract is executory, the infant can simply disaffirm. If the contract has been executed, however, the infant must face more onerous consequences. Although he will not be required to perform under the contract, he will be liable under a theory of "quasi-contract" for the reasonable value of the necessity.

In *Gastonia Personnel Corp. v. Rogers*, 172 S.E.2d 19 (N.C. 1970) an emancipated infant, nineteen years old (before the age of minority was reduced), needed employment; he contracted with a personnel company to find him a job, for which it would charge him a fee. The company did find him a job, and when he attempted to disaffirm his liability for payment on the grounds of infancy, the North Carolina court ruled against him, holding that the concepts of necessities "should be enlarged to include such…services as are reasonable and necessary to enable the infant to earn the money required to provide the necessities of life for himself" and his dependents. *Id.* at 24.

Nonvoidable Contracts

Second, state statutes variously prohibit disaffirmation for such contracts as insurance, education or medical care, bonding agreements, stocks, or bank accounts. In addition, an infant will lose her power to avoid the contract if the rights of third parties intervene. Roberta, an infant, sells a car to Oswald; Oswald, in turn, shortly thereafter sells it to Byers, who knows nothing of Roberta. May Roberta—still an infant—recover it from Byers? No: the rights of the third party have intervened. To allow the infant seller recovery in this situation would undermine good faith in commercial transactions.

Misrepresentation of Age

A third exception involves misrepresentation of age. Certainly, that the adult reasonably believed the infant was an adult is of no consequence in a contract suit. In many states, an infant may misrepresent his age and disaffirm in accordance with the general rule. But it depends. If an infant affirmatively lies about his age, the trend is to deny disaffirmation. A Michigan statute, for instance, prohibits an infant from disaffirming if he signed a "separate instrument containing only the statement of age, date of signing and the signature." Mich. Comp. Laws Serv. § 600.1403 (LexisNexis 2021). And some states estop him from claiming to be an infant even if he less expressly falsely represented himself as an adult.

Estoppel is a refusal by the courts on equitable grounds to allow a person to escape liability on an otherwise valid defense; unless the infant can return the consideration, the contract will be enforced. It is a question of fact how far a nonexpress (an implied) misrepresentation will be allowed to go before it is considered so clearly misleading as to range into the prohibited area. Some states hold the infant liable for damages for the tort of misrepresentation, but others do not. As William Prosser, the noted torts scholar, said of cases paying no attention to an infant's lying about his age, "The effect of the decisions refusing to recognize tort liability for misrepresentation is to create a privileged class of liars who are a great trouble to the business world" (Prosser 999.)

Ratification

Fourth, when the infant becomes an adult, she has two choices: she may ratify the contract or disaffirm it. She may ratify explicitly; no further consideration is necessary. She may also do so by implication—for instance, by continuing to make payments or retaining goods for an unreasonable period of time. If the child has not disaffirmed the contract while still an infant, she may do so within a reasonable time after reaching majority; what is a "reasonable time" depends on the circumstances.

Duty to Return Consideration Received

Fifth, in most cases of disavowal, the infant's only obligation is to return the goods (if he still has them) or repay the consideration (unless it has been dissipated); he does not have to account for what he wasted, consumed, or damaged during the contract. But since the age of majority has been lowered to eighteen or nineteen, when most young people have graduated from high school, some courts require, if appropriate to avoid injustice to the adult that the infant account for what he got. In *Dodson v. Shrader*, the Supreme Court of Tennessee held that an infant would–if the contract was fair–have to pay for the pickup truck he bought and wrecked. *Dodson v. Shrader*, 824 S.W.2d 545 (Tenn. 1992).

Tort Connected with a Contract

Sixth, the general rule is that infants are liable for their torts (e.g., assault, trespass, nuisance, negligence) unless the tort suit is only an indirect method of enforcing a contract. Henry, age seventeen, holds himself out to be a competent mechanic. He is paid $500 to overhaul Baker's engine, but he does a careless job and the engine is seriously damaged. He offers to return the $500 but disaffirms any further contractual liability. Can Baker sue him for his negligence, a tort? No, because such a suit would be to enforce the contract.

Parental Liability

Parents are generally not liable for a minor's contracts unless they separately agreed (such as co-signed) for the contract.

Persons Who Are Mentally Ill or Intoxicated

Mentally Ill Persons

The general rule is that a contract made by person who is mentally ill is voidable by the person when she regains her sanity, or, as appropriate, by a guardian. If, though, a guardian has been legally appointed for a person who is mentally ill, any contract made by the mentally ill person is void, but may nevertheless be ratified by the ward (the incompetent person who is under a guardianship) upon regaining sanity or by the guardian. Restat 2d of Contracts, § 13.

However, if the contract was for a necessity, the other party may have a valid claim against the estate of the one who is mentally ill in order to prevent unjust enrichment. In other cases, whether a court will enforce a contract made with a person who is mentally ill depends on the circumstances. Only if the mental illness impairs the competence of the person in the particular transaction can the contract be avoided; the test is whether the person understood the nature of the business at hand. Upon avoidance, the mentally ill person must return any property in her possession. And if the contract was fair and the other party had no knowledge of the mental illness, the court has the power to order other relief.

Intoxicated Persons

States vary in how they treat intoxication as a defense to a contract claim. Some states require that the other party be aware of the intoxication to invalidate a contract; others do not require notice of the intoxication by the other party. A contract with an intoxicated person is voidable, meaning it can be ratified or disclaimed by the intoxicating party after he or she regains sobriety. In Maryland

"the intoxication of a person which will invalidate a deed or contract made by him must be such as to render him incapable of knowing what he is doing, or to deprive him of the powers of reasoning and understanding to such an extent that he fails entirely to comprehend the consequences of his act. In order to set aside a person's contract on the ground of drunkenness, it is not sufficient to show that he was under undue excitement from the use of liquor. His incompetency can be established only by proof that at the time of the challenged act his understanding was clouded or his reason dethroned by actual intoxication. The mere showing that he had previously been intoxicated on numerous occasions is not sufficient. The temporary mental derangement produced by intoxication must be shown to have existed at the time of the transaction." *Lynn v. Magness*, 191 Md. 674, 682, 62 A.2d 604, 608 (1948)

If a person is only partially inebriated and has some understanding of his actions, "avoidance depends on a showing that the other party induced the drunkenness or that the consideration was inadequate or that the transaction departed from the normal pattern of similar transactions; if the particular transaction is one which a reasonably competent person might have made, it cannot be avoided even though entirely executory." Restat 2d of Contracts, § 16(b). A person who was intoxicated at the time he made the contract may nevertheless subsequently ratify it. Thus where Mervin Hyland, several times involuntarily committed for alcoholism, executed a promissory note in an alcoholic stupor but later, while sober, paid the interest on the past-due note, he was denied the defense of intoxication; the court said he ratified his contract. *First State Bank of Sinai v. Hyland*, 399 N.W.2d 894 (S.D. 1987). In any event, intoxicated is a disfavored defense on public policy grounds.

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Contract Interpretation, Performance & Breach

Once a valid contract has been formed, the next issue for the parties is what exactly they have agreed to. There are a variety of issues related to how to interpret a contract, including the kind of evidence that is admissible to aid a court in interpreting a contract, and other doctrines courts employ to interpret the language of the agreement itself.

The Parol Evidence Rule

Unlike Minerva sprung forth whole from the brow of Zeus in Greek mythology, contracts do not appear at a stroke memorialized on paper. Almost invariably, negotiations of some sort precede the concluding of a deal. People write letters, talk by telephone, meet face-to-face, send e-mails, and exchange thoughts and views about what they want and how they will reciprocate. They may even lie and cajole in duplicitous ways, making promises they know they cannot or will not keep in order not to kill the contract talks. In the course of these discussions, they may reach tentative agreements, some of which will ultimately be reflected in the final contract, some of which will be discarded along the way, and some of which perhaps will not be included in the final agreement but will nevertheless not be contradicted by it. Whether any weight should be given to these prior agreements is a problem that frequently arises.

Parol Evidence at Common-Law

The rule at common law is this: a written contract intended to be the parties' complete understanding discharges all prior or contemporaneous promises, statements, or agreements that add to, vary, or conflict with it. "Essentially, the **parol evidence rule** excludes . . . evidence of prior and contemporaneous agreements, unless the terms of the agreement are ambiguous." *Ruiz v. Kinoshita*, 239 Md. App. 395, 424, 197 A.3d 47, 64 (2018) (quoting *Sutton v. Banner Life Ins. Co.*, 686 A.2d 1045, 1049 (D.C. 1996)).

The parol evidence rule (*parol* means oral; it is related to *parliament* and *parly*—talking) is a substantive rule of law that operates to bar the introduction of evidence intended to show that the parties had agreed to something different from what they finally arrived at and wrote down. It applies to prior written as well as oral discussions that don't make it into the final written agreement. Though its many apparent exceptions make the rule seem difficult to apply, its purposes are simple: to give freedom to the parties to negotiate without fear of being held to the consequences of asserting preliminary positions, and to give finality to the contract.

The rule applies to all written contracts, whether or not the Statute of Frauds requires them to be in writing. The Statute of Frauds gets to whether there was a contract at all; the parol evidence rule says, granted there was a written contract, does it express the parties' understanding? But the rule is concerned only with events that transpired before the contract in dispute was signed. It has no bearing on agreements reached subsequently that may alter the terms of an existing contract.

The Exemptions and Exceptions

Despite its apparent stringency, the parol evidence rule does not negate all prior agreements or statements, nor preclude their use as evidence. A number of situations fall outside the scope of the rule and hence are not technically exceptions to it, so they are better phrased as exemptions (something not within the scope of a rule).

Table 13 Exceptions to Parol Evidence Rule

Exceptions
Not An Integrated Contract
Void or voidable contract
Contracts subject to a condition precedent
Untrue Recitals or Errors
Ambiguity
Post-contract modification
UCC - Course of Dealing, Usage of Trade, or Course of Performance

Not an Integrated Contract

If the parties never intended the written contract to be their full understanding—if they intended it to be partly oral—then the rule does not apply. If the document is fully integrated, no extrinsic evidence will be permitted to modify the terms of the agreement, even if the modification is in addition to the existing terms, rather than a contradiction of them.

If the contract is partially integrated, prior consistent additional terms may be shown. It is the duty of the party who wants to exclude the parol evidence to show the contract was intended to be integrated. That is not always an easy task. To prevent a party later from introducing extrinsic evidence to show that there were prior agreements, the contract itself can recite that there were none. Here, for example, is the final clause in the National Basketball Association Uniform Player Contract: "This agreement contains the entire agreement between the parties and there are no oral or written inducements, promises or agreements except as contained herein." Such a clause is known as a merger clause.

Void or Voidable Contracts

Parol evidence is admissible to show the existence of grounds that would cause the contract to be void. Such grounds include illegality, fraud, duress, mistake, and lack of consideration. *See Hearn v. Hearn*, 177 Md App. 525, 541-43, 936 A.2d 400 (2007) (parol evidence to establish mutual mistake). And parol evidence is allowed to show evidence of lack of contractual capacity. Evidence of infancy, incompetency, and intoxication would not change the terms of the contract at all but would show it was voidable or void.

Contracts Subject to a Condition Precedent

When the parties orally agree that a written contract is contingent on the occurrence of an event or some other condition (a condition precedent), the contract is not integrated and the oral agreement may be introduced. The classic case is that of an inventor who sells in a written contract an interest in his invention. Orally, the inventor and the buyer agree that the contract is to take effect only if the buyer's engineer approves the invention. (The contract was signed in advance of approval so that the parties would not need to meet again.) The engineer did not approve it, and in a suit for performance, the court permitted the evidence of the oral agreement because it showed "that in fact there never was any agreement at all." *Pym v. Campbell*, 119 Eng. Rep. 903 (Q.B. 1856). Note that the oral condition does not contradict a term of the written contract; it negates it. The parol evidence rule will not permit evidence of an oral agreement that is inconsistent with a written term, for as to that term the contract is integrated.

Untrue Recital or Errors

The parol evidence rule does not prevent a showing that a fact stated in a contract is untrue. The rule deals with prior agreements; it cannot serve to choke off inquiry into the facts. Thus the parol evidence rule will not bar a showing that one of the parties is a minor, even if the contract recites that each party is over eighteen. Nor will it prevent a showing that a figure in the contract had a typographical error—for example, a recital that the rate charged will be the plumber's "usual rate of $3 per hour" when both parties understood that the usual rate was in fact $30 per hour. A court would allow reformation (correction) of such errors.

Ambiguity

To enforce a contract, its terms must be understood, so parol evidence would be allowed, but a claim of ambiguity cannot be used to alter, vary, or change the contract's meaning.

Post-contract Modification

Ordinarily, an additional consistent oral term may be shown only if the contract was partially integrated. The parol evidence rule bars evidence of such a term if the contract was fully integrated. However, when there is additional consideration for the term orally agreed, it lies outside the scope of the integrated contract and may be introduced. In effect, the law treats each separate consideration as creating a new contract; the integrated written document does not undercut the separate oral agreement, as long as they are consistent.

Buyer purchases Seller's business on a contract; as part of the agreement, Seller agrees to stay on for three weeks to help Buyer "learn the ropes." Buyer realizes she is not yet prepared to go on her own. She and Seller then agree that Seller will stay on as a salaried employee for five more weeks. Buyer cannot use the parol evidence rule to preclude evidence of the new agreement: it is a postcontract modification supported by new consideration. Similarly, parties could choose to rescind a previously made contract, and the parol evidence rule would not bar evidence of that.

The UCC Approach

Under Section 2-202 of the UCC, a course of dealing, a usage of trade, or a course of performance can be introduced as evidence to explain or supplement any written contract for the sale of goods.

A course of dealing is defined as "a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct." Md. Code Ann., Com. Law, §§ 2-105, 2-202. A usage of trade is "any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question." *Id.* A course of performance is the conduct of a party in response to a contract that calls for repeated action (e.g., a purchase agreement for a factory's monthly output, or an undertaking to wash a neighbor's car weekly). Md. Code Ann., Com. Law, §§ 2-202, 2-208.

Interpretation of Agreements: Practicalities versus Legalities

The General Problem and the Purpose of Contractual Interpretation

As any reader knows, the meaning of words depends in part on context and in part on the skill and care of the writer. As Justice Oliver Wendell Holmes Jr. once succinctly noted, "A word is not a crystal, transparent and unchanged; it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used." *Towne v. Eisner*, 245 US 418, 425 (1917). Words and phrases can be ambiguous, either when they stand alone or when they take on a different coloration from words and phrases near them. A writer can be careless and contradict himself without intending to; people often read hurriedly and easily miss errors that a more deliberate perusal might catch. Interpretation difficulties can arise for any of a number of reasons: a form contract might contain language that is inconsistent with provisions specifically annexed; the parties might use jargon that is unclear; they might forget to incorporate a necessary term; assumptions about prior usage or performance, unknown to outsiders like judges, might color their understanding of the words they do use. Because ambiguities do arise, courts are frequently called on to give content to the words on paper.

The Basic Rule of Interpretation

Courts attempt to give meaning to the parties' understanding when they wrote the contract.

The intention of the parties governs, and if their purpose in making the contract is known or can be ascertained from all the circumstances, it will be given great weight in determining the meaning of an obscure, murky, or ambiguous provision or a pattern of conduct. A father tells the college bookstore that in consideration of its supplying his daughter, a freshman, with books for the coming year, he will guarantee payment of up to $350. His daughter purchases books totaling $400 the first semester, and he pays the bill. Midway through the second semester, the bookstore presents him with a bill for an additional $100, and he pays that. At the end of the year, he refuses to pay a third bill for $150. A court could construe his conduct as indicating a purpose to ensure that his daughter had whatever books she needed, regardless of cost, and interpret the contract to hold him liable for the final bill.

Tools of Interpretation

The policy of uncovering purpose has led to a number of tools of judicial interpretation:

- More specific terms or conduct are given more weight than general terms or unremarkable conduct. Thus a clause that is separately negotiated and added to a contract will be counted as more significant than a standard term in a form contract.
- A writing is interpreted as a whole, without undue attention to one clause.
- Common words and terms are given common meaning; technical terms are given their technical meanings.
- In the range of language and conduct that helps in interpretation, the courts prefer the following items in the order listed: express terms, course of performance, course of dealing, and usage of trade.
- If an amount is given in words and figures that differ, the words control.
- Writing controls over typing; typing controls over printed
- Ambiguities are construed against the party that wrote the contract.

In this section, we have considered a set of generally technical legal rules that spell out the consequences of contracts that are wholly or partially oral or that, if written, are ambiguous or do not contain every term agreed upon.

These rules fall within three general headings:

1. the Statute of Frauds,
2. the parol evidence rule, and
3. the rules of interpretation.

Obviously, the more attention paid to the contract before it is formally agreed to, the fewer the unforeseen consequences. In general, the conclusion is inescapable that a written contract will avoid a host of problems. Writing down an agreement is not always sensible or practical, but it can probably be done more often than it is. Writing almost fifty years ago—and it is still true—a law professor studying business practices noted the following:

> Businessmen often prefer to rely on "a man's word" in a brief letter, a handshake or "common honesty and decency"—even when the transaction involves exposure to serious risks. Seven lawyers from law firms with business practices were interviewed. Five thought that businessmen often entered contracts with only a minimal degree of advanced planning. They complained that businessmen desire to "keep it simple and avoid red tape" even where large amounts of money and significant risks are involved.…Another said that businessmen when bargaining often talk only in pleasant generalities, think they have a contract, but fail to reach agreement on any of the hard, unpleasant questions until forced to do so by a lawyer (Macaulay 58–59).

Written contracts do not, to be sure, guarantee escape from disputes and litigation. Sometimes ambiguities are not seen; sometimes they are necessary if the parties are to reach an agreement at all.

Rather than back out of the deal, it may be worth the risk to one or both parties deliberately to go along with an ambiguous provision and hope that it never arises to be tested in a dispute that winds up in court. Nevertheless, it is generally true that a written contract has at least three benefits over oral ones, even those that by law are not required to be in writing:

(1) The written contract usually avoids ambiguity.

(2) It can serve both as a communications device and as a device for the allocation of power, especially within large companies. By alerting various divisions to its formal requirements, the contract requires the sales, design, quality-control, and financial departments to work together. By setting forth requirements that the company must meet, it can place the power to take certain actions in the hands of one division or another.

(3) Finally, should a dispute later arise, the written contract can immeasurably add to proof both of the fact that a contract was agreed to and of what its terms were.

When a contract's content is defined, the next question presented is whether a party has performed the agreement when a duty under an agreement is due. A party is liable to perform agreed-to contract duties until or unless he or she is discharged. If the person fails to perform without being discharged, liability for damages arises.

Discharge by Performance (or Nonperformance) of the Duty

A contract can be discharged by complete performance or material nonperformance of the contractual duty. Note, in passing, that the modern trend at common law and explicit under the UCC, Section 1-203 is that the parties have a good-faith duty to perform. Md. Code Ann., Com. Law § 1-203; *Plank v.*

Cherneski, 469 Md. 548, 582, 231 A.3d 436, 456 (2020). There is in every contract "an implied covenant of good faith" (honesty in fact in the transaction) that the parties will deal fairly, keep their promises, and not frustrate the other party's reasonable expectations of what was given and what received.

Full Performance

Full performance of the contractual obligation discharges the duty. If Ralph does a fine job of plumbing Betty's new bathroom, she pays him. Both are discharged. Both fully performed their obligations to each other.

Nonperformance, Material Breach

If Ralph doesn't do any work at all on Betty's bathroom, or almost none, then Betty owes him nothing. This would be a material breach of contract – a serious and significant failure on the part of Ralph to perform his obligation. As a result, Betty—the nonbreaching party—is discharged from performing (after all – Betty's obligation is to make payment and there is nothing to pay for), and Ralph is liable for breach of contract. If Betty hires a replacement plumber that costs 50% more than Ralph – Ralph is liable for the additional cost.

Under UCC Section 2-106(4), a party that ends a contract breached by the other party is said to have effected a **cancellation**. Md. Code Ann., Com. Law, § 2-106(4). The cancelling party retains the right to seek a remedy for breach of the whole contract or any unperformed obligation. The UCC distinguishes cancellation from **termination**, which occurs when either party exercises a lawful right to end the contract other than for breach. When a contract is terminated, all executory duties are discharged on both sides, but if there has been a partial breach, the right to seek a remedy survives. Md. Code Ann., Com. Law, § 2-106(3).

Substantial Performance

Logically, anything less than full performance, even a slight deviation from what is owed, is sufficient to prevent the duty from being discharged and can amount to a breach of contract. So if Ralph does all the plumbing for Betty's new bathroom *except* hook up the toilet feed, he has not really "plumbed the new bathroom." He only plumbed part of it. At classic common law, that was it: either you did the thing you promised completely or you materially breached.

But under modern theories, an ameliorative doctrine developed, called substantial performance: if one side substantially, but not completely, performed, so that the other side received a benefit, the nonbreaching party owes something for the value received. The Restatement (Second) of Contracts puts it this way:

"In an important category of disputes over failure of performance, one party asserts the right to payment on the ground that he has completed his performance, while the other party refuses to pay on the ground that there is an uncured material failure of performance.…In such cases it is common to state the issue…in terms of whether there has been substantial performance.…If there has been substantial although not full performance, the building contractor has a claim for the unpaid balance and the owner has a claim only for damages. If there has not been substantial performance, the building contractor has no claim for the unpaid balance, although he may have a claim in restitution." Restat 2d of Contracts, § 237(d).

The contest here is between the one who claims discharge by the other's material breach and the one who asserts there has been substantial performance. What constitutes substantial performance is a question of fact, as illustrated in *Dep't of Hous. & Cmty. Dev. v. Mullen*, 165 Md. App. 624, 886 A.2d 900 (2005) (where curators of historic property failed to follow federal historic guidelines as set forth in contract establishing curatorship in conducting renovations, curator did not substantially comply with the contract). With substantial performance, the nonbreaching party is required to pay the contract price, less any damages or allowances for the deviation in strict performance. *Gamble v. Woodlea Constr. Co.,* 246 Md. 260, 267, 228 A.2d 243, 246 (1967) (measure of recovery for substantial performance is contract price less cost of completing the work in accordance with the contract).

Under the UCC, there is no such thing as substantial performance. Section 2-601 requires that the goods delivered according to the contract be the exact things ordered—that there be a perfect tender (unless the parties agree otherwise). Md. Code Ann., Com. Law, § 2-601.

Anticipatory Breach and Demand for Reasonable Assurances

When a promisor announces before the time his performance is due that he will not perform, he is said to have committed an anticipatory breach **(or anticipatory repudiation)**. "A **contracting** party repudiates or breaches a contract "when in anticipation of the time of performance one definitely and specifically refuses to do something which he is obliged to do, so that it amounts to a refusal to go on with the contract, it may be treated as a breach by anticipation…" *Fort Myer Constr. Corp. v. Banneker Ventures, LLC,* No. 1916, 2017 Md. App. LEXIS 1041, at 41 (App. Oct. 10, 2017) (quoting *C. W. Blomquist & Co. v. Capital Area Realty Investors Corp.*, 270 Md. 486, 494, 311 A.2d 787 (1973)).

Of course a person cannot fail to perform a duty before performance is due, but the law allows the promisee to treat the situation as a material breach that gives rise to a claim for damages and discharges the obligee from performing duties required of him under the contract. The common-law rule was first recognized in the well-known 1853 British case *Hochster v. De La Tour,* 2 Ellis & Blackburn 678 (Q.B. 1853). In April, De La Tour hired Hochster as his courier, the job to commence in June. In May, De La Tour changed his mind and told Hochster not to bother to report for duty. Before June, Hochster secured an appointment as courier to Lord Ashburton, but that job was not to begin until July. Also in May, Hochster sued De La Tour, who argued that he should not have to pay Hochster because Hochster had not stood ready and willing to begin work in June, having already agreed to work for Lord Ashburton. The court ruled for the plaintiff Hochster:

"[I]t is surely much more rational, and more for the benefit of both parties, that, after the renunciation of the agreement by the defendant, the plaintiff should be at liberty to consider himself absolved from any future performance of it, retaining his right to sue for any damage he has suffered from the breach of it. Thus, instead of remaining idle and laying out money in preparations which must be useless, he is at liberty to seek service under another employer, which would go in mitigation of the damages to which he would otherwise be entitled for a breach of the contract. It seems strange that the defendant, after renouncing the contract, and absolutely declaring that he will never act under it, should be permitted to object that faith is given to his assertion, and that an opportunity is not left to him of changing his mind." *Hochster v. De La Tour*, 2 Ellis & Blackburn 678 (Q.B. 1853).

Another type of anticipatory breach consists of any voluntary act by a party that destroys, or seriously impairs, that party's ability to perform the promise made to the other side. If a seller of land, having agreed to sell a lot to one person at a date certain, sells it instead to a third party before that time, there is an anticipatory breach. If Carpenter announces in May that instead of building Owner's deck in July, as agreed, he is going on a trip to Europe, there is an anticipatory breach. In the first instance, there would be no point to showing up at the lawyer's office when the date arrives to await the deed, so the law gives a right to sue when the land is sold to the other person. In the second instance, there would be no point to waiting until July, when indeed Carpenter does not do the job, so the law gives the right to sue when the future nonperformance is announced. These same general rules prevail for contracts for the sale of goods under the UCC. Md. Code Ann., Com. Law, § 2-610.

Related to the concept of anticipatory breach is the idea that the obligee has a right to demand reasonable assurances from the obligor that contractual duties will be performed. If the obligee makes such a demand for reasonable assurances and no adequate assurances are forthcoming, the obligee may assume that the obligor will commit an anticipatory breach, and consider it so. That is, after making the contract, the obligee may come upon the disquieting news that the obligor's ability to perform is shaky. A change in financial condition occurs, an unknown claimant to rights in land appears, a labor strike arises, or any of a number of situations may crop up that will interfere with the carrying out of contractual duties. Under such circumstances, the obligee has the right to a demand for reasonable assurance that the obligor will perform as contractually obligated. The general reason for such a rule is given in UCC Section 2- 609(1), which states that a contract "imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired." Md. Code Ann., Com. Law, § 2-609(1). Moreover, an obligee would be foolish not to make alternative arrangements, if possible, when it becomes obvious that his original obligor will be unable to perform. The obligee must have reasonable grounds to believe that the obligor will breach. The fear must be that of a failure of performance that would amount to a total breach; a minor defect that can be cured and that at most would give rise to an offset in price for damages will not generally support a demand for assurances.

Under UCC Section 2-609(1), the demand must be in writing, but at common law the demand may be oral if it is reasonable in view of the circumstances. *Id.* If the obligor fails within a reasonable time to give adequate assurance, the obligee may treat the failure to do so as an anticipatory repudiation, or she may wait to see if the obligor might change his mind and perform. *RAD Concepts, Inc. v. Wilks Precision Instrument Co.*, 167 Md. App. 132, 891 A.2d 1148 (2006) (corporation stated unwillingness to continue with contract and manufacturer materially changed its position, there was repudiation where the corporation did not subsequently offer adequate assurances in regard to its payment plan).

Discharge by Conditions

Usually contracts consist of an exchange of promises—a pledge or commitment by each party that somebody will or will not do something. Andy's promise to cut Anne's lawn "over the weekend" in return for Anne's promise to pay twenty-five dollars is a commitment to have the lawn mowed by Sunday night. Andy's promise "not to tell anyone what I saw you doing Saturday night" in return for Anne's promise to pay one hundred dollars is a commitment that an event (the revealing of a secret) will not occur. These promises are known as **independent or absolute or unconditional**, because their performance does not depend on any outside event. Such promises, if contractually binding, create a present duty to perform (or a duty to perform at the time stated).

However, it is common that the obligation to perform a contract is conditioned (or conditional).

A **condition** is an event the happening or nonhappening of which gives rise to a duty to perform (or discharges a duty to perform). *Chesapeake Bank of Md. v. Monro Muffler/Brake, Inc.*, 166 Md. App. 695, 707, 891 A.2d 384, 391 (2006) (language in option providing for extension of lease if tenant provided 90 days prior written notice was a condition precedent). Conditions may be express or implied; they may also be precedent, concurrent, subsequent, or to the satisfaction of a party.

Conditions Classified Based on How They Are Created

Express conditions are stated in words in the contract, orally or written. Andy promises to mow Anne's lawn "provided it doesn't rain." "Provided it doesn't rain" is an express condition. If rain comes, there is no duty to cut the lawn, and Andy's failure to do so is not a breach of promise. Express conditions are usually introduced by language such as “provided that,” “if,” “when,” “assuming that,” “as soon as,” “after,” and the like.

Implied conditions are unexpressed but understood to be part of the contract. If Mr. Olson guarantees Jack’s used car for ninety days, it is implied that his obligation to fix any defects doesn’t arise until Jack lets him know the car is defective. If Ralph is hired to plumb Betty’s new bathroom, it is implied that Betty’s duty to pay is conditioned on Ralph’s completion of the job.

Conditions Classified Based on Their Effect on Duty to Perform

A **condition precedent** is a term in a contract (express or implied) that requires performance only in the event something else happens first. *See id.* Jack will buy a car from Mr. Olson if Jack gets financing. “If Jack gets financing” is a condition precedent. A concurrent condition arises when the duty to perform the contract is simultaneous: the promise of a landowner to transfer title to the purchaser and the purchaser to tender payment to the seller at a real estate settlement. The duty of each to perform is conditioned on the performance by the other. (As a practical matter, of course, somebody has to make the first move, proffering deed or tendering the check.)

A condition that terminates an already existing duty of performance is known as a **condition subsequent**. Ralph agrees to do preventive plumbing maintenance on Deborah Dairy’s milking equipment for as long as David Dairy, Deb’s husband, is stationed overseas. When David returns, Ralph’s obligation to do the maintenance (and Deb’s duty to pay him) terminates.

Concurrent Conditions

Concurrent conditions are also known as mutually dependent conditions, meaning each party's duty to perform is conditioned on the other party's duty to perform. Concurrent conditions exist when each party must perform simultaneously. For example, John promises to pay for a shipment of soda to his store upon delivery. Until delivery occurs, John's duty to pay does not arise.

Condition of Timeliness

If, as often occurs, it does not matter a great deal whether a contract is performed exactly on time, failure to do so is not a material breach, and the promisee has to accept the performance and deduct any losses caused by the delay. If, though, it makes a difference to the promisee whether the promisor acts on time, then it is said that “time is of the essence.”

Time as a condition can be made explicit in a clause reciting that time is of the essence. If there is no express clause, the courts will read it in when the purpose of the contract was clearly to provide for performance at or by a certain time, and the promisee will gain little from late performance. But even express clauses are subject to a rule of reason, and if the promisor would suffer greatly by enforcement of the clause (and the promisee would suffer only slightly or not at all from a refusal to invoke it), the courts will generally excuse the untimely performance, as long as it was completed within a reasonable time. A builder’s failure to finish a house by July 1 will not discharge the buyer’s obligation to pay if the house is finished a week or even a month later, although the builder will be liable to the buyer for expenses incurred because of the lateness (storage charges for furniture, costs for housing during the interim, extra travel, and the like).

Condition That a Party Must Be Satisfied

"You must be satisfied or your money back" is a common advertisement. A party to a contract can require that he need not pay or otherwise carry out his undertaking unless satisfied by the obligor's performance, or unless a third party is satisfied by the performance. However, there is an implied understanding that the party to be satisfied will exercise this duty in good faith. *United Wholesalers, Inc. v. A.J. Armstrong, Co.*, 251 F.2d 860, 862 (4th Cir. 1958) (applying Maryland law).

Parties may contract to perform to one side's personal satisfaction. Andy tells Anne, a prospective client, that he will cut her hair better than her regular hairdresser, and that if she is not satisfied, she need not pay him. Andy cuts her hair, but Anne frowns and says, "I don't like it." Assume that Andy's work is excellent. Whether Anne must pay depends on the standard for judging to be employed—a standard of objective or subjective satisfaction. The **objective standard** is that which would satisfy the reasonable purchaser. Most courts apply this standard when the contract involves the performance of a mechanical job or the sale of a machine whose performance is capable of objective measurement. So even if the obligee requires performance to his "personal satisfaction," the courts will hold that the obligor has performed if the service performed or the goods produced are in fact satisfactory. By contrast, if the goods or services contracted for involve personal judgment and taste, the duty to pay will be discharged if the obligee states **personal (subjective) dissatisfaction.** No reason at all need be given, but it must be for a good-faith reason, not just to escape payment.

The duty to make a contract payment may be conditioned on the satisfaction of a third party. Building contracts frequently make the purchaser's duty to pay conditional on the builder's receipt of an architect's certificate of compliance with all contractual terms; road construction contracts often require that the work be done "to the satisfaction of the County Engineer." These conditions can be onerous. The builder has already erected the structure and cannot "return" what he has done. Nevertheless, because the purchaser wants assurance that the building (obviously a major purchase) or road meets his specifications, the courts will hold the contractor to the condition unless it is impossible to provide a certificate (e.g., architect may have died) or the architect acted in bad faith, or the purchaser prevented the certificate from being issued. The third party's refusal to issue a certificate needs to be reasonable.

Discharge by Agreement of the Parties

Parties are free to agree to almost any contract they want, and they are free to agree to end the contract whenever they want. There are several ways this is done.

Mutual Rescission

The parties may agree to give up the duties to perform, called mutual rescission. *Lemlich v. Board of Trustees for Harford Community College*, 282 Md. 495, 385 A.2d 1185 (1978). This may be by a formal written release saying the obligor is discharged upon delivery of the writing or upon occurrence of a condition. Or an obligation may be discharged by a contract not to sue about it. The Restatement terms this an agreement of rescission. Restat 2d of Contracts, § 283.

An agreement to rescind will be given effect even though partial performance has been made or one or both parties have a claim for partial breach. The agreement need not be in writing or even expressed in words. By their actions, such as failure to take steps to perform or enforce, the parties may signal their mutual intent to rescind. Andy starts to mow Anne's lawn as they agreed. He begins the job, but it is unbearably hot. She sees how uncomfortable he is and readily agrees with him when he says, "Why don't we just forget the whole thing?" Andy's duty to finish mowing is discharged, as is Anne's duty to pay Andy, either for the whole job or for the part he has done.

Business executives live by contracts, but they do not necessarily die by them. A sociologist who studied business behavior under contract discovered a generation ago—and it is still valid—that in the great majority of cases in which one party wishes to "cancel an order," the other party permits it without renegotiation, even though the cancellation amounts to a repudiation of a contract. As one lawyer was quoted as saying,

"Often business [people] do not feel they have "a contract"—rather they have an "order." They speak of "cancelling the order" rather than "breaching our contract." When I began practice I referred to order cancellations as breaches of contract, but my clients objected since they do not think of cancellation as wrong. Most clients, in heavy industry at least, believe that there is a right to cancel as part of the buyer-seller relationship. There is a widespread attitude that one can back out of any deal within some very vague limits. Lawyers are often surprised by this attitude." (Macaulay 61).

This attitude is understandable. People who depend for their economic survival on continuing relationships will be loath to react to every change in plans with a lawsuit. The legal consequences of most of these cancellations are an agreement of rescission. Under UCC, the use of a word like "cancellation" or "rescission" does not by itself amount to a renunciation of the right to sue for breach of a provision that occurred before the rescission. Md. Code Ann., Com. Law § 2-720 ("Unless the contrary intention clearly appears, expressions of "cancellation" or "rescission" of the contract or the like shall not be construed as a renunciation or discharge of any claim in damages for an antecedent breach."). If the parties mean to discharge each other fully from all duties owed, they must say so explicitly. Actions continue to speak more loudly than words, however, and in law, so can inactions. Legal rights under contracts may be lost by both parties if they fail to act; by abandoning their claims, they can affect rescission.

Waiver

A second means of discharge is by waiver, whereby a party voluntarily gives up a right she has under a contract but doesn't give up the entire right to performance by the other side. Tenant is supposed to pay rent on the first of the month, but because his employer pays on the tenth, Tenant pays Landlady on that day. If Landlady accepts the late payment without objection, she waived her right to insist on payment by the first of the month, unless the lease provides that no waiver occurs from the acceptance of any late payments. *See Minor v. Chase Auto Finance Corporation*, 372 S.W.3d 762 (Ark. 2010). A waiver is not a release, however. A **"waiver"** is permission to deviate from the contract; a "**release"** means to let go of the whole thing.

Substituted Agreement- Novation

Discharge by substituted agreement is a third way of mutual rescission. The parties may enter into a novation, either a new contract or one whereby a new person is substituted for the original obligor, and the latter is discharged. If Mr. Olson is obligated to deliver a car to Jack, Jack and Mr. Olson may agree that Dewey Dealer should deliver the car to Jack instead of Mr. Olson; the latter is discharged by this novation.

A novation consists of four elements: "(1) [a] previous valid obligation; (2) the agreement of all the parties to the new contract; (3) the validity of such new contract, and (4) the extinguishment of the old contract, by the substitution for it of the new one." *Walter v. Atl. Builders Grp., Inc.*, 180 Md. App. 347, 361, 951 A.2d 94, 102 (2008) (citing *Leisner v. Finnerty*, 252 Md. 558, 564, 250 A.2d641 (1969)).

Accord and Satisfaction

Discharge by accord and satisfaction is a fourth way of mutual rescission. Here the parties to a contract (usually a disputed one) agree to substitute some performance different from what was originally agreed, and once this new agreement is executed, the original contract (as well as the more recent accord) is satisfied. But before then, the original agreement is only suspended: if the obligor does not satisfy the accord, the other side can sue on the original obligation or on the accord.

Discharge When Performance Becomes Impossible or Very Difficult

There are situations in which parties may be discharged from contractual obligations because performance is impossible, difficult, or useless.

Every contract contains some element of risk: the buyer may run out of money before he can pay; the seller may run out of goods before he can deliver; the cost of raw materials may skyrocket, throwing off the manufacturer's fine financial calculations. Should the obligor's luck run out, he is stuck with the consequences—or, in the legal phrase, his **liability is strict**: he must either perform or risk paying damages for breach of contract, even if his failure is due to events beyond his control. Of course, an obligor can always limit his liability through the contract itself. Instead of obligating himself to deliver one million units, he can restrict his obligation to "one million units or factory output, whichever is less." Instead of guaranteeing to finish a job by a certain date, he can agree to use his "best efforts" to do so.

Similarly, damages in the event of breach can be limited. A party can even include a clause canceling the contract in the event of an untoward happening. But if these provisions are absent, the obligor is generally held to the terms of his bargain.

However, in some circumstances, a court may permit a party to defend performance under a contract for a reasonably unforeseeable event that prevents performance of a contract. The English common law did not initially recognize these defenses of impossibility, impracticability, or frustration of purpose. However, over time, the law evolved to recognize these defenses in particular circumstances.

Impossibility

If performance is impossible, the duty is discharged. For the defense of impossibility to be applicable, the events giving rise to the impossibility must occur after the formation of the contract, not reasonably anticipated by the parties, and the parties did not contribute to the occurrence of. *Stone v. Stone*, 34 Md. App. 509, 368 A.2d 496 (1977). The categories presented here are (1) death or incapacity of a personal services contractor, (2) destruction of a thing necessary for performance, and (3) performance prohibited by government order.

Death or Incapacity of a Personal Services Contractor

If Buyer makes a contract to purchase a car and dies before delivery, Buyer's estate could be held liable; it is not impossible (for the estate) to perform. However, the estate of a painter hired to do a portrait cannot be sued for damages because the painter died before she could complete the work.

Destruction or Deterioration of a Thing Necessary for Performance

When a specific object is necessary for the obligor's performance, its destruction or deterioration making its use impracticable (or its failure to come into existence) discharges the obligor's duty.

Diane's Dyers contracts to buy the annual wool output of the Sheepish Ranch, but the sheep die of an epidemic disease before they can be shorn. Since the specific thing for which the contract was made has been destroyed, Sheepish is discharged from its duty to supply Diane's with wool, and Diane's has no claim against the Ranch. However, if the contract called for a quantity of wool, without specifying that it was to be from Sheepish's flock, the duty would not be discharged; since wool is available on the open market, Sheepish could buy that and resell it to Diane's.

Performance Prohibited by Government Regulation or Order

When a government promulgates a rule after a contract is made, and the rule either bars performance or will make it impracticable, the obligor's duty is discharged. An obligor is not required to break the law and risk the consequences. Financier Bank contracts to sell World Mortgage Company certain collateralized loan instruments. The federal government, in a bank reform measure, prohibits such sales. The contract is discharged. If the Supreme Court later declared the prohibition unconstitutional, World Mortgage's duty to buy (or Financier Bank's to sell) would not revive.

Impracticability

Less entirely undoable than impossibility, but still grounds for discharge, are common-law impracticability and its relative, commercial impracticability.

Common-Law Impracticability

Impracticability is said to exist when there is a radical departure from the circumstances that the parties reasonably contemplated would exist at the time they entered into the contract; on such facts, the courts might grant relief. They will do so when extraordinary circumstances (often called "acts of God" or "force majeure") make it unjust to hold a party liable for performance. Although the justification for judicial relief could be found in an implied condition in all contracts that extraordinary events shall not occur, the Restatement eschews so obvious a bootstrap logic and adopts the language of UCC Section 2-615(a), which states that the crux of the analysis is whether the nonoccurrence of the extraordinary circumstance was "a basic assumption on which the contract was made." Restat 2d of Contracts, § 261. If it was—if, that is, the parties assumed that the circumstance would not occur— then the duty is discharged if the circumstance later does occur.

In one well-known case, *Autry v. Republic Productions*, 180 P.2d 144 (Cal. 1947), the famous cowboy movie star, Gene Autry, had a contract to perform for the defendant production company. Autry was drafted into the army in 1942; it was temporarily, at least, impossible for him to perform his movie contractual obligations incurred prior to his service. When he was discharged in 1945, he sued to be relieved of the prewar obligations. The court took notice that there had been a long interruption in Autry's career and of "the great decrease in the purchasing power of the dollar"—postwar inflation—and determined that to require him to perform under the old contract's terms would work a "substantial hardship" on him. A world war is an extraordinary circumstance. The temporary impossibility transformed into impracticability due to the change in circumstances. *Autry v. Republic Productions*, 180 P.2d 144 (Cal. 1947).

Impracticability refers to the performance, not to the party doing it. Only if the performance is impracticable is the obligor discharged. The distinction is between "the thing cannot be done" and "I cannot do it." The former refers to that which is objectively impracticable, and the latter to that which is subjectively impracticable. That a duty is subjectively impracticable does not excuse it if the circumstances that made the duty difficult are not extraordinary. A buyer is liable for the purchase price of a house, and his inability to raise the money does not excuse him or allow him to escape from a suit for damages when the seller tenders the deed. *Christy v. Pilkinton*, 273 S.W.2d 533 (Ark. 1954).

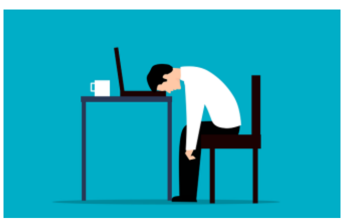
If Andy promises to transport Anne to the football stadium for ten dollars, he cannot wriggle out of his agreement because someone smashed into his car (rendering it inoperable) a half hour before he was due to pick her up. He could rent a car or take her in a taxi, even though that will cost considerably more than the sum she agreed to pay him. But if the agreement was that he would transport her in his car, then the circumstances make his performance **objectively impracticable**—the equivalent of impossible—and he is excused.

Commercial Impracticability

This common-law concept of impracticability has been adopted by the UCC. Md. Code Ann., Com. Law, § 2-615. When performance cannot be undertaken except with extreme difficulty or at highly unreasonable expense, it might be excused on the theory of commercial impracticability. However, "impracticable" (the action is impossible) is not the same as "impractical" (the action would yield an insufficient return or would have little practical value). The courts allow a considerable degree of fluctuation in market prices, inflation, weather, and other economic and natural conditions before holding that an extraordinary circumstance occurred. A manufacturer that based its selling price on last year's costs for raw materials cannot avoid its contracts by claiming that inflation within the historical range made it difficult or unprofitable to meet its commitments.

Examples of circumstances that could excuse might be severe limitations of supply due to war, embargo, or a natural disaster. Thus a ship owner who contracted with a purchaser to carry goods to a foreign port would be excused if an earthquake destroyed the harbor or if war broke out and the military authorities threatened to sink all vessels that entered the harbor. But if the ship owner planned to steam through a canal that is subsequently closed when a hostile government seizes it, his duty is not discharged if another route is available, even if the route is longer and consequently more expensive.

Frustration of Purpose



If the parties made a basic assumption, express or implied, that certain circumstances would not arise, but they do arise, then a party is discharged from performing his duties if his principal purpose in making the contract has been "substantially frustrated." This is not a rule of objective impossibility. It operates even though the parties easily might be able to carry out their contractual duties.

The frustration of purpose doctrine (also known as commercial frustration) comes into play when circumstances make the value of one party's performance virtually worthless to the other. This rule does not permit one party to escape a contract simply because he will make less money than he had planned or because one potential benefit of the contract has disappeared. The purpose that is frustrated must be the core of the contract, known and understood by both parties, and the level of frustration must be severe, such that performance is now objectively impossible. *Panitz v. Panitz*, 144 Md. App. 627, 799 A.2d 452 (2002).

In Maryland, the Court of Appeals outlined three factors that courts should examine when determining whether the frustration doctrine applies: (1) whether the intervening act was reasonably foreseeable; (2) whether the act was an exercise of sovereign power; and (3) whether the parties were instrumental in bringing about the intervening event." Panitz, 144 Md. App. at 639, 799 A.2d at 459 (quoting *Montauk Corp. v. Seeds*, 215 Md. 491, 499, 138 A.2d 907 (1958)).

The classic illustration of frustration of purpose is the litigation that gave birth to the rule: the so-called coronation cases. In 1901, when King Edward VII was due to be crowned following the death of Queen Victoria, a parade route was announced for the coronation. Scores of people rented rooms in buildings that lined the streets of the route to watch the grand spectacle. But the king fell ill, and the procession was canceled. Many expectant viewers failed to pay, and the building owners took them to court; many lessees who had paid took the owners to court to seek refunds. The court declared that the lessees were not liable because the purpose of the contract had been frustrated by the king's illness.

Supervening government regulations (though here different from illegality), floods that destroy buildings in which an event was to take place, and business failures may all contribute to frustration of purpose. But there can be no general rule: the circumstances of each case are determinative. Suppose, for example, that a manufacturer agrees to supply a crucial circuit board to a computer maker who intends to sell his machine and software to the government for use in the international space station's ventilation systems.

After the contract is made but before the circuit boards are delivered, the government decides to scrap that particular space station module. The computer manufacturer writes the circuit board maker, canceling the contract. Whether the manufacturer is discharged depends on the commercial prospects for the computer and the circuit board. If the circuit board can be used only in the particular computer, and it in turn is only of use on the space station, the duty to take the boards is discharged. But if the computer can be sold elsewhere, or the circuit boards can be used in other computers that the manufacturer makes, it is liable for breach of contract, since its principal purpose—selling computers—is not frustrated.

As before, the parties can provide in the contract that the duty is absolute and that no supervening event shall give rise to discharge by reason of frustration of purpose.

Other Methods of Discharge Cancellation, Destruction, or Surrender

An obligee may unilaterally discharge the obligor's duty toward him by canceling, destroying, or surrendering the written document embodying the contract or other evidence of the duty. No consideration is necessary; in effect, the obligee is making a gift of the right that he possesses. No particular method of cancellation, destruction, or surrender is necessary, as long as the obligee manifests his intent that the effect of his act is to discharge the duty. The entire document can be handed over to the obligor with the words, "Here, you don't owe me anything." The obligee can tear the paper into pieces and tell the obligor that he has done so because he does not want anything more. Or he can mutilate the signatures or cross out the writing. If Ben owes John $50 under an IOU from last month. Ben can choose unilaterally to forgive the debt, tear up the IOU and tell John to forget it.

Material Alteration

To prevent fraud on one of the parties by the other, where a party materially alters a contract that has previously been agreed to, without the knowledge or consent of the other party, the contract will be discharged. The term must be material to the contract, such as price or quantity, in order for all under this exception. So, if John enters into a contract with Sam to purchase 300 computers for a total price of $15,000 and after the contract is signed, John changes 300 to 3000 (without Sam's knowledge or consent), this is a material alteration that will terminate the contract.

Power of Avoidance

A contractual duty can be discharged if the obligor can avoid the contract. As discussed in the section on "Real Assent," a contract is either void or can be avoided if one of the parties lacked capacity (infancy, insanity, intoxication); if there has been duress, undue influence, misrepresentation, or mistake; or if the contract is determined to be unconscionable. Where a party has a power of avoidance and exercises it, that party is discharged from further obligation.

Statute of Limitations

When an obligor breached a contract, the obligee has the right to sue in court for a remedy. But that right does not last forever. Every state has a statute of limitations establishing time periods within which the suit must be brought (different time periods are spelled out for different types of legal wrongs: contract breach, various types of torts, and so on). The time period for contract actions under most statutes of limitations ranges between two and six years. The UCC has a four-year statute of limitations and Maryland follows this for contracts under the UCC. Md. Code Ann., Com. Law, § 2-725. For common law contract actions, unless the parties agree otherwise, the statute of limitations in Maryland is three years from either the breach or from when the party should have known of the breach through the exercise of reasonable diligence. Md. Code Ann., Cts & Jud. Proc. § 5-101 (LexisNexis 2021).

The period begins to run from the day on which the suit could have been filed in court—for example, from the moment of contract breach or from when the party should have known of the breach, whichever comes first. An obligee who waits until after the statute has run—that is, does not seek legal relief within the period prescribed by the statute of limitations—is barred from going to court thereafter (unless she is under some incapacity like infancy), but the obligor is not thereby discharged. The effect is simply that the obligee has no legal remedy. If the parties have a continuing relationship, the obligee might be able to recoup—for example, by applying a payment for another debt to the one barred by the statute (if allowed under the contract or by law), or by offsetting a debt the obligee owes to the obligor.

Bankruptcy

Under the federal bankruptcy laws certain obligations are discharged once a court declares a debtor to be bankrupt. The law spells out the particular types of debts that are canceled upon bankruptcy. However, what is discharged depends on the type of bankruptcy action filed and actual completion of the bankruptcy case. The nuances of bankruptcy law are beyond the scope of this course.

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Third Parties to Contracts

To this point, we have focused on the rights and duties of the two parties to the contract. In this section, we turn our attention to contracts in which outsiders acquire rights or duties or both. Three types of outsiders merit examination:

1. Assignees (outsiders who acquire rights after the contract is made)
2. Delegatees (outsiders who acquire duties after the contract is made)

3. Third-party beneficiaries (outsiders who acquire rights when the original contract is made)

Assignment of Rights

The Concept of a Contract Assignment

Contracts create rights and duties. By an assignment, an obligee (one who has the right to receive a contract benefit) transfers a right to receive a contract benefit owed by the obligor (the one who has a duty to perform) to a third person (assignee); the obligee then becomes an assignor (one who makes an assignment).

A simple example of this concept is as follows: You agree to buy Sam's car for $2,500. Sam in turn owes John $2,500 for work John performed on Sam's house last month. Sam instructs you to pay the $2,500 to John instead of to Sam when Sam delivers the car to you. You are the obligor - you owe Sam $2,500. Sam is the obligee- he is entitled to receive the $2,500 from you when he delivers the car. John is the assignor - he is receiving the right of payment of the $2,500.

The Restatement (Second) of Contracts defines an assignment of a right as "a manifestation of the assignor's intention to transfer it by virtue of which the assignor's right to performance by the obligor is extinguished in whole or in part and the assignee acquires the right to such performance." Restat 2d of Contracts, § 317(1). The one who makes the assignment is both an obligee and a transferor. The assignee acquires the right to receive the contractual obligations of the promisor, who is referred to as the obligor (see Figure 9 "Assignment of Rights"). The assignor may assign any right unless (1) doing so would materially change the obligation of the obligor, materially burden him, increase his risk, or otherwise diminish the value to him of the original contract; (2) statute or public policy forbids the assignment; or (3) the contract itself precludes assignment. The common law of contracts and Articles 2 and 9 of the Uniform Commercial Code (UCC) govern assignments.

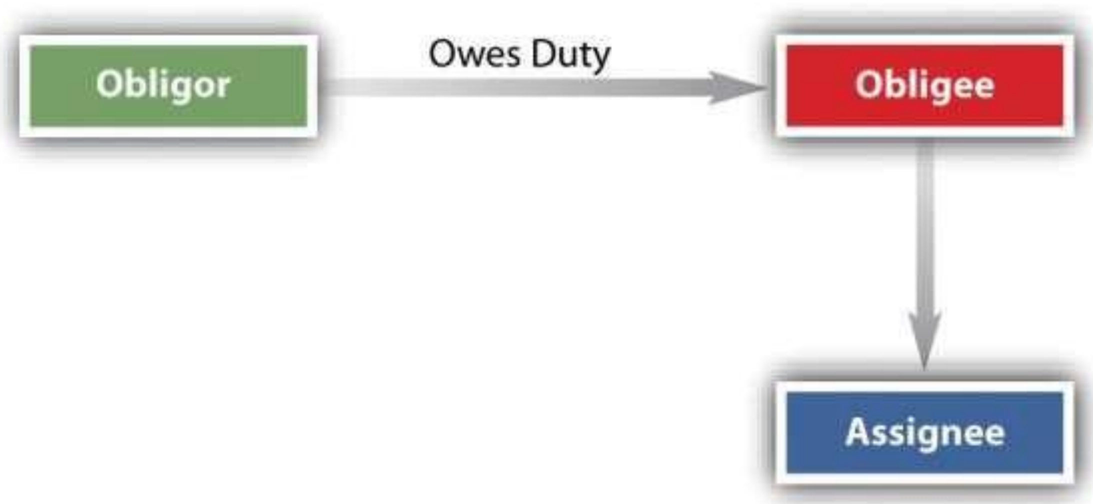

Figure 8 Assignment of Rights

Another type of assignment is the transfer of rights to receive settlement monies. J.G. Wentworth is a company that buys settlements and pays the person a lump sum of money in lieu of receiving a monthly check. Another way of looking at it is this: Say you were injured in a car accident and you reach a settlement with the other driver in which the other driver agrees to pay you $200,000. However, rather than paying it all at once, you and the other driver agree to a payment plan of $2,000 per month. Fast forward one year and you really could use the entire amount now, rather than waiting years to fully collect. Companies like J.G. Wentworth pay you a flat sum for your settlement for the assignment of your rights to continue collecting the payments under your payment plan. You will not get the full $200,000, but you will get a good amount that you can use now versus waiting years to collect. And J.G. Wentworth continues to collect the monthly payments under your settlement agreement. [Disclosure- the professor is not a compensated spokesperson for J.G. Wentworth- she just really likes their commercials.]

Here is a J.G. Wentworth commercial - they are cute.

https://www.youtube.com/watch?v=UGUefzSP6U4

Method of Assignment

Manifesting Assent

To effect an assignment, the assignor must make known his intention to transfer the rights to the third person. The assignor's intention must be that the assignment is effective without need of any further action or any further manifestation of intention to make the assignment. In other words, the assignor must intend and understand himself to be making the assignment then and there; he is not promising to make the assignment sometime in the future.

Under the UCC, any assignments of rights in excess of $5,000 must be in writing, but otherwise, assignments can be oral and consideration is not required: the assignor could assign the right to the assignee for nothing (not likely in commercial transactions, of course). Mrs. Franklin has the right to receive $750 a month from the sale of a house she formerly owned; she assigns the right to receive the money to her son Jason, as a gift. The assignment is good, though such a gratuitous assignment is usually revocable, which is not the case where consideration has been paid for an assignment.

Acceptance and Revocation

For the assignment to become effective, the assignee must manifest his acceptance under most circumstances. This is done automatically when, as is usually the case, the assignee has given consideration for the assignment (i.e., there is a contract between the assignor and the assignee in which the assignment is the assignor's consideration), and then the assignment is not revocable without the assignee's consent. Problems of acceptance normally arise only when the assignor intends the assignment as a gift. Then, for the assignment to be irrevocable, either the assignee must manifest his acceptance or the assignor must notify the assignee in writing of the assignment.

Notice

Notice to the obligor is not required, but an obligor who renders performance to the assignor without notice of the assignment (that performance of the contract is to be rendered now to the assignee) is discharged. Obviously, the assignor cannot then keep the consideration he has received; he owes it to the assignee. It would be obvious to state that if you were paying $500 per month under a settlement agreement to John and he assigns his right of payment to J.G. Wentworth, but you are never notified, you are discharged for subsequent payments made to John after the assignment. You do not have to pay twice. John owes the money you paid him to J.G. Wentworth.

But if notice is given to the obligor and she performs to the assignor anyway, the assignee can recover from either the obligor or the assignee, so the obligor could have to perform twice. *Aldana v. Colonial Palms Plaza*, 591 So.2d 953 (Fla. Ct. App. 1991). Of course, an obligor who receives notice of the assignment from the assignee will want to be sure the assignment really occurred. After all, anybody could waltz up to the obligor and say, "I'm the assignee of your contract with the bank. From now on, pay me the $500 a month, not the bank." The obligor is entitled to verification of the assignment.

Effect of Assignment

General Rule

An assignment of rights effectively makes the assignee stand in the shoes of the assignor. He gains all the rights against the obligor that the assignor had, but no more. An obligor who could avoid the assignor's attempt to enforce the rights could avoid a similar attempt by the assignee. Likewise, under UCC Section 9-318(1), the assignee of an account is subject to all terms of the contract between the debtor and the creditor-assignor. Suppose Dealer sells a car to Buyer on a contract where Buyer is to pay $300 per month and the car is warranted for 50,000 miles. If the car goes on the fritz before then and Dealer won't fix it, Buyer could fix it for, say, $250 and deduct that $250 from the amount owed Dealer on the next installment (called a setoff). Now, if Dealer assigns the contract to Assignee, Assignee stands in Dealer's shoes, and Buyer could likewise deduct the $250 from payment to Assignee.

Exceptions

The "shoe rule" does not apply to two types of assignments. First, it is inapplicable to the sale of a negotiable instrument to a holder in due course (this is outside of the scope of this course but covered in MNGT 141, Business Law II). Second, the rule may be waived: under the UCC and at common law, the obligor may agree in the original contract not to raise defenses against the assignee that could have been raised against the assignor. Md. Code Ann., Com. Law § 9-206.

While a waiver of defenses makes the assignment more marketable from the assignee's point of view, it is a situation fraught with peril to an obligor, who may sign a contract without understanding the full import of the waiver. Under the waiver rule, for example, a farmer who buys a tractor on credit and discovers later that it does not work would still be required to pay a credit company that purchased the contract; his defense that the merchandise was shoddy would be unavailing (he would, as used to be said, be "having to pay on a dead horse").

For that reason, there are various rules that limit both the holder in due course and the waiver rule. Certain defenses, the so-called real defenses (infancy, duress, and fraud in the execution, among others), may always be asserted. Also, the waiver clause in the contract must have been presented in good faith, and if the assignee has actual notice of a defense that the buyer or lessee could raise, then the waiver is ineffective. Moreover, in consumer transactions, the UCC's rule is subject to state laws that protect consumers (people buying things used primarily for personal, family, or household purposes), and many states, by statute or court decision, have made waivers of defenses ineffective in such consumer transactions. Federal Trade Commission regulations also affect the ability of many sellers to pass on rights to assignees free of defenses that buyers could raise against them. Because of these various limitations on the holder in due course and on waivers, the "shoe rule" will not govern in consumer transactions and, if there are real defenses or the assignee does not act in good faith, in business transactions as well.

When Assignments Are Not Allowed

The general rule—as previously noted—is that most contract rights are assignable. But there are exceptions. Five of them are noted here.

Material Change in Duties of the Obligor

When an assignment has the effect of materially changing the duties that the obligor must perform, it is ineffective. Changing the party to whom the obligor must make a payment is not a material change of duty that will defeat an assignment, since that, of course, is the purpose behind most assignments. (Remember our J.G. Wentworth example from the beginning of this material.) Nor will a minor change in the duties the obligor must perform defeat the assignment.

Several residents in the town of Centerville sign up on an annual basis with the Centerville *Times* to receive their morning paper. A customer who is moving out of town may assign his right to receive the paper to someone else within the delivery route. As long as the assignee pays for the paper, the assignment is effective; the only relationship the obligor has to the assignee is a routine delivery in exchange for payment.

Obligors can consent in the original contract, however, to a subsequent assignment of duties. Here is a clause from the World Team Tennis League contract: "It is mutually agreed that the Club shall have the right to sell, assign, trade and transfer this contract to another Club in the League, and the Player agrees to accept and be bound by such sale, exchange, assignment or transfer and to faithfully perform and carry out his or her obligations under this contract as if it had been entered into by the Player and such other Club." Consent is not necessary when the contract does not involve a personal relationship.

Assignment of Personal Rights

When it matters to the obligor who receives the benefit of his duty to perform under the contract, then the receipt of the benefit is a personal right that cannot be assigned. For example, a student seeking to earn pocket money during the school year signs up to do research work for a professor she admires and with whom she is friendly. The professor assigns the contract to one of his colleagues with whom the student does not get along. The assignment is ineffective because it matters to the student (the obligor) who the person of the assignee is.

An insurance company provides auto insurance covering Mohammed Kareem, a sixty-five-year-old man who drives very carefully. Kareem cannot assign the contract to his seventeen- year-old grandson because it matters to the insurance company who the person of its insured is. Tenants usually cannot assign (sublet) their tenancies without the landlord's permission because it matters to the landlord who the person of their tenant is. The case of *Nassau Hotel Co. v. Barnett & Barse Corp.*, 147 N.Y.S. 283 (1914), is an example of the nonassignability of a personal right. Barnett and Barse entered into a contract to run the Nassau Hotel in their individual capacities and based on their personal experience in the industry. After the contract was signed, Barnett and Barse attempted to assign the contract to their corporate entity Barnett & Barse Corporation. The owners of the hotel objected to the assignment. The Court in the *Nassau Hotel* case held that under the terms of the parties original contract, the obligations of Barnett and Barse were personal to them and could therefore not be assigned even to their corporate entity.

Assignment Forbidden by Statute or Public Policy

Various federal and state laws prohibit or regulate some contract assignment. The assignment of future wages is regulated by state and federal law to protect people from improvidently denying themselves future income because of immediate present financial difficulties. For example, Maryland prohibits the assignment of worker's compensation benefits before issuance and payment of the check. Md. Code, Ann., Lab & Empl. § 9-732 (LexisNexis 2021). And even in the absence of statute, public policy might prohibit some assignments.

Contracts That Prohibit Assignment

Assignability of contract rights is useful, and prohibitions against it are not generally favored. Many contracts contain general language that prohibits assignment of rights or of "the contract." Both the Restatement and UCC Section 2-210 declare that in the absence of any contrary circumstances, a provision in the agreement that prohibits assigning "the contract" bars "only the delegation to the assignee of the assignor's performance." Restat 2d of Contracts, § 322; Md. Code Ann., Com. Law § 2-210. In other words, unless the contract specifically prohibits assignment of any of its terms, a party is free to assign anything except his or her own duties.

Even if a contractual provision explicitly prohibits it, a right to damages for breach of the whole contract is assignable in contracts for the sale of goods. Md Code Ann., Com. Law § 2-210(2). Indeed, in some states, at common law, a clause specifically prohibiting assignment will fail. For example, the buyer and the seller agree to the sale of land and to a provision barring assignment of the rights under the contract. The buyer pays the full price, but the seller refuses to convey. The buyer then assigns to her friend the right to obtain title to the land from the seller. The latter's objection that the contract precludes such an assignment will fall on deaf ears in some states; the assignment is effective, and the friend may sue for the title.

Future Contracts

The law distinguishes between assigning future rights under an existing contract and assigning rights that will arise from a future contract. Rights contingent on a future event can be assigned in exactly the same manner as existing rights, as long as the contingent rights are already incorporated in a contract. Ben has a long-standing deal with his neighbor, Mrs. Robinson, to keep the latter's walk clear of snow at twenty dollars a snowfall. Ben is saving his money for a new printer, but when he is eighty dollars shy of the purchase price, he becomes impatient and cajoles a friend into loaning him the balance. In return, Ben assigns his friend the earnings from the next four snowfalls. The assignment is effective because the contract is currently existing between Mrs. Robinson and Ben.

However, a right that will arise from a future contract cannot be the subject of a present assignment. In Ben's scenario, if he did not have a current contract with Mrs. Robinson but was planning on entering into a contract with her next year - meaning the contract did not presently exist - then there is nothing to assign to Ben's friend today because no contract exists.

Partial Assignments

An assignor may assign part of a contractual right, but only if the obligor can perform that part of his contractual obligation separately from the remainder of his obligation. Assignment of part of a payment due is always enforceable. However, if the obligor objects, neither the assignor nor the assignee may sue him unless both are party to the suit. Mrs. Robinson owes Ben one hundred dollars. Ben assigns fifty dollars of that sum to his friend. Mrs. Robinson is perplexed by this assignment and refuses to pay until the situation is explained to her satisfaction. The friend brings suit against Mrs. Robinson. The court cannot hear the case unless Ben is also a party to the suit. This ensures all parties to the dispute are present at once and avoids multiple lawsuits.

Successive Assignments

It may happen that an assignor assigns the same interest twice (see Figure 10 "Successive Assignments"). With certain exceptions, the first assignee takes precedence over any subsequent assignee. One obvious exception is when the first assignment is ineffective or revocable. A subsequent assignment has the effect of revoking a prior assignment that is ineffective or revocable.

Another exception: if in good faith the subsequent assignee gives consideration for the assignment and has no knowledge of the prior assignment, he takes precedence whenever he obtains payment from, performance from, or a judgment against the obligor, or whenever he receives some tangible evidence from the assignor that the right has been assigned (e.g., a bank deposit book or an insurance policy).

Some states follow the different English rule: the first assignee to give notice to the obligor has priority, regardless of the order in which the assignments were made.

Figure 9 Successive Assignments

Assignor's Warranties

An assignor has legal responsibilities in making assignments. He cannot blithely assign the same interests pell-mell and escape liability. Unless the contract explicitly states to the contrary, a person who assigns a right for value makes certain assignor's warranties to the assignee: that he will not upset the assignment, that he has the right to make it, and that there are no defenses that will defeat it. However, the assignor does not guarantee payment; assignment does not by itself amount to a warranty that the obligor is solvent or will perform as agreed in the original contract. Mrs. Robinson owes Ben fifty dollars. Ben assigns this sum to his friend. Before the friend collects, Ben releases Mrs. Robinson from her obligation. The friend may sue Ben for the fifty dollars. Or again, if Ben represents to his friend that Mrs. Robinson owes him (Ben) fifty dollars and assigns his friend that amount, but in fact Mrs. Robinson does not owe Ben that much, then Ben has breached his assignor's warranty. The assignor's warranties may be express or implied.

Delegation of Duties

Basic Rules Regarding Delegation

To this point, we have been considering the assignment of the assignor's rights (usually, though not solely, to money payments). But in every contract, a right connotes a corresponding duty, and these may be delegated. A delegation is the transfer to a third party of the duty to perform under a contract. The one who delegates is the delegator. Because most obligees are also obligors, most assignments of rights will simultaneously carry with them the delegation of duties. Unless public policy or the contract itself bars the delegation, it is legally enforceable.

In most states, at common law, duties must be expressly delegated. Under the UCC and in a minority of states at common law (as illustrated in *Rose v. Vulcan Materials Co.*, 194 S.E.2d 521 (N.C. 1973)), an assignment of "the contract" or of "all my rights under the contract" is not only an assignment of rights but also a delegation of duties to be performed; by accepting the assignment, the delegatee (one to whom the delegation is made) implies a promise to perform the duties. Md. Code Ann., Com. Law § 2-210(5).

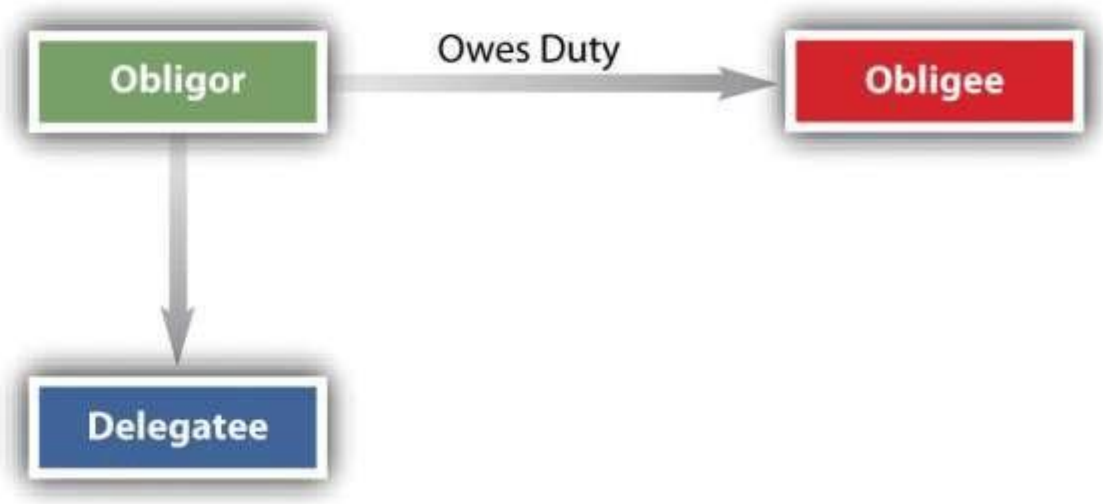

Figure 10 Delegation of Duties

Effect on Obligor

An obligor who delegates a duty (and becomes a delegator) does not thereby escape liability for performing the duty himself. The obligee of the duty may continue to look to the obligor for performance unless the original contract specifically provides for substitution by delegation. This is a big difference between assignment of contract rights and delegation of contract duties: in the former, the assignor is discharged (absent breach of assignor's warranties); in the latter, the delegator remains liable.

The obligee (again, the one to whom the duty to perform flows) may also, in many cases, look to the delegatee, because the obligee becomes an intended beneficiary of the contract between the obligor and the delegatee, as discussed below in "Third-Party Beneficiaries". Of course, the obligee may subsequently agree to accept the delegatee and discharge the obligor from any further responsibility for performing the duty. A contract among three persons having this effect is called a novation; it is a new contract. Fred sells his house to Lisa, who assumes his mortgage. Fred, in other words, has delegated the duty to pay the bank to Lisa. If Lisa defaults, Fred continues to be liable to the bank, unless in the original mortgage agreement a provision specifically permitted any purchaser to be substituted without recourse to Fred, or unless the bank subsequently accepts Lisa and discharges Fred.

Nondelegable Duties

Personal Services

Personal services are not delegable. If the contract is such that the promisee expects the obligor personally to perform the duty, the obligor may not delegate it. Suppose the Catskill Civic Opera Association hires a famous singer to sing in its production of *Carmen* and the singer delegates the job to her understudy. The delegation is ineffective, and performance by the understudy does not absolve the famous singer of liability for breach.

Many duties may be delegated, however. Indeed, if they could not be delegated, much of the world's work would not get done. If you hire a construction company and an architect to design and build your house to certain specifications, the contractor may in turn hire individual craftspeople—plumbers, electricians, and the like—to do these specialized jobs, and as long as they are performed to specification, the contract terms will have been met. If you hired an architecture firm, though, you might not be contracting for the specific services of a particular individual in that firm.

Public Policy

Public policy may prohibit certain kinds of delegations. A public official, for example, may not delegate the duties of her office to private citizens, although various statutes generally permit the delegation of duties to her assistants and subordinates.

Delegations Barred by Contract

As we have already noted, the contract itself may bar assignment. The law generally disfavors restricting the right to assign a benefit, but it will uphold a contract provision that prohibits delegation of a duty.

Thus, as we have seen, UCC Section 2-210(4) states that in a contract for sale of goods, a provision against assigning "the contract" is to be construed only as a prohibition against delegating the duties. Md. Code Ann., Com. Law § 2-210(4) ("Unless the circumstances indicate the contrary a prohibition of assignment of the "contract" is to be construed as barring only the delegation to the assignee of the assignor's performance."

Third-Party Beneficiaries

The fundamental issue with third-party beneficiaries gets to this: can a person who is not a party to a contract sue to enforce its terms?

The general rule is this: persons not a party to a contract cannot enforce its terms; they are said to lack privity, a private, face-to-face relationship with the contracting parties. But if the persons are intended to benefit from the performance of a contract between others, then they can enforce it: they are intended beneficiaries. *Precision Small Engines, Inc. v. City of Coll. Park*, 457 Md. 573, 179 A.3d 1019 (2018).

Two Types of Third-Party Beneficiaries

In the vocabulary of the Restatement, a third person whom the parties to the contract intend to benefit is an intended beneficiary—that is, one who is entitled under the law of contracts to assert a right arising from a contract to which he or she is not a party. Whether a third-party is an intended beneficiary depends on the intention of the parties and whether they intend to make the third person a "real promisee" under the contract, and not merely that the contract benefit the third person. *Wm. T. Burnett Holding, LLC v. Berg Brothers Co.*, 235 Md. App. 204, 213, 175 A.3d 876, 882 (2017). There are two types of intended beneficiaries: creditor beneficiaries and donee beneficiaries.

Creditor Beneficiary

A creditor beneficiary is one to whom the promisor agrees to pay a debt of the promisee.

Suppose Customer pays Ace Dealer for a new car, and Ace contracts with Beta Dealer to provide and deliver the car (delegates his performance to Beta). Ace is now a debtor: he owes Customer something: a car. Customer is a creditor; she is owed something: a car. When Beta performs under his delegated contract with Ace, Beta is discharging the debt Ace owes to Customer. Customer is a creditor beneficiary of Beta and Ace's contract and could sue either one for nondelivery. Customer could sue Ace because she made a contract with him, and she could sue Beta because— again—she was intended to benefit from the performance of Ace and Beta's agreement.

Donee Beneficiary

The second type of intended beneficiary is a donee beneficiary. When the promisee is not indebted to the third person but intends for him or her to have the benefit of the promisor's performance, the third person is a donee beneficiary (and the promise is sometimes called a gift promise). *Shillman v. Hobstetter*, 249 Md. 678, 690-91, 241 A.2d 570, 577 (1968).

For example, an insurance company (the promisor) promises to its policyholder (the promisee), in return for a premium, to pay $100,000 to the policyholder's wife on his death; this makes the wife a donee beneficiary. The wife could sue to enforce the contract although she was not a party to it.

Or if Able makes a contract with Woodsman for the latter to cut the trees in Able's backyard as a Christmas gift to Able's uphill Neighbor (so that Neighbor will have a view), Neighbor could sue Woodsman for breach of the contract if Woodsman fails to cut down the trees.

If a person is not an intended beneficiary—not a creditor or donee beneficiary—then he or she is said to be only an incidental beneficiary, and that person has no rights to sue on the contract.

So if Able makes the contract with Woodsman not to as a Christmas gift to Neighbor but for Able's own benefit, the fact that the tree removal would benefit Neighbor does not make Neighbor an intended beneficiary and Neighbor could not sue Woodsman if he failed to cut down the trees.

The beneficiary's rights are always limited by the terms of the contract. A failure by the promisee to perform his part of the bargain will terminate the beneficiary's rights if the promisee's lapse terminates his own rights, absent language in the contract to the contrary.

If Able makes the contract as a gift to Neighbor but doesn't make the required down payment to Woodsman, Neighbor's claim fails. In a suit by the beneficiary, the promisor may avail himself of any defense he could have asserted against the promisee. Woodsman may defend himself against Neighbor's claim that Woodsman did not do the whole job by showing that Able didn't make full payment for the work.

Vesting of Rights for Intended Beneficiary

An intended beneficiary cannot enforce his or her rights under a contract until the rights have vested. A beneficiary's rights will vest under one of the following situations:

1. the beneficiary consents to the agreement either in writing or orally;
2. the beneficiary materially alters his or her position in detrimental reliance on the contract; or
3. the specific conditions in the contract for vesting of the beneficiary's rights are satisfied.

Modification of the Beneficiary's Rights

Conferring rights on an intended beneficiary is relatively simple. Whether his rights can be modified or extinguished by subsequent agreement of the promisor and promisee is a more troublesome issue. The general rule is that the beneficiary's rights may be altered as long as there has been no vesting of rights (the rights have not taken effect- see above). The Restatement says that unless the contract provides that its terms cannot be changed without the beneficiary's consent, the parties may change or rescind the benefit unless the beneficiary 1) sued on the promise, 2) detrimentally relied, or 3) assented to the promise at the request of one of the parties. Restat 2d of Contracts, § 311.

Some contracts provide that the benefit never vests; for example, standard insurance policies today reserve to the insured the right to substitute beneficiaries, to borrow against the policy, to assign it, and to surrender it for cash.

Government Contracts

The general rule is that members of the public are only incidental beneficiaries of contracts made by the government with a contractor to do public works contracts. It is not illogical to see a contract between the government and a company pledged to perform a service on behalf of the public as one creating rights in particular members of the public, but the consequences of such a view could be extremely costly because everyone has some interest in public works and government services.

A restaurant chain, hearing that the county was planning to build a bridge that would reroute commuter traffic, might decide to open a restaurant on one side of the bridge; if it later discovered that the bridge was to be delayed or canceled, could it sue the county's contractor? In general, the answer is no. A promisor under contract to the government is not liable for the consequential damages to a member of the public arising from its failure to perform (or from a faulty performance) unless the agreement specifically calls for such liability or unless the promisee (the government) would itself be liable and a suit directly against the promisor would be consistent with the contract terms and public policy. When the government retains control over litigation or settlement of claims, or when it is easy for the public to insure itself against loss, or when the number and amount of claims would be excessive, the courts are less likely to declare individuals to be intended beneficiaries.

But the service to be provided can be so tailored to the needs of particular persons that it makes sense to view them as intended beneficiaries—in the case of a service station licensed to perform emergency road repairs. *See Kornblut v. Chevron Oil Co*., 62 A.D.2d 831 (N.Y. 1978) (driver was third party beneficiary of contract to provide emergency road services, but driver's death from exertion due to changing flat tire when services were not provided in a timely manner was not envisioned in the contract and suit for consequential damages for person injury was dismissed).

Contract Remedies

We come at last to the question of remedies. A valid agreement has been made, the promisor's duties have not been discharged; he or she has breached the contract. When one party has failed to perform, what are the rights of the parties? Or when the contract has been avoided because of incapacity or misrepresentation and the like, what are the rights of the parties after disaffirmance? These questions form the focus of this section. Remedies for breach of contracts for the sale of goods will be considered separately, in Unit 3.

Purpose of Remedies

The fundamental purpose of remedies in noncriminal cases is not to punish the breaching party but—if possible—to put the nonbreaching party in the position he or she would have been in had there been no breach. Or, as is said, the purpose is to make the nonbreaching party whole.

There are two general categories of remedies—legal and equitable. In the category of legal remedies are damages. Damages are money paid by one party to another; there are several types of damages. In the category of equitable remedies are:

1) specific performance, which means a person is ordered to deliver a unique thing (land or a unique personal property, such as a painting or an antique car);
2) injunction, a judicial order directing a person to stop doing what he or she should not do (such as competing with a former employer in violation of a noncompete agreement); and
3) restitution, which means putting the parties back into the position they were in before the contract was made. Restat 2d of Contracts, § 345.

Parties Have the Power—but Not the Right—to Breach

In view of the importance given to the intention of the parties in forming and interpreting contracts, it may seem surprising that the remedy for every breach is not a judicial order that the obligor carry out his or her undertakings. But it is not. Of course, some duties cannot be performed after a breach, because time and circumstances will have altered their purpose and rendered many worthless. Still, there are numerous occasions on which it would be theoretically possible for courts to order the parties to carry out their contracts, yet the courts will not do it.

In 1897, Justice Oliver Wendell Holmes Jr. declared in a famous line that "the duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it." (Holmes 457). By that, he meant simply that the common law looks more toward compensating the promisee for his or her loss than toward compelling the promisor to perform. Indeed, the law of remedies often provides the parties with an incentive to break the contract. In short, the promisor has a choice: perform or pay.

The logic of this position is clear in many typical cases. The computer manufacturer orders specially designed circuit boards, then discovers before the circuits are made that a competitor has built a better machine and destroyed his market. The manufacturer cancels the order. It would make little economic sense for the circuit board maker to fabricate the boards if they could not be used elsewhere. A damage remedy to compensate the maker for out-of-pocket loss or lost profits is sensible; a judicial decree forcing the computer manufacturer to pay for and take delivery of the boards would be wasteful.

In general and if possible, the fundamental purpose of contract remedies is to put the nonbreaching party in the position it would have been in had there been no breach. Contract remedies serve to protect three different interests:

- an expectation interest,
- a reliance interest, and
- a restitution interest. Restat 2d of Contracts, § 344.

A promisee will have one of these and may have two or all three. An **expectation interest** is the benefit for which the promisee bargained, and the remedy is to put him in a position as good as that which he would have been in had the contract been performed. A **reliance interest** is the loss suffered by relying on the contract and taking actions consistent with the expectation that the other party will abide by it; the remedy is reimbursement that restores the promisee to his position before the contract was made. A **restitution interest** is that which restores to the promisee any benefit he conferred on the promisor. These interests do not dictate the outcome according to a rigid formula; circumstances and the nature of the contract, as usual, will play a large role. But in general, specific performance is a remedy that addresses the expectation interest, monetary damages address all three interests, and, not surprisingly, restitution addresses the restitution interest.

Consider some simple examples. A landowner repudiates an executory contract with a builder to construct a garage on her property for $100,000. The builder anticipated a $10,000 profit (the garage would have cost him $90,000 to build). What can he expect to recover in a lawsuit against the owner? The court will not order the garage to be built; such an order would be wasteful, since the owner no longer wants it and may not be able to pay for it. Instead, the court will look to the builder's three possible interests. Since the builder has not yet started his work, he has given the owner nothing, and therefore has no restitution interest. Nor has he any reliance interest, since we are assuming that he has not paid out any money for supplies, hired a work crew, or advanced money to subcontractors. But he anticipated a profit, and so he has an expectation interest of $10,000 and would be able to sue the owner for the lost profit.

Now suppose that the builder already started work, he dug out the foundation and poured concrete, at a cost of $15,000. His expectation interest is now $25,000 ($10,000 in profit he anticipates and $15,000 in payment for services rendered). His reliance interest is $15,000, because this is the amount he has already spent. He may also have a restitution interest, depending on how much the foundation of the house is worth to the owner. (The value could be more or less than the sum of money actually expended to produce the foundation; for example, the builder might have had to pay his subcontractors for a greater share of the job than they completed, and those sums therefore would not be reflected in the worth of the foundation.)

Normally, the promisee will choose which of the three interests to pursue. As is to be expected, the choice hinges on the circumstances of the case, his feelings, and the amount at stake.

Legal Remedies: Damages

The promisee, whom we will hereafter refer to as the nonbreaching party, has the right to damages (a money award), if that is required to make her whole, whenever the other party has breached the contract, unless, of course, the contract itself or other circumstances suspend or discharge that right. **Damages** refers to money paid by one side to the other; it is a legal remedy. For historical and political reasons in the development of the English legal system, the courts of law were originally only able to grant monetary relief. If a petitioner wanted something other than money, recourse to a separate system of equity was required. The courtrooms and proceedings for each were separate. That actual separation is long gone, but the distinction is still recognized; a judge may be said to be "sitting in law" or "sitting in equity," or a case may involve requests for both money and some action. We take up the legal remedies of damages first.

Types of Damages

There are four main types of damages under contract law:

1) compensatory,
2) consequential,
3) nominal, and
4) (sometimes) punitive.

Compensatory Damages

Damages paid to directly compensate the nonbreaching party for the value of what was not done or performed are **compensatory damages**. Sometimes calculating that value of the promisor's performance is easy—for example, when the nonbreaching party has ascertainable costs and profits, as in the case of the builder who would have earned $10,000 profit on a $100,000 house. When the performance is a service, a useful measure of loss is what it would cost to substitute performance by someone else. But the calculation is frequently difficult, especially when the performance is a service that is not easily duplicated. If Rembrandt breached a contract to paint your portrait, the loss could not be measured simply by inquiring how much Van Gogh would charge to do the same thing. Nevertheless, in theory, whatever net value would ultimately have been conferred on the nonbreaching party is the proper measure of compensatory damages. An author whose publisher breaches its contract to publish the book and who cannot find another publisher is entitled to lost royalties (if ascertainable) plus the value that would have accrued from her enhanced reputation.

Since the nonbreaching party usually has obligations under the contract also, a breach by the other party discharges his duty to perform and may result in savings. Or he may have made substitute arrangements and realized at least a partial profit on the substitution. Or, as in the case of the builder, he may have purchased goods intended for the job that can be used elsewhere. In all these situations, the losses he has avoided—savings, profits, or value of goods—are subtracted from the losses incurred to arrive at the net damages. The nonbreaching party may recover his actual losses, not more. Suppose an employer breaches a contract with a prospective employee who was to begin work for a year at a salary of $35,000. The employee quickly finds other, similar work at a salary of $30,000. Aside from whatever he might have had to spend searching for the job (incidental damages), his compensatory damages are limited to $5,000, the difference between what he would have earned and what he is earning.

Lost volume can be a troublesome problem in calculating damages. This problem arises when the nonbreaching party, a supplier of goods or services, enters a second contract when the buyer repudiates. The question is whether the second contract is a substituted performance or an additional one. If it is substituted, damages may be little or nothing; if additional, the entire expectation interest may be recovered. An automobile dealer contracts to sell a car in his inventory. Shortly before the deal is closed, the buyer calls up and repudiates the contract. The dealer then sells the car to someone else. If the dealer can show that he could have sold an identical car to the second purchaser regardless of what the first purchaser did, then the second sale stands on its own and cannot be used to offset the net profit recoverable from the first purchaser. The factual inquiry in lost volume cases is whether the nonbreaching party would have engaged in the second transaction if the breach had never occurred.

One form of compensatory damages the nonbreaching party may recover are referred to as **incidental damages**. Incidental loss includes expenditures that the nonbreaching party incurs in attempting to minimize the loss that flows from the breach. To arrange for substitute goods or services, the nonbreaching party might have to pay a premium or special fees to locate another supplier or source of work.

Consequential Damages

"Consequential damages cover those losses suffered by the non-breaching party other than the loss in value of the other party's performance. Such damages must be "reasonably foreseeable" and must "fairly and reasonably be supposed to *have been in the contemplation of both parties* at the time they made the contract, as the probable result of the breach of it." *Simard v. Burson*, 197 Md. App. 396, 414-15, 14 A.3d 6, 16 (2011) (citing *Minh-Vu Hoang v. Hewitt Ave. Assocs., LLC*, 177 Md. App. 562, 594-95, 936 A.2d 915 (2007)).

For example, if Ralph does a poor job of plumbing Betty's bathroom and the toilet leaks, damaging the floor, the downstairs ceiling, and the downstairs rug, Ralph would owe for those loses in consequential damages. Or, lost sales stemming from a failure to fix a manufacturer's machine in time, or physical and property injury due to a defective machine sold by the promisor would be addressed with consequential damages. Note, however, that one obvious, and often large, expenditure occasioned by a breach—namely, legal expenses in bringing a lawsuit to remedy the particular breach—is not an element of damages, unless the contract explicitly states that it is, and cannot be charged to the defendant. There is one situation, however, in which legal costs can be added to damages: when the breach causes the nonbreaching party to be involved in a lawsuit with someone else. Consequential damages will not be allowed if those damages are not foreseeable.

The issue of consequential damages will be discussed later in the seminal case of *Hadley v. Baxendale* in our discussion of foreseeability of damages.

Nominal Damages

In the situation where there has been a breach but the nonbreaching party has really suffered no loss or cannot prove what his loss is, he is entitled to nominal damages. Ricardo contracts to buy a new car from a dealer; the dealer breaches the contract. Ricardo finds and buys the same car from another dealer at the same price that the first one was to sell it for. Ricardo has suffered nominal damages: five dollars, perhaps.

Punitive Damages

Punitive damages are those awarded for the purpose of punishing a defendant in a civil action, in which criminal sanctions are of course unavailable. They are proper in cases in which the defendant has acted willfully and maliciously and are thought to deter others from acting similarly. Since the purpose of contract law is compensation, not punishment, punitive damages have not traditionally been awarded, with one exception—when the breach of contract is also a tort for which punitive damages may be recovered.

Punitive damages are permitted in the law of torts (in all but four states) when the behavior is malicious or willful (reckless conduct causing physical harm, deliberate defamation of one's character, a knowingly unlawful taking of someone's property), and some kinds of contract breach are also tortious. For example, when a creditor holding collateral as security under a contract for a loan sells the collateral to a good-faith purchaser for value even though the debtor was not in default, he has breached the contract and committed the tort of conversion; punitive damages may be awarded, assuming the behavior was willful and not merely mistaken.

In Maryland, conduct giving rise to an order for punitive damages requires clear and convincing evidence. *Owens-Illinois, Inc. v. Zenobia*, 325 Md. 420, 469, 601 A.2d 633, 657 (1992). Once the evidence establishes the right to punitive damages, such awards cannot be excessive or grossly out of proportion to the actual damages incurred by the nonbreaching party. The U.S. Supreme Court in *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 418 (2003) gave three guideposts for lower courts to use when making a determination of punitive damages:

“(1) the degree of reprehensibility of the defendant's misconduct; (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award; and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases.”

In *State Farm*, the jury awarded $1 million in compensatory damages and another $145 million in punitive damages in an insurance case that alleged bad faith failure to settle on the part of State Farm by its insured, Campbell, arising out of an auto accident. The Supreme Court reversed the jury award of $145 million in punitive damages and remanded the case back to the state court system for a redetermination of punitive damages in light of the guideposts the Court put forth. *Id.* at 429.

Equitable Remedies

Really the only explanation for the differences between law and equity is to be found in the history and politics of England dating to the twelfth century, but in practical terms, the distinctions are notable. First, juries are not used in equitable cases. Second, equity relies less on precedent and more on the sense that justice should be served. Third, and of most significance, where what is sought by the nonbreaching party is not money—that is, where there is no adequate legal remedy—equity may afford relief. In equity a person may get a judge to order the breaching party to deliver some actual property, or to stop doing something that he should not do, or to return the consideration the nonbreaching party gave so as to return the parties to the precontract status (specific performance, injunction, and restitution, respectively).

Types of Remedies in Equity

There are four types of equitable remedies:

1) specific performance,
2) injunction,
3) rescission and restitution, and
4) reformation.

Specific Performance

Specific performance is a judicial order to the promisor that he undertake the performance to which he obligated himself in a contract. Specific performance is an alternative remedy to damages and may be issued at the discretion of the court, when money damages are not adequate to make the non-breaching party whole. Restate 2d of Contracts §§ 357, 359. Emily signs a contract to sell Charlotte a gold tea samovar, a Russian antique of great sentimental value because it once belonged to Charlotte’s mother. Emily then repudiates the contract before providing the samovar to Charlotte. A court may properly grant Charlotte an order of specific performance against Emily- because the item is unique.

Charlie signs a contract to purchase Mary’s townhouse. Before settlement, Mary changes her mind and decides she does not want to sell. Charlie can ask a court to grant specific performance and require Mary to sell her townhouse. Real estate is always considered unique and subject to an award of specific performance- even if Charlie could have purchased an almost identical townhouse across the street.

Once students understand the basic idea of specific performance, they often want to pounce upon it as the solution to almost any breach of contract. It seems reasonable that the nonbreaching party could ask a court to simply require the promisor to do what she promised she would. But specific performance is a very limited remedy: it is *only* available for breach of contract to sell a unique item, that is, a unique item of personal property (the samovar), or a parcel of real estate (the townhouse as all real estate is unique). But if the item is not unique, so that the nonbreaching party can go out and buy another one, then the legal remedy of money damages will solve the problem.

And specific performance will never be used to force a person to perform services against his will, which would be involuntary servitude. A person may be forced to stop doing that which he should not do (injunction), but not forced to do what he will not do.

Injunction

An **injunction** is the second type of equitable remedy available in contract (it is also available in tort). It is a court order directing a person to stop doing that which she should not do.

For example, if an employer has a valid noncompete contract with an employee, and the employee, in breach of that contract, nevertheless undertakes to compete with his former employer, a court may **enjoin** (issue an order of injunction), directing the former employee to stop such competition. A promise by a person not to do something—in this example, not to compete—is called a **negative covenant** (a covenant is a promise in a contract, itself a contract). Or if Seller promises to give Buyer the right of first refusal on a parcel of real estate or a unique work of art, but Seller, in breach of a written promise, offers the thing to a third party, a court may enjoin Seller from selling it to the third party. If a person violates an injunction, he may be held in contempt of court and put in jail for a while.

Rescission and Restitution

The third type of equitable relief is **rescission and restitution**. Rescission is the cancelling of the contract to put the parties in the position they were in prior to the contract. In rescinding a contract many times one or both of the parties is required to make restitution to the other party. Restitution is a remedy applicable to several different types of cases: those in which the contract was avoided because of incapacity or misrepresentation, those in which the other party breached, and those in which the party seeking restitution breached. As the word implies, *restitution* is a restoring to one party of what he gave to the other.

Reformation

Reformation allows the courts to re-write a parties' agreement to reflect the true intentions of the parties. This happens when the parties did not accurately state their agreement in writing originally. Where there is a mutual mistake or fraud, the courts can order reformation. For example, if Steve and Tom contract for Steve to purchase Tom's car for $2,000, and Tom has two cars (a 2017 BMW worth $45,000 and a 1990 Subaru) but the agreement does not state which one, the court can amend the contract to list the correct car.

A court will also order reformation where the parties had an oral agreement that they later put into writing, but make an error in the process. Finally, as noted previously, courts may reform a covenant not to compete where it is found unreasonable in terms of duration and/or location.

Total Nonperformance by Breaching Party

The nonbreaching party is always entitled to restitution in the event of total breach by nonperformance or repudiation, unless both parties have performed all duties except for payment by the other party of a definite sum of money for the injured party's performance. Restat 2d of Contracts, § 373.

Calhoun, a contractor, agrees to build $3,000 worth of fences for only $2,000 and completes the construction. Arlene, the landowner, refuses to pay. Calhoun's only right is to get the $2,000; he does not have a restitution right to $2,500, the market price of his services (or $3,000, the amount by which her property increased in value); he is entitled, instead, only to $2,000, his contract price. Had Arlene repudiated prior to completion, however, Calhoun would then have been entitled to restitution based either on the market price of the work or on the amount by which he enhanced her property.

If the one party breaches, the nonbreaching party is generally entitled to restitution of property that can be returned. Arlene gives Calhoun a valuable Ming vase in return for his promise to construct the fences. Upon Calhoun's breach, Arlene is entitled to specific restitution of the vase.

Measuring restitution interest can be problematic. The courts have considerable discretion to award either what it would have cost to hire someone else to do the work that the nonbreaching party performed (generally, the market price of the service) or the value that was added to the property of the party in breach by virtue of the claimant's performance.

Calhoun, the contractor, agrees to construct ten fences around Arlene's acreage at the market price of $25,000. After erecting three, Calhoun performed services that would cost $7,500, market value. Assume that he increased the value of Arlene's grounds by $8,000. If Arlene repudiated, there are two measures of Calhoun's restitution interest: $8,000, the value by which the property was enhanced, or $7,500, the amount it would have cost Arlene to hire someone else to do the work. Which measure to use depends on who repudiated the contract and for what reason. In some cases, the enhancement of property or wealth measurement could lead to an award vastly exceeding the market price for the service. In such cases, the smaller measure is used.

For a doctor performing lifesaving operations on a patient, restitution would recover only the market value of the doctor's services—not the monetary value of the patient's life.

Part Performance and Then Breach

A party who substantially performed and then breached is entitled to restitution of a benefit conferred on the injured party, if the injured party refused (even though justifiably) to complete his own performance owing to the other's breach. Since the party in breach is liable to the injured party for damages for loss, this rule comes into play only when the benefit conferred is greater than the amount the nonbreaching party lost.

Arlene agrees to sell her property to Calhoun for $120,000, and Calhoun makes a partial payment of $30,000. He then repudiates. Arlene turns around and sells the property to a third party for $110,000. Calhoun—the breaching party—can get his money back, less the damages Arlene suffered as a result of his breach. He gets $30,000 minus the $10,000 loss Arlene incurred. He gets $20,000 in restitution. Otherwise Arlene would be enriched by Calhoun's breach: she'd get $140,000 in total for real estate worth $120,000. But if he gets $20,000 of his $30,000 back, she receives $110,000 from the third party and $10,000 from Calhoun, so she gets $120,000 total (plus, we hope, incidental damages, at least).

Restitution in Other Cases

Upon repudiation of an oral contract governed by the Statute of Frauds, the nonbreaching party is not entitled to her expectation interest, but she may recover in restitution unless the purpose of the statute would be frustrated. When one party avoids a contract owing to lack of capacity, mistake, misrepresentation, duress, or the like, she is entitled to restitution for benefit conferred on the other party. Restitution is also available if a contract duty is discharged or never arises because (1) performance was impracticable, (2) the purpose of the contract was frustrated, (3) a condition did not occur, or (4) a beneficiary disclaimed his benefit.

Limitations on Contract Remedies

We have observed that the purpose of remedies in contract law is, where possible, to put the nonbreaching party in as good a position as he would have been in had there been no breach. There are, however, several limitations or restrictions affecting when a person can claim remedies, in both law (damages) and equity.

Of course the contract itself may—if not unconscionable—limit remedies. Beyond that, the nonbreaching party must be able to articulate with some degree of certainty what her damages are (they cannot be speculative); the damages must be foreseeable; the nonbreaching party must have made a reasonable effort to mitigate the damages; she must sometime elect to go with one remedy and forgo another; and she cannot seek to avoid a contract if she lost the power to do so. We turn to these points.

Foreseeability

If the damages that flow from a breach of contract lack foreseeability, they will not be recoverable. Failures to act, like acts themselves, have consequences. As the old fable has it, "For want of a nail, the kingdom was lost." To put a nonbreaching party in the position he would have been in had the contract been carried out could mean, in some cases, providing compensation for a long chain of events. In many cases, that would be unjust, because a person who does not anticipate a particular event when making a contract will not normally take steps to protect himself (either through limiting language in the contract or through insurance). The law is not so rigid; a loss is not compensable to the nonbreaching party unless the breaching party, at the time the contract was made, understood the loss was foreseeable as a probable result of his breach.

Of course, the loss of the contractual benefit in the event of breach is always foreseeable. A company that signs an employment contract with a prospective employee knows full well that if it breaches, the employee will have a legitimate claim to lost salary. But it might have no reason to know that the employee's holding the job for a certain length of time was a condition of his grandfather's gift of $1 million.

The leading case, perhaps the most studied case, in all the common law is from England, *Hadley v. Baxendale*, 9 Ex. 341, 354, 156 Eng. Rep. 145, 151 (1854). Joseph and Jonah Hadley were proprietors of a flour mill in Gloucester. In May 1853, the shaft of the milling engine broke, stopping all milling. An employee went to Pickford and Company, a common carrier, and asked that the shaft be sent as quickly as possible to a Greenwich foundry that would use the shaft as a model to construct a new one. The carrier's agent promised delivery within two days. But through an error, the shaft was shipped by canal rather than by rail and did not arrive in Greenwich for seven days. The Hadleys sued Joseph Baxendale, managing director of Pickford, for the profits they lost because of the delay. In ordering a new trial, the Court of Exchequer ruled that Baxendale was not liable because he had had no notice that the mill was stopped:

Where two parties have made a contract which one of them broke, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.

Thus when the party in breach does not know, and has no reason to know, that the contract entailed a special risk of loss, the burden must fall on the nonbreaching party. In *Hadley*, the carrier had no reason to know of the mill stoppage when it agreed to ship the shaft. As we have seen, damages attributable to losses that flow from events that do not occur in the ordinary course of events are known as consequential or special damages. The exact amount of a loss need not be foreseeable; it is the nature of the event that distinguishes between claims for ordinary or consequential damages. A repair shop agrees to fix a machine that it knows is intended to be resold. Because it delays, the sale is lost. The repair shop, knowing why timeliness of performance was important, is liable for the lost profit, as long as it was reasonable. It would not be liable for an extraordinary profit that the seller could have made because of circumstances peculiar to the particular sale unless they were disclosed.

The special circumstances need not be recited in the contract. It is enough for the party in breach to have actual knowledge of the loss that would occur through his breach. Moreover, the parol evidence rule does not bar introduction of evidence bearing on the party's knowledge before the contract was signed. So the lesson to a promisee is that the reason for the terms he bargains for should be explained to the promisor— although too much explanation could kill a contract. A messenger who is paid $5 to deliver a letter across town is not likely to undertake the mission if he is told in advance that his failure for any reason to deliver the letter will cost the sender $1 million, liability to be placed on the messenger.

Actual knowledge is not the only criterion, because the standard of foreseeability is objective, not subjective. That means that if the party had reason to know—if a reasonable person would have understood—that a particular loss was probable should he breach, then he is liable for damages. What one has reason to know obviously depends on the circumstances of the case, the parties' prior dealings, and industry custom. A supplier selling to a middleman should know that the commodity will be resold and that delay or default may reduce profits, whereas delay in sale to an end user might not. If it was foreseeable that the breach might cause the nonbreaching party to be sued, the other party is liable for legal fees and a resulting judgment or the cost of a settlement.

Even though the breaching party may have knowledge, the courts will not always award full consequential damages. In the interests of fairness, they may impose limitations if such an award would be manifestly unfair. Such cases usually crop up when the parties have dealt informally and there is a considerable disproportion between the loss caused and the benefit the nonbreaching party agreed to confer on the party who breached. The messenger may know that a huge sum of money rides on his prompt delivery of a letter across town, but unless he explicitly contracted to bear liability for failure to deliver, it is unlikely that the courts would force him to ante up $1 million when his fee for the service was only $5. *EBWS, LLC v. Britly Corp.*, 928 A.2d 497 (Vt. 2007), is a case that represents a modern application of the rule of *Hadley v. Baxendale* on the issue of foreseeability of consequential damages.

EBWS involved a construction contract to build creamery. After construction was complete numerous defects resulted in repairs that required to creamery to be shut down for a period of time. In suing for consequential damages for milk that the creamery had to dispose of and employee wages for the period of shutdown, the trial court granted consequential damages of over $35,000. The Supreme Court of Vermont reversed, however, stating that it was not reasonable to expect the contractor to know its failure to perform would result in these types of damages – they were not foreseeable when the parties entered into the contract. At time of contracting, EBWS was not currently running a creamery operation and had no creamery employees. *Id.* at 504-05.

Mitigation of Damages

Contract law encourages the nonbreaching party to avoid loss wherever possible; this is called **mitigation of damages**. The concept is a limitation on damages in law. So there can be no recovery if the nonbreaching party had an opportunity to avoid or limit losses and failed to take advantage of it. Such an opportunity exists as long as it does not impose, in the Restatement's words, an "undue risk, burden or humiliation." Restat 2d of Contracts, § 350. As long as the nonbreaching party makes a reasonable, good-faith attempt to mitigate his losses, damages are recoverable. And, the burden of establishing that damages could have been mitigated is on the breaching party. *Volos, Ltd. v. Sotera*, 264 Md. 155, 286 A.2d 101 (1972).

Mitigation crops up in many circumstances. Thus a nonbreaching party who continues to perform after notice that the promisor breached or will breach may not recover for expenses incurred in continuing to perform. And losses from the use of defective goods delivered in breach of contract are not compensable if the nonbreaching party knew before use that they were defective. Often the nonbreaching party can make substitute arrangements—find a new job or a new employee, buy substitute goods or sell them to another buyer—and his failure to do so will limit the amount of damages he will recover from the party who breaches. Under the general rule, failure to mitigate when possible permits the promisor to deduct from damages the amount of the loss that the nonbreaching party could have avoided. When there is a readily ascertainable market price for goods, damages are equal to the difference between the contract price and the market price.

The nonbreaching party must mitigate in timely fashion, but each case is different. If it is clear that the promisor unconditionally repudiated before performance is due, the nonbreaching party must begin to mitigate as soon as practicable and should not wait until the day performance is due to look for an alternative.

As long as the effort to mitigate is reasonable, the success of that effort is not an issue in assessing damages. If a film producer's original cameraman breaches the contract, and the producer diligently searched for a substitute cameraman, who cost $150 extra per week and it later came to light that the producer could have hired a cameraman for $100, the company is entitled nevertheless to damages based on the higher figure. *Parker v. Twentieth Century-Fox Corp.*, 3 Cal. 3d 176 (Cal. 1970) (before projected earnings in substituted movie role could be used to mitigate damages in suit by actress for lost earnings from cancelled movie, movie studio must show substituted role was comparable to initial role).

Certainty of Damages

A party can recover only that amount of damage in law which can be proved with reasonable certainty. Damages cannot be based on a guess or speculative. Especially troublesome in this regard are lost profits and loss of goodwill, which can be difficult to quantify. "Under Maryland law, in order to recover **lost profits damages**, a plaintiff must show that (1) the breach by the defendant was the proximate cause of the plaintiff's loss; (2) the defendant could reasonably foresee that a loss of profits would result from the breach; and (3) the amount of lost profits can be proved with reasonable certainty." *CR-RSC Tower I, LLC v. RSC Tower I, LLC*, 202 Md. App. 307, 332-33, 32 A.3d 456, 471 (2011).

Alf is convinced that next spring the American public will be receptive to polka-dotted belts with his name monogrammed in front in sequins. He arranges for a garment factory to produce 300,000 such belts, but the factory, which takes a large deposit from him in advance, misplaces the order and does not produce the belts in time for the selling season. When Alf discovers the failure, he cannot raise more money to go elsewhere, and his project fails. He cannot recover damages for lost profits because the figure is entirely speculative; no one can prove how much he would have made, if anything. He can, instead, seek restitution of the monies advanced. If he rented a warehouse to store the belts, he would also be able to recover his expenses for the warehouse rental.

Proof of lost profits is not always difficult: a seller can generally demonstrate the profit he would have made on the sale to the buyer who has breached. The problem is more difficult, as Alf's case demonstrates, when it is the seller who has breached. A buyer who contracts for but does not receive raw materials, supplies, and inventory cannot show definitively how much he would have netted from the use he planned to make of them. But he is permitted to prove how much money he has made in the past under similar circumstances, and he may proffer financial and market data, surveys, and expert testimony to support his claim. When proof of profits is difficult or impossible, the courts may grant a nonmonetary award, such as specific performance.

Loss of Power of Avoidance

You will recall that there are several circumstances when a person may avoid a contract: duress, undue influence, misrepresentation (fraudulent, negligent, or innocent), or mistake. But a party may lose the right to avoid, and thus the right to any remedy, in several ways.

Delay

If a party is the victim of fraud, she must act promptly to rescind the contract, or she will lose the right and her remedy will be limited to damages in tort.

Affirmation

An infant who waits too long to disaffirm (again, delay) will have ratified the contract, as will one who—notwithstanding being the victim of duress, undue influence, mistake, or any other grounds for avoidance—continues to operate under the contract with full knowledge of his right to avoid. Of course the disability that gave rise to the power of avoidance must have passed before affirmation works.

Rights of Third Parties

The intervening rights of third parties may terminate the power to avoid. For example, Michelle, a minor, sells her watch to Betty Buyer. Up to and within a reasonable time after reaching majority, Michelle could avoid—disaffirm—the contract. But if, before that time, Betty sells the watch to a third party, Michelle cannot get it back from the third party. Similarly, Salvador Seller sells his car to Bill Buyer, who pays for it with a bad check. If the check bounces, Salvador can rescind the deal—Bill's consideration (the money represented by the check) failed: Salvador could return the check and get his car back. But if, before the check from Bill bounces, Bill in turn sells the car to Pat Purchaser, Salvador cannot avoid the contract. Pat gets to keep the car. And. Salvador gets to sue Bill.

Agreement of the Parties Limiting Remedies

Certainly it is the general rule that parties are free to enter into any kind of a contract they want, so long as it is not illegal or unconscionable. It is very common for one side to limit its liability, or for one side to agree that it will pursue only limited remedies against the other in case of breach. Such agree- to limitations on the availability of remedies are generally OK provided they are conspicuous, bargained- for, and not unconscionable. In consumer transactions, courts are more likely to find a contracted-for limitation of remedies unconscionable than in commercial transactions, and under the UCC there are further restrictions on contractual remedy limitations.

For example, Juan buys ten bags of concrete to make a counter and stand for his expensive new barbecue. The bags have this wording in big print: "Attention. Our sole liability in case this product is defective will be to provide you with a like quantity of nondefective material. We will not be liable for any other damages, direct or indirect, express or implied." That's fine. If the concrete is defective, the concrete top breaks, and Juan's new barbecue is damaged, he will get nothing but some new bags of good concrete. He could have shopped around to find somebody who would deliver concrete with no limitation on liability. As it is, his remedies are limited by the agreement he entered into.

Election of Remedies

At Common Law

Another limitation on remedies—at common law—is the concept of election of remedies. The nature of a loss resulting from a contract breach may be such as to entitle one party to a choice among two or more means to redress the grievance, where the choices are mutually exclusive.

At common law, a person who was defrauded had an election of remedies: she could, immediately upon discovering the fraud, rescind the contract, or she could retain the item (real estate or personal property) and attempt to remedy the fraudulently defective performance by suing for damages, but not both. Buyer purchases real estate from Seller for $300,000 and shortly discovers that Seller fraudulently misrepresented the availability of water. Buyer spends $60,000 trying to drill wells. Finally he gives up and sues Seller for fraud, seeking $360,000. Traditionally at common law, he would not get it. He should have rescinded upon discovery of the fraud. Now he can only get $60,000 in damages in tort. *Merritt v. Craig*, 130 Md. App. 350, 746 A.2d 923 (2000). "The right to rescind may be waived by not acting promptly on discovery of the facts from which it arises. The right to waive must be exercised within a reasonable time, which is determined, in large part, by whether the period has been long enough to result in prejudice. Rescission requires at a minimum that the party exercising a right to rescind notify the other party and demonstrate an unconditional willingness to return to the other party both the consideration that was given and any benefits received." *Id.*at 360, 746 A.2d at 928.

The purpose of the election of remedies doctrine is to prevent the victim of fraud from getting a double recovery, but it has come under increasing criticism. Here is one court's observation: "A host of commentators support elimination of the election of remedies doctrine. A common theme is that the doctrine substitutes labels and formalism for inquiry into whether double recovery results in fact. The rigid doctrine goes to the other extreme, actually resulting in the under compensation of fraud victims and the protection of undeserving wrongdoers." *Head & Seemann, Inc. v. Gregg*, 311 N.W.2d 667, 670 (Wis. Ct. App. 1981).

Under the UCC

The doctrine of election of remedy has been rejected by the UCC, which means that the remedies are cumulative in nature. According to Section 2-703(1): "Whether the pursuit of one remedy bars another depends entirely on the facts of the individual case." Md. Code Ann., Com. Law § 2-721. Neither demand for rescission of the contract in the case of misrepresentation or fraud, nor the return or rejection of goods, bars a claim for damages or any other remedy permitted under the UCC for nonfraudulent breach.

Tort versus Contract

Frequently a contract breach may also amount to tortious conduct. A physician warrants her treatment as perfectly safe but performs the operation negligently, scarring the patient for life. The patient could sue for malpractice (tort) or for breach of warranty (contract). The choice involves at least four considerations:

1. Statute of limitations. Most statutes of limitations prescribe longer periods for contract than for tort actions.
2. Allowable damages. Punitive damages are more often permitted in tort actions, and certain kinds of injuries are compensable in tort but not in contract suits—for example, pain and suffering.
3. Expert testimony. In most cases, the use of experts would be the same in either tort or contract suits, but in certain contract cases, the expert witness could be dispensed with, as, for example, in a contract case charging that the physician abandoned the patient.
4. Insurance coverage. Most policies do not cover intentional torts, so a contract theory that avoids the element of willfulness would provide the plaintiff with a surer chance of recovering money damages.

Legal versus Extralegal Remedies

A party entitled to a legal remedy is not required to pursue it. Lawsuits are disruptive not merely to the individuals involved in the particular dispute but also to the ongoing relationships that may have grown up around the parties, especially if they are corporations or other business enterprises. Buyers must usually continue to rely on their suppliers, and sellers on their buyers. Not surprisingly, therefore, many business people refuse to file suits even though they could, preferring to settle their disputes privately or even to ignore claims that they might easily press. Indeed, the decision whether or not to sue is not one for the lawyer but for the client, who must analyze a number of pros and cons, many of them not legal ones at all.

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The Uniform Commercial Code (UCC)

In Introduction to Contract Law we introduced the Uniform Commercial Code. As we noted, the UCC has become a national law, adopted in every state—although Louisiana has not enacted Article 2, and differences in the law exist from state to state. Of all the uniform laws related to commercial transactions, the UCC is by far the most successful, and its history goes back to feudal times.

In a mostly agricultural, self-sufficient society there is little need for trade, and almost all law deals with things related to land (real estate): its sale, lease, and devising (transmission of ownership by inheritance); services performed on the land; and damages to the land or to things related to it or to its productive capacity (torts). Such trade as existed in England before the late fourteenth century was dominated by foreigners. But after the pandemic of the Black Death in 1348–49 (when something like 30 percent to 40 percent of the English population died), the self-sufficient feudal manors began to break down. There was a shortage of labor. People could move off the manors to find better work, and no longer tied immediately to the old estates, they migrated to towns. Urban centers—cities—began to develop. Urbanization inevitably reached the point where citizens' needs could not be met locally. Enterprising people recognized that some places had a surplus of a product and that other places were in need of that surplus and had a surplus of their own to exchange for it. So then, by necessity, people developed the means to transport the surpluses. Enter ships, roads, some medium of exchange, standardized weights and measures, accountants, lawyers, and rules governing merchandising. And enter merchants.

The power of merchants was expressed through franchises obtained from the government which entitled merchants to create their own rules of law and to enforce these rules through their own courts. Franchises to hold fairs [retail exchanges] were temporary; but the franchises of the staple cities, empowered to deal in certain basic commodities [and to have mercantile courts], were permanent.…Many trading towns had their own adaptations of commercial law.… The seventeenth century movement toward national governments resulted in a decline of separate mercantile franchises and their courts. The staple towns…had outlived their usefulness. When the local law on merchants became incorporated into a national system of laws enforced by national courts of general jurisdiction, the local codes were finally extinguished. But national systems of law necessarily depended upon the older codes for their stock of ideas and on the changing customs of merchants for new developments. Frederick G. Kempin Jr., *Historical Introduction to Anglo-American Law* (Eagan, MN: West, 1973), 217–18, 219– 20, 221.

When the American colonies declared independence from Britain, they continued to use British law, including the laws related to commercial transactions. By the early twentieth century, the states had inconsistent rules, making interstate commerce difficult and problematic. Several uniform laws affecting commercial transactions were floated in the late nineteenth century, but few were widely adopted. In 1942, the American Law Institute (ALI) hired staff to begin work on a rationalized, simplified, and harmonized national body of modern commercial law. American Law Insitute, "ALI Overview," accessed March 1, 2011,[http://www.ali.org/index.cfm?fuseaction=about.overview.](http://www.ali.org/index.cfm?fuseaction=about.overview)

The ALI's first draft of the UCC was completed in 1951.The UCC was adopted by Pennsylvania two years later, and other states followed in the 1950s and 1960s. In the 1980s and 1990s, the leasing of personal property became a significant factor in commercial transactions, and although the UCC had some sections that were applicable to leases, the law regarding the sale of goods was inadequate to address leases. Article 2A governing the leasing of goods was approved by the ALI in 1987. It essentially repeats Article 2 but applies to leases instead of sales. In 2001, amendments to Article 1—which applies to the entire UCC—were proposed and subsequently have been adopted by over half the states. No state has yet adopted the modernizing amendments to Article 2 and 2A that the ALI proposed in 2003. That's the short history of why the body of commercial transaction law is separate from the common law.

Scope of the UCC

The UCC embraces the law of commercial transactions, a term of some ambiguity. A commercial transaction may seem to be a series of separate transactions; it may include, for example, the making of a contract for the sale of goods, the signing of a check, the endorsement of the check, the shipment of goods under a bill of lading, and so on. However, the UCC presupposes that each of these transactions is a facet of one single transaction: the lease or sale of, and payment for, goods. The code deals with phases of this transaction from start to finish. These phases are organized according to the following articles:

- Sales (Article 2)
- Leases (Article 2A)
- Commercial Paper (Article 3)
- Bank Deposits and Collections (Article 4)
- Funds Transfers (Article 4A)
- Letters of Credit (Article 5)
- Bulk Transfers (Article 6)
- Warehouse Receipts, Bills of Lading, and Other Documents of Title (Article 7)
- Investment Securities (Article 8)
- Secured Transactions; Sales of Accounts and Chattel Paper (Article 9)

Although the UCC comprehensively covers commercial transactions, it does not deal with every aspect of commercial law. Among the subjects not covered are the sale of real property, mortgages, insurance contracts, suretyship transactions (unless the surety is party to a negotiable instrument), and bankruptcy. Moreover, common-law principles of contract law that were examined in previous sections continue to apply to many transactions covered in a particular way by the UCC. These principles include capacity to contract, misrepresentation, coercion, and mistake. Many federal laws supersede the UCC; these include the Bills of Lading Act, the Consumer Credit Protection Act, the warranty provisions of the Magnuson- Moss Act, and other regulatory statutes.

We follow the general outlines of the UCC in this chapter and in the next sections "Title and Risk of Loss" and "Performance and Remedies". In this section, we cover the law governing sales (Article 2) and make some reference to leases (Article 2A), though space constraints preclude an exhaustive analysis of leases. We now turn our attention to the sale—the first facet, and the cornerstone, of the commercial transaction.

Scope of Articles 2 and 2A and Definitions

In dealing with any statute, it is of course very important to understand the statute's scope or coverage. Article 2 does not govern all commercial transactions, only sales. It does not cover all sales, only the sale of goods. Article 2A governs leases, but only of personal property (goods), not real estate. So we need to consider the definitions of sale, goods, and lease. All references to the UCC will be to Maryland's statute – contained in its Commercial Law article of Maryland's Annotated Code.

Definition of Sale

A sale "consists in the passing of title from the seller to the buyer for a price." Md. Code Ann., Com. Law § 2-106 (LexisNexis 2021).

Sales are distinguished from gifts, bailments, leases, and secured transactions. Article 2 sales should be distinguished from gifts, bailments, leases, and secured transactions. A gift is the transfer of title without consideration, and a "contract" for a gift of goods is unenforceable under the UCC or otherwise (with some exceptions). A bailment is the transfer of possession but not title or use; parking your car in a commercial garage often creates a bailment with the garage owner. A lease (see the formal definition later in this section) is a fixed-term arrangement for possession and use of something— computer equipment, for example—and does not transfer title. In a secured transaction, the owner-debtor gives a security interest in collateral to a creditor that allows the creditor to repossess the collateral if the owner defaults.

Definition of Goods

Even if the transaction is considered a sale, the question still remains whether the contract concerns the sale of goods. Article 2 applies only to goods; sales of real estate and services are governed by non-UCC law. Goods are defined as "all things…which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid." Md. Code Ann., Com. Law § 2-105(1). Money can be considered goods subject to Article 2 if it is the object of the contract—for example, foreign currency. *See Central GMC, Inc. v. Helms*, 303 Md. 266, 492 A.2d 1313 (1985) (motor vehicle is a good under § 2-105).

In certain cases, the courts have difficulty applying this definition because the item in question can also be viewed as realty or service. Most borderline cases raise one of two general questions:

1. Is the contract for the sale of the real estate, or is it for the sale of goods?
2. Is the contract for the sale of goods, or is it for services?

Real Estate versus Goods

The dilemma is this: A landowner enters into a contract to sell crops, timber, minerals, oil, or gas. If the items have already been detached from the land—for example, timber has been cut and the seller agrees to sell logs—they are goods, and the UCC governs the sale. But what if, at the time the contract is made, the items are still part of the land? Is a contract for the sale of uncut timber governed by the UCC or by real estate law?

The UCC governs under either of two circumstances: (1) if the contract calls for the seller to sever the items or (2) if the contract calls for the buyer to sever the items and if the goods can be severed without material harm to the real estate. Md. Code Ann., Com. Law § 2-107 (LexisNexis 2021). The second provision specifically includes growing crops and timber.

By contrast, the law of real property governs if the buyer's severance of the items will materially harm the real estate; for example, the removal of minerals, oil, gas, and structures by the buyer will cause the law of real property to govern. (See Figure 12 "Governing Law".)

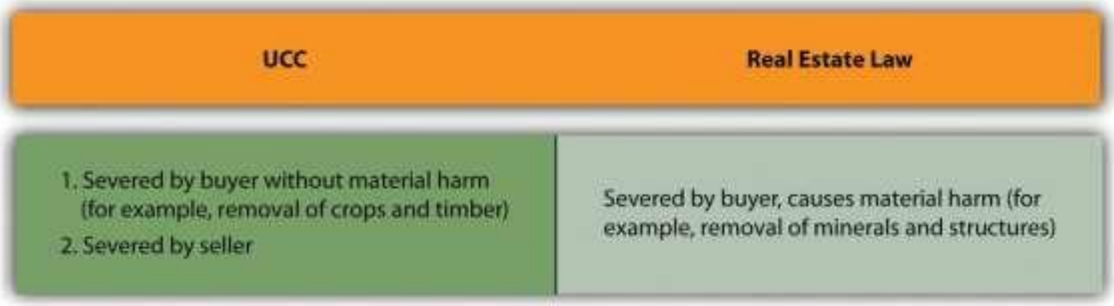


Figure 11 Governing Law of Contracts

Goods versus Services

Distinguishing goods from services is the other major difficulty that arises in determining the nature of the object of a sales contract. The problem: how can goods and services be separated in contracts calling for the seller to deliver a combination of goods and services? That issue is examined in "Mixed Goods and Services Contracts: The "Predominant Factor" Test" (*Burton v. Artery Co.*, 279 Md. 94, 367 A.2d 935 (1976)) where the court applied the common "predominant factor" (also sometimes "predominate purpose" or "predominant thrust") test—that is, it asked whether the transaction was predominantly a contract for goods or for services. However, the results of this analysis are not always consistent.

"Burton is a nurseryman. He is engaged, therefore, in selling trees and shrubs. If he also grows sod, then he is engaged in the business of selling sod. The number of trees and shrubs and the substantial amount of sod here involved make this contract much more nearly analogous to the installation of a water heater in a bathroom than to a contract with an artist for a painting. Thus, the predominant factor here, the thrust, the purpose, reasonably stated, is a transaction of sale [of goods] with labor incidentally involved. Therefore, the contract is one governed by the UCC and the four year statute of limitations is applicable." *Id.* at 114-15, 367 A.2d at 946.

Compare *Epstein v. Giannattasio*, 197 A.2d 342 (Conn. 1963), in which the court held that no sale of goods had been made because the plaintiff received a treatment in which the cosmetics were only incidentally used, with *Pittsley v. Houser*, 875 P.2d 232 (Idaho Ct. App. 1994) in which the court in "[a]pplying the predominant factor test to the case … conclude[d] that the UCC was applicable to the subject transaction. The record indicates that the contract between the parties called for "165 yds Masterpiece #2122 [carpet]--Installed" for a price of $ 4319.50. There was an additional charge for removing the existing carpet. The record indicates that Hilton paid the installers $ 700 for the work done in laying Pittsley's carpet. It appears that Pittsley entered into this contract for the purpose of obtaining carpet of a certain quality and color. It does not appear that the installation, either who would provide it or the nature of the work, was a factor in inducing Pittsley to choose Hilton as the carpet supplier. On these facts, we conclude that the sale of the carpet was the predominant factor in the contract, with the installation being merely incidental to the purchase." *Id.* at 235.

In two areas, state legislatures have taken the goods-versus-services issue out of the courts' hands and resolved the issue through legislation. Food sold in restaurants is a sale of goods, whether it is to be consumed on or off the premises. Blood transfusions (really the sale of blood) in hospitals have been legislatively declared a service, not a sale of goods, in more than forty states, thus relieving the suppliers and hospitals of an onerous burden for liability from selling blood tainted with the undetectable hepatitis virus.

Definition of Lease

Section 2A-103(j) of the UCC defines a lease as "a transfer of the right to possession and use of goods for a term in return for consideration." Md. Code Ann., Com. Law § 2A-103(j). The lessor is the one who transfers the right to possession to the lessee. If Alice rents a party canopy from Equipment Supply, Equipment Supply is the lessor and Alice is the lessee.

Two Types of Leases

The UCC recognizes two kinds of leases: consumer leases and finance leases. A consumer lease is used when a lessor leases goods to "an individual…primarily for personal, family, or household purposes," where total lease payments are less than $25,000. Md. Code Ann., Com. Law § 2A-103(e). The UCC grants some special protections to consumer lessees. A finance lease is used when a lessor "acquires the goods or the right to [them]" and leases them to the lessee. Md. Code Ann., Com. Law § 2A-103(g). The person from whom the lessor acquires the goods is a supplier, and the lessor is simply financing the deal. Jack wants to lease a boom lift (personnel aerial lift, also known as a cherry picker) for a commercial roof renovation. First Bank agrees to buy (or itself lease) the machine from Equipment Supply and in turn lease it to Jack. First Bank is the lessor, Jack is the lessee, and Equipment Supply is the supplier.

Sales Law Compared with Common Law Contracts

Sales law deals with the sale of goods. Sales law is a special type of contract law, but the common law informs much of Article 2 of the UCC—with some differences, however. Some of the similarities and differences were discussed in previous chapters that covered common-law contracts, but a review here is appropriate.

Mutual Assent: Offer and Acceptance

Definiteness of the Offer

The common law requires more definiteness than the UCC. Under the UCC, a contractual obligation may arise even if the agreement has open terms. Under Section 2-204(3), such an agreement for sale is not voidable for indefiniteness, as in the common law, if the parties have intended to make a contract and the court can find a reasonably certain basis for giving an appropriate remedy. Md. Code Ann., Com. Law § 2-204(3). *See Universal Life Distribs., Inc. v. Northwest Indus., Inc.*, 602 F.2d 1173 (4th Cir. 1979) (lowest price provision was enforceable). Perhaps the most important example is the open price term.

The open price term is covered in detail in Section 2-305. At common law, a contract that fails to specify price or a means of accurately ascertaining price will almost always fail. This is not so under the UCC provision regarding open price terms. If the contract says nothing about price, or if it permits the parties to agree on price but they fail to agree, or if it delegates the power to fix price to a third person who fails to do so, then Section 2-305(1) "plugs" the open term and decrees that the price to be awarded is a "reasonable price at the time for delivery." Md. Code Ann., Com. Law § 2-305(1). When one party is permitted to fix the price, Section 2-305(2) requires that it be fixed in good faith. Md. Code Ann., Com. Law § 2-305(2). However, if the parties *intend* not to be bound unless the price is first fixed or agreed on, and it is not fixed or agreed on, then no contract results. Md. Code Ann., Com. Law § 2- 305(4).

Another illustration of the open term is in regard to particulars of performance. Section 2-311(1) provides that a contract for sale of goods is not invalid just because it leaves to one of the parties the power to specify a particular means of performing. However, "any such specification must be made in good faith and within limits set by commercial reasonableness.” Md. Code Ann., Com. Law § 2-311(1). (Performance will be covered in greater detail in "Title and Risk of Loss".)

Acceptance Varying from Offer: Battle of the Forms

The concepts of offer and acceptance are basic to any agreement, but the UCC makes a change from the common law in its treatment of an acceptance that varies from the offer (this was discussed in "Introduction to Contract Law"). At common law, where the “mirror image rule” reigns, if the acceptance differs from the offer, no contract results. If that were the rule for sales contracts, with the pervasive use of form contracts—where each side’s form tends to favor that side—it would be very problematic.

Section 2-207 of the UCC attempts to resolve this “battle of the forms” by providing that additional terms or conditions in an acceptance operate as such unless the acceptance is conditioned on the offeror’s consent to the new or different terms. Md. Code Ann., Com. Law § 2-207. The new terms are construed as offers but are automatically incorporated in any contract between merchants for the sale of goods unless “(a) the offer expressly limits acceptance to the terms of the offer; (b) [the terms] materially alter it; or (c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received.” *Id.* In any case, Section 2-207(3) goes on like this: “Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act.” *Id.*

Revocation of Offer

Under both common law and the UCC, an offer can be revoked at any time prior to acceptance unless the offeror has given the offeree an option (supported by consideration); under the UCC, an offer can be revoked at any time prior to acceptance unless a merchant gives a “firm offer” (for which no consideration is needed). *See* Md. Code Ann., Com. Law § 2-205 (LexisNexis 2021) (“An offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or if no time is stated for a reasonable time, but in no event may such period of irrevocability exceed three months; but any such term of assurance on a form supplied by the offeree must be separately signed by the offeror.”)

Reality of Consent

There is no particular difference between the common law and the UCC on issues of duress, misrepresentation, undue influence, or mistake.

Consideration

The UCC requires no consideration for modification of a sales contract made in good faith; at common law, consideration is required to modify a contract. Md. Code Ann., Com. Law § 2-209(1). *See Ritz-Craft Corp. v. Stanford Mgt. Group*, 800 F. Supp. 1312 (D. Md. 1992). The UCC requires no consideration if one party wants to forgive another’s breach by written waiver or renunciation signed and delivered by the aggrieved party; under common law, consideration is required to discharge a breaching party. Md. Code Ann., Com. Law § 1–107. The UCC requires no consideration for a “firm offer”—a writing signed by a merchant promising to hold an offer open for some period of time; at common law an option requires consideration. (Note, however, the person can give an option under either common law or the code.)

Form and Meaning

Requirement of a Writing

The common law has a Statute of Frauds, and so does the UCC. It requires a writing to enforce a contract for the sale of goods worth $500 or more, with some exceptions, as discussed in "Form and Meaning". Proposed amendments by UCC revisioners presented in 2003 would have raised the amount of money—to take into account inflation since the mid-fifties—to $5,000, but no state has yet adopted this amendment; Uniform Commercial Code, Section 2-201. Md. Code Ann., Com. Law § 2-201.

Parol Evidence

Section 2-202 of the UCC provides pretty much the same as the common law: if the parties have a writing intended to be their final agreement, it "may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement." Md. Code Ann., Com. Law § 2-202. However, it may be explained by "course of dealing or usage of trade or by course of performance" and "by evidence of consistent additional terms." *Id.*; *see also Snyder v. Herbert Greenbaum & Assocs.*, 38 Md. App. 144, 380 A.2d 618 (1977).

Article 2 of the UCC of course has rules governing the obligations of parties specifically as to the offer, acceptance, performance of sales contracts, and so on. But it also imposes some general obligations on the parties. Two are called out here: one deals with unfair contract terms, and the second with obligations imposed on merchants.

Obligation of Good-Faith Dealings in General

Section 1-203 of the UCC provides, "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." *Good faith* is defined at Section 2-103(j) as "honesty in fact and the observance of reasonable commercial standards of fair dealing." Md. Code Ann., Com. Law § 2-103(j). This is pretty much the same as what is held by common law, which "imposes a duty of good faith and fair dealing upon the parties in performing and enforcing the contract." Restat 2d of Contracts, § 205.

The UCC's good faith in "performance or enforcement" of the contract is one thing, but what if the terms of the contract itself are unfair? The courts may tinker with a contract if they determine that it is particularly unfair. "If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result." Md. Code Ann., Com. Law § 2-302(1)

The court thus has considerable flexibility. It may refuse to enforce the entire contract, strike a particular clause or set of clauses, or limit the application of a particular clause or set of clauses.

And what does "unconscionable" mean? The UCC provides little guidance on this crucial question. The test is "whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract.…The principle is one of the prevention of oppression and unfair surprise and not of disturbance of allocation of risks because of superior bargaining power." Md. Code Ann., Com. Law § 2-302(1), cmt. 1; *see also Gladding v. Langrall, Muir & Noppinger*, 285 Md. 210, 401 A.2d 662 (1979) (fairness or hardship of contract is determined at time contract is made).

The definition is somewhat circular. For the most part, judges have had to develop the concept with little help from the statutory language. Unconscionability is much like US Supreme Court Justice Potter Stewart's famous statement about obscenity: "I can't define it, but I know it when I see it." In the leading case, *Williams* *v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965), Judge J. Skelly Wright attempted to develop a framework for analysis. He refined the meaning of unconscionability by focusing on "absence of meaningful choice" (often referred to as procedural unconscionability) and on terms that are "unreasonably favorable" (commonly referred to as substantive unconscionability). An example of procedural unconscionability is the salesperson who says, "Don't worry about all that little type on the back of this form." Substantive unconscionability is the harsh term—the provision that permits the "taking of a pound of flesh" if the contract is not honored. *Id.*, at 448. Despite its fuzziness, the concept of unconscionability has had a dramatic impact on American law. In many cases, in fact, the traditional notion of *caveat emptor* (Latin for "buyer beware") has changed to *caveat venditor* ("let the seller beware"). So important is this provision that courts in recent years have applied the doctrine in cases not involving the sale of goods.

Obligations Owed by Merchants

"Merchant" Sellers

Although the UCC applies to all sales of goods (even when you sell your used car to your neighbor), merchants often have special obligations or are governed by special rules.

As between Merchants

The UCC assumes that merchants should be held to particular standards because they are more experienced and have or should have special knowledge. Rules applicable to professionals ought not apply to the casual or inexperienced buyer or seller. For example, we noted previously that the UCC relaxes the mirror image rule and provides that as "between merchants" additional terms in an acceptance become part of the contract, and we have discussed the "ten-day-reply doctrine" that says that, again "as between merchants," a writing signed and sent to the other binds the recipient as an exception to the Statute of Frauds. Md. Code Ann., Com. Law §§ 2-205, 2A-205.

Merchant to Nonmerchant

In addition to duties imposed between merchants, the UCC imposes certain duties on a merchant when she sells to a nonmerchant. A merchant who sells her merchandise makes an important implied warranty of merchantability. That is, she promises that goods sold will be fit for the purpose for which such goods are normally intended. A nonmerchant makes no such promise, nor does a merchant who is not selling merchandise—for example, a supermarket selling a display case is not a "merchant" in display cases.

In *Sheeskin v. Giant Foods, Inc.*, 20 Md. App. 611, 318 A.2d 874 (Md. Ct. App. 1974), the problem of whether a merchant made an implied warranty of merchantability was nicely presented. Mr. Seigel, the plaintiff, was carrying a six-pack carton of Coca-Cola from a display bin to his shopping cart when one or more of the bottles exploded. He lost his footing and was injured. When he sued the supermarket and the bottler for breach of the implied warranty of fitness, the defendants denied there had been a sale: he never paid for the soda pop, thus no sale by a merchant and thus no warranty. The court said that Mr. Seigel's act of reaching for the soda to put it in his cart was a "reasonable manner of acceptance" *Id.* at 624, 318 A.2d at 882 (quoting UCC, section 2-206(1)).

Who Is a Merchant?

A merchant is defined as one "who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction." Md. Code Ann., Com. Law § 2-104(1). A phrase that recurs throughout Article 2—"between merchants"—refers to any transaction in which both parties are chargeable with the knowledge or skill of merchants. Md. Code Ann., Com. Law §2-104(3). Not every businessperson is a merchant with respect to every possible transaction. But a person or institution normally not considered a merchant can be one under Article 2 if he employs an agent or broker who holds himself out as having such knowledge or skill. (Thus a university with a purchasing office can be a merchant with respect to transactions handled by that department.)

Determining whether a particular person operating a business is a merchant under section 2-104 is a common problem for the courts. *Goldkist, Inc. v. Brownlee*, 355 S.E.2d 773, 775-76 (Ga. App. 1987). "Merchants" under the UCC, shows that making the determination is difficult and contentious, with significant public policy implications.

Obligations May Be Determined by Parties

Under the UCC, the parties to a contract are free to put into their contract pretty much anything they want. Section 1-102 states that "the effect of provisions of this Act may be varied by agreement…except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measure if such standards are not manifestly unreasonable." Md. Code Ann., Com. Law § 1-102.

Thus the UCC is the "default" position: if the parties want the contract to operate in a specific way, they can provide for that. If they don't put anything in their agreement about some aspect of their contract's operation, the UCC applies. For example, if they do not state where "delivery" will occur, the UCC provides that term. Per section 2-308 says it would be at the "seller's place of business or if he has none, his residence." Md. Code Ann., Com. Law § 2-308.

Output versus Requirements Contracts

Two specific types of contracts under the UCC are output and requirements contracts. Under an output contract, a buyer is contracting with a seller to buy all of the seller's output during the specific period. Md. Code Ann. Com. Law § 2-306. For example, James contracts with Sam to purchase all of the widgets Sam's company can produce in the month of September, regardless of whether Sam's company produces 1 ton of widgets or 5 tons of widgets and regardless of James' need.

A requirements contract is the opposite of an outputs contract. Under a requirements contract, a company is contracting to provide all of the requirements that another company needs for a set period of time. Md. Code Ann. Com. Law § 2-306. Under the prior examples, if it was a requirements contract, Sam would be contracting to provide all of James' requirements for the month of September- whether James needed 1 ton of widgets or 5 tons of widgets - Sam agrees to provide all of the requirements.

Title and Risk of Loss Under the UCC

Parties to a sales contract will usually agree on the obvious details of a sales transaction—the nature of goods, the price, and the delivery time, as discussed in the next chapter. But there are two other issues of importance lurking in the background of every sale:

1. When does the title pass to the buyer? This question arises more in cases involving third parties, such as creditors and tax collectors. For instance, a creditor of the seller will not be allowed to take possession of goods in the seller's warehouse if the title has already passed to the buyer.
2. If goods are damaged or destroyed, who must bear the loss? The answer has obvious financial significance to both parties. If the seller must bear the loss, then in most cases he must pay damages or send the buyer another shipment of goods. A buyer who bears the loss must pay for the goods even though they are unusable. In the absence of a prior agreement, loss can trigger litigation between the parties.

Transfer of Title

Why It Is Important When Title Shifts

There are three reasons why it is important when title shifts from seller to buyer—that is, when the buyer gets title.

It Affects Whether a Sale Has Occurred

First, a sale cannot occur without a shift in title. You will recall that a sale is defined as a "transfer of title from seller to buyer for a price." Md. Code Ann., Com. Law § 2-106. Thus if there is no shift of title, there is no sale. And there are several consequences to there being no sale, one of which is— concerning a merchant-seller—that no implied warranty of merchantability arises. (An implied warranty provides that when a merchant-seller sells goods, the goods are suitable for the ordinary purpose for which such goods are used.) In a lease, of course, title remains with the lessor.

Creditors' Rights

Second, title is important because it determines whether creditors may take the goods. If Creditor has a right to seize Debtor's goods to satisfy a judgment or because the parties have a security agreement (giving Creditor the right to repossess Debtor's goods), obviously it won't do at all for Creditor to seize goods when Debtor doesn't have title to them—they are somebody else's goods, and seizing them would be conversion, a tort (the civil equivalent of a theft offense).

Insurable Interest

Third, title is related to who has an **insurable interest**. A buyer cannot legally obtain insurance unless he has an insurable interest in the goods. Without an insurable interest, the insurance contract would be an illegal gambling contract. For example, if you attempt to take out insurance on a ship with which you have no connection, hoping to recover a large sum if it sinks, the courts will construe the contract as a wager you have made with the insurance company that the ship is not seaworthy, and they will refuse to enforce it if the ship should sink and you try to collect. Thus this question arises: under the UCC, at what point does the buyer acquire an insurable interest in the goods? Certainly a person has insurable interest if she has title, but the UCC allows a person to have insurable interest with less than full title. The argument here is often between two insurance companies, each *denying* that its insured had insurable interest as to make it liable.

Goods Identified to the Contract

The Identification Issue

Section 2-401 provides that "title to goods cannot pass under a contract for sale prior to their identification to the contract." Md. Code Ann., Com. Law § 2-401. In a lease, of course, title to the leased goods does not pass at all, only the right to possession and use for some time in return for consideration. Md. Code Ann., Com. Law § 2A-103(1)(j). So identification to the contract has to happen before title can shift. Identification to the contract here means that the seller in one way or another picks the goods to be sold out of the mass of inventory so that they can be delivered or held for the buyer.

When are goods "identified"? There are two possibilities as to when identification happens.

Parties May Agree

Section 2-501(1) says "identification can be made at any time and in any manner explicitly agreed to by the parties." Md. Code Ann., Com. Law § 2-501(1).

UCC Default Position

If the parties do not agree on when identification happens, the UCC default kicks in. Section 2-501(1) says identification occurs

1. when the contract is made if it is for the sale of goods already existing and identified;
2. if the contract is for the sale of future goods other than those described in paragraph 3 below, when goods are shipped, marked, or otherwise identified by the seller as goods to which the contract refers;
3. when crops are planted or otherwise become growing crops or the young are conceived if the contract is for the sale of unborn young (livestock) to be born within twelve months after contract or for the sale of corps to be harvested within twelve months or the next normal harvest seasons after contracting, whichever is longer. Md. Code Ann., Com. Law § 2-501.

Thus if Very Fast Food Inc.'s purchasing agent looks at a new type of industrial sponge on Delta Sponge Makers' store shelf for restaurant supplies, points to it, and says, "I'll take it," identification happens then, when the contract is made. But if the purchasing agent wants to purchase sponges for her fast-food restaurants, sees a sample on the shelf, and says, "I want a gross of those"—they come in boxes of one hundred each—identification won't happen until one or the other of them chooses the gross of boxes of sponges out of the warehouse inventory.

When Title Shifts

Parties May Agree

Assuming identification is done, when does title shift? The law begins with the premise that the agreement of the parties governs. Section 2-401(1) of the UCC says that, in general, "title to goods passes from the seller to the buyer in any manner and on any conditions explicitly agreed on by the parties." Md. Code Ann., Com. Law § 2-401(1). Many companies specify in their written agreements at what moment the title will pass; here, for example, is a clause that appears in sales contracts of Dow Chemical Company: "Title and risk of loss in all goods sold hereunder shall pass to Buyer upon Seller's delivery to carrier at shipping point." Thus Dow retains title to its goods only until it takes them to the carrier for transportation to the buyer.

Because the UCC's default position (discussed later in this section) is that title shifts when the seller completed delivery obligations, and because the parties may agree on delivery terms, they also may, by choosing those terms, effectively agree when title shifts (again, they also can agree using any other language they want). So it is appropriate to examine some delivery terms at this juncture. There are three possibilities: shipment contracts, destination contracts, and contracts where the goods are not to be moved.

Shipment Contracts

In a shipment contract, the seller's obligation is to send the goods to the buyer, but not to a particular destination. The typical choices are set out in Section 2-319:

- F.O.B. [place of shipment] (the place from which the goods are to be shipped goes in the brackets, as in "F.O.B. Seattle"). F.O.B. means "free on board"; the seller's obligation, according to Section 2-504, is to put the goods into the possession of a carrier and make a reasonable contract for their transportation, to deliver any necessary documents so the buyer can take possession, and promptly notify the buyer of the shipment. Md. Code Ann., Com. Law § 2-319(1).
- F.A.S. [named port] (the name of the seaport from which the ship is carrying the goods goes in the brackets, as in "F.A.S. Long Beach"). F.A.S means "free alongside ship"; the seller's obligation is to at his "expense and risk deliver the goods alongside the vessel in the manner usual in that port" and to provide the buyer with pickup instructions. Md. Code Ann., Com. Law § 2-319(2).
- C.I.F. and C. & F. These are actually not abbreviations for delivery terms, but rather they describe who pays insurance and freight. "C.I.F" means "cost, insurance, and freight"—if this term is used, it means that the contract price "includes in a lump sum the cost of the goods and the insurance and freight to the named destination." "C. & F." means that "the price so includes cost and freight to the named destination." Md. Code Ann., Com. Law §§ 2-319, 2-320.

Destination Contracts

In a destination contract, the seller's obligation is to see to it that the goods actually arrive at the destination. Here again, the parties may employ the use of abbreviations that indicate the seller's duties. See the following from Section 2-319:

- F.O.B. [destination] means the seller's obligation is to "at his own expense and risk transport the goods to that place and there tender delivery of them" with appropriate pickup instructions to the buyer. Md. Code Ann., Com. Law § 2-319(1).
- Ex-ship "is the reverse of the F.A.S. term." Md. Code Ann., Com. Law § 2-322. It means "from the carrying vessel"—the seller's obligation is to make sure the freight bills are paid and that "the goods leave the ship's tackle or are otherwise properly unloaded."
- No arrival, no sale means the "seller must properly ship conforming goods and if they arrive by any means he must tender them on arrival but he assumes no obligation that the goods will arrive unless he has caused the non-arrival." Md. Code Ann., Com. Law § 2-324. If the goods don't arrive, or if they are damaged or deteriorated through no fault of the seller, the

buyer can either treat the contract as avoided, or pay a reduced amount for the damaged goods, with no further recourse against the seller. Md. Code Ann., Com. Law § 2-613.

Goods Not to Be Moved

It is not uncommon for contracting parties to sell and buy goods stored in a grain elevator or warehouse without physical movement of the goods. There are two possibilities:

1. Goods with documents of title. A first possibility is that the ownership of the goods is manifested by a document of title—"bill of lading, dock warrant, dock receipt, warehouse receipt or order for the delivery of goods, and also any other document which in the regular course of business or financing is treated as adequately evidencing that the person in possession of it is entitled to receive, hold and dispose of the document and the goods it covers." Md. Code Ann., Com. Law § 1- 201(15). In that case, Section 2-401(3)(a), says that title passes "at the time when and the place where" the documents are delivered to the buyer. Md. Code Ann., Com. Law § 2-401(3)(a).
2. Goods without documents of title. If there is no physical transfer of the goods and no documents to exchange, then Section 2-401(3)(b), provides that "title passes at the time and place of contracting." Md. Code Ann., Com. Law § 2-401(3)(b).

Here are examples showing how these concepts work.

Suppose the contract calls for Delta Sponge Makers to "ship the entire lot of industrial grade Sponge No. 2 by truck or rail" and that is all that the contract says about shipment. That's a "shipment contract," and the UCC, Section 2-401(2)(a), says that title passes to Very Fast Foods at the "time and place of shipment." At the moment that Delta turns over the 144 cartons of 1,000 sponges each to a trucker— perhaps Easy Rider Trucking comes to pick them up at Delta's own factory—title has passed to Very Fast Foods.

Suppose the contract calls for Delta to "deliver the sponges on June 10 at the Maple Street warehouse of Very Fast Foods Inc." This is a destination contract, and the seller "completes his performance with respect to the physical delivery of the goods" when it pulls up to the door of the warehouse and tenders the cartons. Uniform Commercial Code, Section 2-401(2)(b). "Tender" means that the party—here Delta Sponge Makers—is ready, able, and willing to perform and has notified its obligor of its readiness. When the driver of the delivery truck knocks on the warehouse door, announces that the gross of industrial grade Sponge No. 2 is ready for unloading, and asks where the warehouse foreman wants it, Delta has tendered delivery, and title passes to Very Fast Foods.

Suppose Very Fast Foods fears that the price of industrial sponges is about to soar; it wishes to acquire a large quantity long before it can use them all or even store them all. Delta does not store all of its sponges in its own plant, keeping some of them instead at Central Warehousing. Central is a bailee, one who has rightful possession but not title. (A parking garage often is a bailee of its customers' cars; so is a carrier carrying a customer's goods.) Now assume that Central has issued a warehouse receipt (a document of title that provides proof of ownership of goods stored in a warehouse) to Delta and that Delta's contract with Very Fast Foods calls for Delta to deliver "document of title at the office of First Bank" on a particular day. When the goods are not to be physically moved, that title passes to Very Fast Foods "at the time when and the place where" Delta delivers the document.

Suppose the contract did not specify physical transfer or exchange of documents for the purchase price. Instead, it said, "Seller agrees to sell all sponges stored on the north wall of its Orange Street warehouse, namely, the gross of industrial Sponge No. 2, in cartons marked B300–B444, to Buyer for a total purchase price of $14,000, payable in twelve equal monthly installments, beginning on the first of the month beginning after the signing of this agreement." Then title passes at the time and place of contracting—that is, when Delta Sponge Makers and Very Fast Foods sign the contract.

So, as always under the UCC, the parties may agree on the terms they want when title shifts. They can do that directly by just saying when—as in the Dow Chemical example—or they can indirectly agree when title shifts by stipulating delivery terms: shipment, destination, goods not to be moved. If they don't stipulate, the UCC default kicks in.

UCC Default Provision

If the parties do not stipulate by any means when title shifts, Section 2-401(2) of the UCC provides that "title passes to the buyer at the time and place at which seller completes his performance with reference to the physical delivery of the goods." And if the parties have no term in their contract about delivery, the UCC's default delivery term controls. It says "the place for delivery is the seller's place of business or if he has none his residence," and delivery is accomplished at the place when the seller "put[s] and hold[s] conforming goods at the buyer's disposition and give[s] the buyer any notification reasonably necessary to enable him to take delivery." Uniform Commercial Code, Sections 2-308 and 2-503.

Title from Nonowners

The Problem of Title from Nonowners

We have examined when title transfers from buyer to seller, and here the assumption is, of course, that seller had good title in the first place. But what title does a purchaser acquire when the seller has no title or has at best only a voidable title? This question has often been difficult for courts to resolve. It typically involves a type of eternal triangle with a three-step sequence of events, as follows (see Figure 13 "Sales by Nonowners"): (1) The nonowner obtains possession, for example, by loan or theft; (2) the nonowner sells the goods to an innocent purchaser for cash; and (3) the nonowner then takes the money and disappears, goes into bankruptcy, or ends up in jail. The result is that two innocent parties battle over the goods, the owner usually claiming that the purchaser is guilty of conversion (i.e., the unlawful assumption of ownership of property belonging to another) and claiming damages or the right to recover the goods.

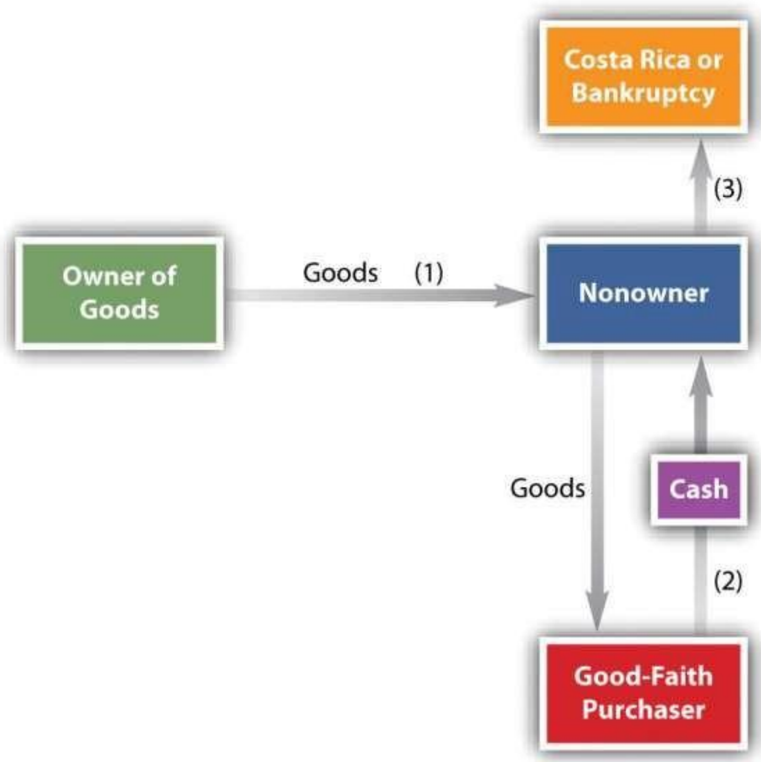


Figure 12 Sales by Nonowners

The Response to the Problem of Title from Nonowners The Basic Rule

To resolve this dilemma, we begin with a basic policy of jurisprudence: a person cannot transfer better title than he or she had. (This policy is noted in Sections 2-403, 2A-304, and 2A-305.) This policy would apply in a sale-of-goods case in which the non-owner had a void title or no title at all. For example, if a non-owner stole the goods from the owner and then sold them to an innocent purchaser, the owner would be entitled to the goods or to damages. Because the thief had no title, he had no title to transfer to the purchaser. A person cannot get good title to goods from a thief, nor does a person have to retain physical possession of her goods at all times to retain their ownership—people are expected to leave their cars with a mechanic for repair or to leave their clothing with a dry cleaner.

If thieves could pass on good title to stolen goods, there would be a huge increase in the trafficking of stolen property; that would be unacceptable. In such a case, the owner can get her property back from whomever the thief sold it to in a civil action called replevin (an action to recover personal property unlawfully taken). On the other hand, when a buyer in good faith buys goods from an apparently reputable seller, she reasonably expects to get good title, and that expectation cannot be dashed with impunity without faith in the market being undermined. Therefore, as between two innocent parties, sometimes the original owner does lose, on the theory that (1) that person is better able to avoid the problem than the downstream buyer, who had absolutely no control over the situation, and (2) faith in commercial transactions would be undermined by allowing original owners to claw back their property under all circumstances.

So the basic legal policy that a person cannot pass on better title than he had is subject to a number of exceptions. Likewise, the law governing the sale of goods contains exceptions to the basic legal policy. These usually fall within one of two categories: sellers with voidable title and entrustment.

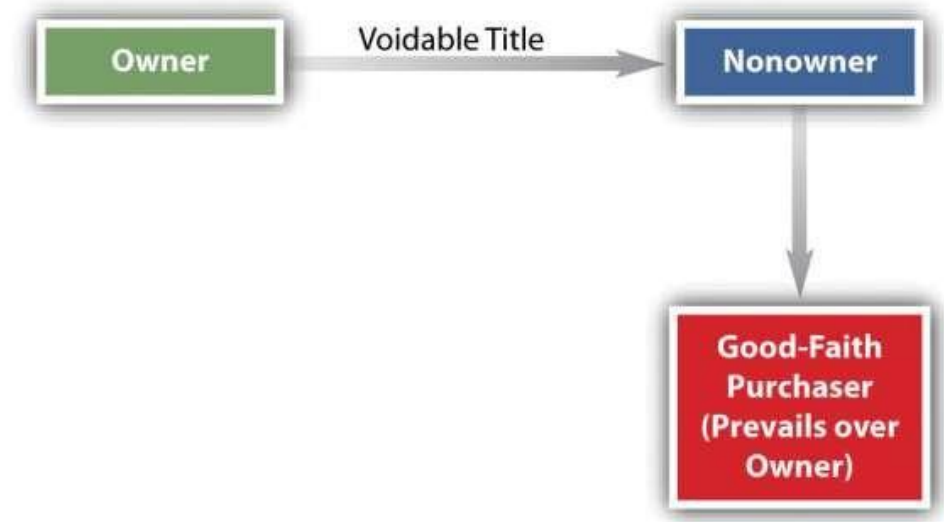
The Exceptions

Sellers with a Voidable Title

Under the UCC, a person with a voidable title has the power to transfer title to a good-faith purchaser for value (see Figure 14 "Voidable Title"). The UCC defines *good faith* as “honesty in fact in the conduct or transaction concerned.” Md. Code Ann., Com. Law § 1-201(19). A “purchaser” is not restricted to one who pays cash; any taking that creates an interest in property, whether by mortgage, pledge, lien, or even gift, is a purchase for purposes of the UCC. And “value” is not limited to cash or goods; a person gives value if he gives any consideration sufficient to support a simple contract, including a binding commitment to extend credit and security for a preexisting claim. Recall from the section in Contract Law on "The Agreement" that a “voidable” title is one that, for policy reasons, the courts will cancel on application of one who is aggrieved. These reasons include fraud, undue influence, mistake, and lack of capacity to contract. When a person has a voidable title, title can be taken away from her, but if it is not, she can transfer better title than she has to a good-faith purchaser for value.

Rita, sixteen years old, sells a video game to her neighbor Annie, who plans to give the game to her nephew. Since Rita is a minor, she could rescind the contract; that is, the title that Annie gets is voidable: it is subject to be avoided by Rita’s rescission. But Rita does not rescind. Then Annie discovers that her nephew already has that video game, so she sells it instead to an office colleague, Donald. He had no notice that Annie bought the game from a minor and has only a voidable title. He pays cash. Should Rita— the minor—subsequently decide she wants the game back, it would be too late: Annie transferred good title to Donald even though Annie’s title was voidable. *See Inmi-Etti v. Aluisi*, 63 Md. App., 492 A.2d 917 (1985) (voidable title can only arise from a voluntary transaction).

Figure 13 Voidable Title



Suppose Rita was an adult and Annie paid her with a check that later bounced, but Annie sold the game to Donald before the check bounced. Does Donald still have good title? The UCC says he does, and it identifies three other situations in which the good-faith purchaser is protected: (1) when the original transferor was deceived about the identity of the purchaser to whom he sold the goods, who then transfers to a good-faith purchaser; (2) when the original transferor was supposed to but did not receive cash from the intermediate purchaser; and (3) when "the delivery was procured through fraud punishable as larcenous under the criminal law." Md. Code Ann., Com. Law §§ 2-403(1), 2A-304, 2A-305.

This last situation may be illustrated as follows: Dimension LLC leased a Volkswagen to DK Inc. The agreement specified that DK could use the Volkswagen solely for business and commercial purposes and could not sell it. Six months later, the owner of DK, Darrell Kempf, representing that the Volkswagen was part of DK's used-car inventory, sold it to Edward Seabold. Kempf embezzled the proceeds from the sale of the car and disappeared. When DK defaulted on its payments for the Volkswagen, Dimension attempted to repossess it. Dimension discovered that Kempf executed a release of interest on the car's title by forging the signature of Dimension's manager. The Washington Court of Appeals, applying the UCC, held that Mr. Seabold should keep the car. The car was not stolen from Dimension; instead, by leasing the vehicle to DK, Dimension transferred possession of the car to DK voluntarily, and because Seabold was a good-faith purchaser, he won. *Dimension Funding, L.L.C. v. D.K. Associates, Inc.*, 191 P.3d 923, 927 (Wash. Ct. App. 2008).

Entrustment

A merchant who deals in particular goods has the power to transfer all rights of one who entrusts to him goods of the kind to a "buyer in the ordinary course of business" (see Figure 4 "Entrustment"). Md. Code Ann., Com. Law §§ 2-403(2), 2A-304(2), 2A-305(2). The UCC defines such a buyer as a person who buys goods in an ordinary transaction from a person in the business of selling that type of goods, as long as the buyer purchases in "good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods." Md. Code Ann., Com. Law § 1-201(9).

Bess takes a pearl necklace, a family heirloom, to Wellborn's Jewelers for cleaning; as the entrustor, she entrusted the necklace to an entrustee, Wellborn's. The owner of Wellborn's—perhaps by mistake—sells the necklace to Clara, a buyer, in the ordinary course of business. Bess cannot take the necklace back from Clara, although Bess has a cause of action against Wellborn's for conversion. As between the two innocent parties, Bess and Clara (owner and purchaser), the latter prevails. Notice that the UCC only says that the entrustee can pass *whatever title the entrustor had* to a good-faith purchaser, not necessarily good title. If Bess's cleaning woman borrowed the necklace, soiled it, and took it to Wellborn's, which then sold it to Clara, Bess could get it back because the cleaning woman had no title to transfer to the entrustee, Wellborn's.

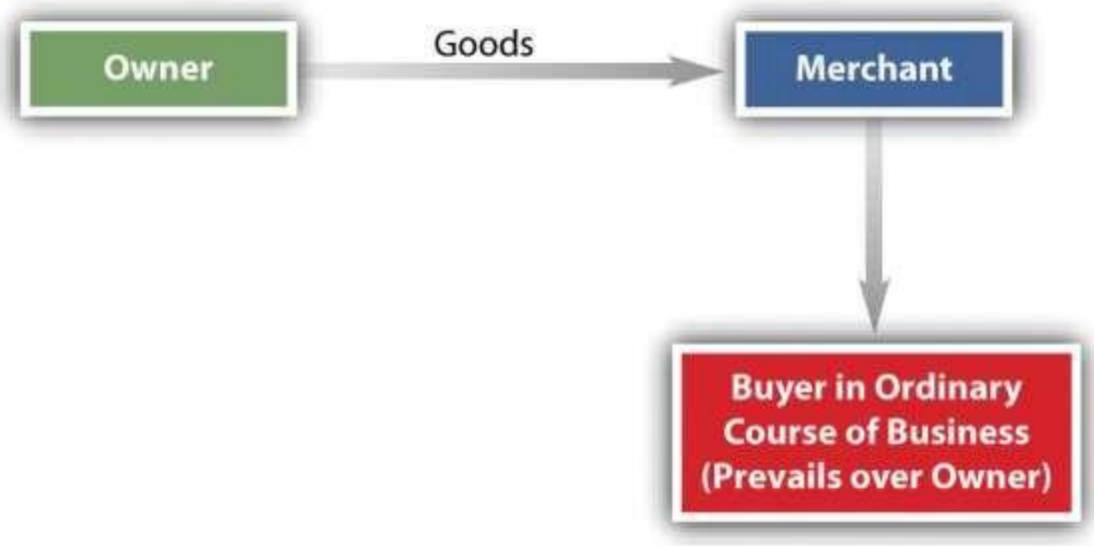


Figure 14 Entrustment

Entrustment is based on the general principle of estoppel: "A rightful owner may be estopped by his own acts from asserting his title. If he has invested another with the usual evidence of title, or an apparent authority to dispose of it, he will not be allowed to make claim against an innocent purchaser dealing on the faith of such apparent ownership." *Zendman v. Harry Winston, Inc.*, 111 N.E. 2d 871 (N.Y. 1953).

Risk of Loss

Why Risk of Loss Is Important

"Risk of loss" means who has to pay—who bears the risk—if the goods are lost or destroyed *without the fault of either party*. It is obvious why this issue is important: Buyer contracts to purchase a new car for $35,000. While the car is in transit to Buyer, it is destroyed in a landslide. Who takes the $35,000 hit?

When Risk of Loss Passes

The Parties May Agree

Just as title passes in accordance with the parties' agreement, so too can the parties fix the risk of loss on one or the other. They may even devise a formula to divide the risk between themselves. Md. Code Ann., Com. Law § 2-303.

Common terms by which parties set out their delivery obligations that then affect when title shifts (F.O.B., F.A.S., ex-ship, and so on) were discussed earlier in this section. Similarly, parties may use common terms to set out which party has the risk of loss; these situation arise with trial sales. That is, sometimes the seller will permit the buyer to return the goods even though the seller had conformed to the contract. When the goods are intended primarily for the buyer's use, the transaction is said to be "sale on approval." When they are intended primarily for resale, the transaction is said to be "sale or return." When the "buyer" is really only a sales agent for the "seller," it is a consignment sale. Md. Code Ann., Com. Law §§ 2-326, 2-327.

Sale on Approval

Under a sale-on-approval contract, risk of loss (and title) remains with the seller until the buyer accepts, and the buyer's trial use of the goods does not in itself constitute acceptance. Md. Code Ann., Com. Law § 2-327(1)(a). If the buyer decides to return the goods, the seller bears the risk and expense of return, but a merchant buyer must follow any reasonable instructions from the seller. Very Fast Foods asks Delta for some sample sponges to test on approval; Delta sends a box of one hundred sponges. Very Fast plans to try them for a week, but before that, through no fault of Very Fast, the sponges are destroyed in a fire. Delta bears the loss.

Sale or Return

The buyer might take the goods with the expectation of reselling them—as would a women's wear shop buy new spring fashions, expecting to sell them. Md. Code Ann., Com. Law § 2-326. But if the shop doesn't sell them before summer wear is in vogue, it could arrange with the seller to return them for credit. In contrast to sale-on-approval contracts, sale-or-return contracts have risk of loss (and title too) passing to the buyer, and the buyer bears the risk and expense of returning the goods. Md. Code Ann., Com. Law § 2-327. Occasionally the question arises whether the buyer's other creditors may claim the goods when the sales contract lets the buyer retain some rights to return the goods. The answer seems straightforward: in a sale-on-approval contract, where title remains with the seller until acceptance, the buyer does not own the goods—hence they cannot be seized by his creditors—unless he accepts them, whereas they are the buyer's goods (subject to his right to return them) in a sale-or-return contract and may be taken by creditors if they are in his possession.

Consignment Sales

In a consignment situation, the seller is a bailee and an agent for the owner who sells the goods for the owner and takes a commission. This is considered a sale or return, thus the consignee (at whose place the goods are displayed for sale to customers) is considered a buyer and has the risk of loss and title. Md. Code Ann., Com. Law § 2-326(3). Whether or not the consignee's creditors may seize goods depends on if the consignee has perfected a security interest in the goods. Md. Code Ann., Com. Law § 9-319. Space precludes a detailed discussion of secured transactions and perfected security interests (students interested in further studies on secured transactions should consider taking MNGT 141, Business Law II).

The UCC Default Position

If the parties fail to specify how the risk of loss is to be allocated or apportioned, the UCC again supplies the answers. A generally applicable rule, though not explicitly stated, is that risk of loss passes when the seller has completed obligations under the contract. Notice this is *not* the same as when title passes: title passes when seller has completed *delivery* obligations under the contract, risk of loss passes when *all* obligations are completed. (Thus a buyer could get good title to nonconforming goods, which might be better for the buyer than not getting title to them: if the seller goes bankrupt, at least the buyer has something of value.)

Risk of Loss in Absence of a Breach

If the goods are *conforming*, then risk of loss would indeed pass when delivery obligations are complete, just as with title. This is because delivery of conforming goods completes the seller's obligations. The analysis here would be the same as we looked at in examining shift of title.

A shipment contract. The contract requires Delta to ship the sponges by carrier but does not require it to deliver them to a particular destination. In this situation, risk of loss passes to Very Fast Foods when the goods are delivered to the carrier.

A destination contract. If the destination contract agreement calls for Delta to deliver the sponges by carrier to a particular location, Very Fast Foods assumes the risk of loss only when Delta's carrier tenders them at the specified place.

Goods not to be moved. If Delta sells sponges that are stored at Central Warehousing to Very Fast Foods, and the sponges are not to be moved, Section 2-509(2) of the UCC sets forth three possibilities for transfer of the risk of loss:

The buyer receives a negotiable document of title covering the good. A document of title is negotiable if by its terms goods are to be delivered to the bearer of the document or to the order of a named person.

The bailee acknowledges the buyer's right to take possession of the goods. Delta signs the contract for the sale of sponges and calls Central to inform it that a buyer has purchased 144 cartons and to ask it to set aside all cartons on the north wall for that purpose. Central does so, sending notice to Very Fast Foods that the goods are available. Very Fast Foods assumes risk of loss upon receipt of the notice.

When the seller gives the buyer a nonnegotiable document of title or a written direction to the bailee to deliver the goods and the buyer has had a reasonable time to present the document or direction. Md. Code Ann., Com. Law § 2-509.

All other cases. In any case that does not fit within the rules just described, the risk of loss passes to the buyer only when the buyer actually receives the goods if seller is a merchant; otherwise it passes on tender of delivery. Md. Code Ann., Com. Law § 2-509(3). Cases that come within this section generally involve a buyer who is taking physical delivery from the seller's premises. A merchant who sells on those terms can be expected to insure his interest in any goods that remain under his control. The buyer is unlikely to insure goods not in his possession. The case of *Ramos v. Wheel Sports Center*, 409 N.Y.S.2d 505 (N.Y. Civ. Ct. 1978) demonstrates how this risk-of-loss provision applies when a customer pays for merchandise but never actually receives his purchase because of a mishap. "Whether the contract involves delivery at the seller's place of business or at the situs of the goods, a merchant seller cannot transfer risk of loss and it remains on him until actual receipt by the buyer, even though full payment has been made and the buyer notified that the goods are at his disposal. The underlying theory is that a merchant who is to make physical delivery at his own place continues meanwhile to control the goods and can be expected to insure his interest in them." *Id*. at 506.

Risk of Loss Where Breach Occurs

The general rule for risk of loss was set out as this: risk of loss shifts when seller completed its obligations under the contract. We said if the goods are conforming, the only obligation left is delivery, so then risk of loss would shift upon delivery. But if the goods are nonconforming, then the rule would say the risk doesn't shift. And that's correct, though it's subject to one wrinkle having to do with insurance. Let's examine the two possible circumstances: breach by seller and breach by buyer.

First, suppose the *seller* breaches the contract by proffering nonconforming goods, and the buyer *rejects* them—never takes them at all. Then the goods are lost or damaged. Under Section 2-510(1) of the UCC, the loss falls on seller and remains there until seller cures the breach or until buyer accepts despite the breach. Md. Code Ann., Com. Law § 2-510(1). Suppose Delta is obligated to deliver a gross of industrial No.

2 sponges; instead it tenders only one hundred cartons or delivers a gross of industrial No. 3 sponges. The risk of loss falls on Delta because Delta has not completed its obligation under the contract and Very Fast Foods doesn't have possession of the goods. Or suppose Delta breached the contract by tendering to Very Fast Foods a defective document of title. Delta cures the defect and gives the new document of title to Very Fast Foods, but before it does so the sponges are stolen. Delta is responsible for the loss.

Now suppose that a seller breaches the contract by proffering nonconforming goods and that the buyer, not having discovered the nonconformity, *accepts* them—the nonconforming goods are in the buyer's hands. The buyer has a right to revoke acceptance, but before the defective goods are returned to the seller, they are destroyed while in the buyer's possession. The seller breached, but here's the wrinkle: the UCC says that the seller bears the loss only to the extent of any deficiency in the buyer's insurance coverage. Md. Code Ann., Com. Law § 2-510(2). Very Fast Foods had taken delivery of the sponges and only a few days later discovered that the sponges did not conform to the contract. Very Fast has the right to revoke and announces its intention to do so. A day later its warehouse burns down and the sponges are destroyed. It then discovers that its insurance was not adequate to cover all the sponges. Who stands the loss? The seller does, again, to the extent of any deficiency in the buyer's insurance coverage.

Second, what if the *buyer* breaches the contract? Here's the scenario: Suppose Very Fast Foods calls two days before the sponges identified to the contract are to be delivered by Delta and says, "Don't bother; we no longer have a need for them." Subsequently, while the lawyers are arguing, Delta's warehouse burns down and the sponges are destroyed. Under the rules, risk of loss does not pass to the buyer until the seller has delivered, which has not occurred in this case.

Nevertheless, responsibility for the loss here has passed to Very Fast Foods, to the extent that the seller's insurance does not cover it. Section 2-510(3) permits the seller to treat the risk of loss as resting on the buyer for a "commercially reasonable time" when the buyer repudiates the contract before risk of loss has passed to him. Md. Code Ann., Com. Law § 2-510(3). This transfer of the risk can take place only when the goods are identified to the contract. The theory is that if the buyer had taken the goods as per the contract, the goods would not have been in the warehouse and thus would not have been burned up.

Insurable Interest

Why It Matters

We noted at the start of this chapter that who has title is important for several reasons, one of which is because it affects who has an insurable interest. (You can't take out insurance in something you have no interest in: if you have no title, you may not have an insurable interest.) And it was noted that the rules on risk of loss are affected by insurance. (The theory is that a businessperson is likely to have insurance, which is a cost of business, and if she has insurance and also has possession of goods—even nonconforming ones—it is reasonable to charge her insurance with loss of the goods; thus she will have cause to take care of them in her possession, else her insurance rates increase.) So in commercial transactions insurance is important, and when goods are lost or destroyed, the frequent argument is between the buyer's and the seller's insurance companies, neither of which wants to be responsible. They want to deny that their insured had an insurable interest. Thus it becomes important who has an insurable interest.

Insurable Interest of the Buyer

It is not necessary for the buyer to go all the way to having title in order for him to have an insurable interest. The buyer obtains a "special property and insurable interest in goods by identification of existing goods as goods to which the contract refers." Md. Code Ann., Com. Law § 2-501(1). We already discussed how "identification" of the goods can occur. The parties can do it by branding, marking, tagging, or segregating them—and they can do it at any time. We also set out the rules for when goods will be considered identified to the contract under the UCC if the parties don't do it themselves.

Insurable Interest of the Seller

As long as the seller retains title to or any security interest in the goods, he has an insurable interest. Md. Code Ann., Com. Law § 2-501(2).

Other Rights of the Buyer

The buyer's "special property" interest that arises upon identification of goods gives the buyer rights other than that to insure the goods. For example, under Section 2-502, the buyer who has paid for unshipped goods may take them from a seller who becomes insolvent within ten days after receipt of the whole payment or the first installment payment. ." Md. Code Ann., Com. Law § 2-502. Similarly, a buyer who has not yet taken delivery may sue a third party who has in some manner damaged the property.

UCC Performance & Remedies

The parties often set out in their contracts the details of performance. These include price terms and terms of delivery—where the goods are to be delivered, when, and how. If the parties fail to list these terms, the rules studied in this chapter will determine the parties' obligations: the parties may agree; if they do not, the UCC rules kick in as the default. In any event, the parties have an obligation to act in good faith.

Performance by the Seller

The Seller's Duty in General

The general duty of the seller is this: to make a timely delivery of conforming goods. Md. Code Ann., Com. Law § § 2-301, 2-309.

Analysis of the Seller's Duty

Timing

By agreement or stipulation, the parties may fix the time when delivery is to be made by including statements in contracts such as "Delivery is due on or before July 8" or "The first of 12 installments is due on or before July 8." Both statements are clear.

If the parties do not stipulate in their contract when delivery is to occur, the UCC fills the gap. Section 2- 309 of the UCC says, "The time for shipment or any other action under a contract if not provided for in this Article or agreed upon shall be a reasonable time." Md. Code Ann., Com. Law § 2-309. And what is a "reasonable time" is addressed by comment 1 to this section: It thus turns on the criteria as to "reasonable time" and on good faith and commercial standards set forth in Sections 1-202, 1-203 and 2-103. It…depends on what constitutes acceptable commercial conduct in view of the nature, purposes and circumstances of the action to be taken. *Id.* at cmt. 1.

Delivery

The parties may agree as to how delivery shall be accomplished; if they do not, the UCC fills the gap. "Unless otherwise agreed all goods called for by a contract for sale must be tendered in a single delivery and payment is due only on such tender but where the circumstances give either party the right to make or demand delivery in lots the price if it can be apportioned may be demanded for each lot." Md. Code Ann., Com. Law § 2-307.

By Agreement

The parties may use any language they want to agree on delivery terms.

If There Is No Agreement

If the parties do not stipulate delivery terms or if their agreement is incomplete or merely formulaic, the UCC describes the seller's obligations or gives meaning to the formulaic language. (Because form contracts are prevalent, formulaic language is customary.) As we will cover in Title and Risk of Loss, title to goods shifts when the seller has completed delivery obligations under the contract. The contract may be either a *shipment* contract, a *destination* contract, or a contract where the *goods are not to be moved* (being held by a bailee). In any case, unless otherwise agreed, the delivery must be at a reasonable time and the tender (the offer to make delivery) must be kept open for a reasonable time; the buyer must furnish facilities "reasonably suited to the receipt of the goods." Md. Code Ann., Com. Law § 2-503.

In a shipment contract, the seller has four duties: (1) to deliver the goods to a carrier; (2) to deliver the goods with a reasonable contract for their transportation; (3) to deliver them with proper documentation for the buyer; and (4) to promptly notify the buyer of the shipment. Md. Code Ann., Com. Law § 2-504. The contract may set out the seller's duties using customary abbreviations, and the UCC interprets those: "F.O.B [insert place where goods are to be shipped from]" means "free on board"—the seller must see to it that the goods are loaded on the vehicle of conveyance at the place of shipment. "F.A.S. [port of shipment inserted here]" means the seller must see to it that the goods are placed along the ship on the dock ready to be loaded. Md. Code Ann., Com. Law § 2-319. Price terms include "C.I.F.," which means the sale price includes the cost of the goods, insurance, and freight charges, and "C. & F.," which means the sales price includes the cost of the goods at a cheaper unit price and freight but not insurance. Md. Code Ann., Com. Law § 2-320. If it is clear from the contract that the seller is supposed to ship the goods (i.e., the buyer is not going to the seller's place to get them) but not clear whether it is a shipment or a destination contract, the UCC presumes it is a shipment contract. Md. Code Ann., Com. Law § 2-503(5).

If it is a destination contract, the seller has two duties: to get the goods to the destination at the buyer's disposal and to provide appropriate documents of delivery. Md. Code Ann., Com. Law § 2-503. The contract language could be "F.O.B. [place of destination inserted here]," which obligates the seller to deliver to that specific location; "ex-ship," which obligates the seller to unload the goods from the vehicle of transportation at the agreed location (e.g., load the goods onto the dock); or it could be "no arrival, no sale," where the seller is not liable for failure of the goods to arrive, unless she caused it. Md. Code Ann., Com. Law §§ 2-319, 2-322, 2-324.

If the goods are in the possession of a bailee and are not to be moved—and the parties don't stipulate otherwise—Section 2-503 says delivery is accomplished when the seller gives the buyer a negotiable document of title, or if none, when the bailee acknowledges the buyer's right to take the goods. Md. Code

Ann., Com. Law § 2-503(4). If nothing at all is said about delivery, the place for delivery is the seller's place of business or his residence if he has no place of business. Md. Code Ann., Com. Law § 2-308.

Conforming Goods

As always, the parties may put into the contract whatever they want about the goods as delivered. If they don't, the UCC fills the gaps.

By Agreement

The parties may agree on what "conforming goods" means. An order will specify "large grade A eggs," and that means something in the trade. Or an order might specify "20 gross 100-count boxes No. 8 × 3/8 × 32 Phillips flathead machine screws." That is a screw with a designated diameter, length, number of threads per inch, and with a unique, cruciform head insert to take a particular kind of driver. The buyer might, for example, agree to purchase "seconds," which are goods with some flaw, such as clothes with seams not sewed quite straight or foodstuffs past their pull date. The parties may also agree in the contract what happens if nonconforming goods are delivered.

If There Is No Agreement

If nothing is said in the contract about what quality of goods conform to the contract, then the UCC default rule kicks in. The seller is to make a perfect tender: what is delivered must in every respect conform to the contract. Md. Code Ann., Com. Law § 2-601. And if what is delivered doesn't conform to the contract, the buyer is not obligated to accept the goods.

Installment Contracts

Unless otherwise agreed, all goods should be delivered at one time, and no payment is due until tender. But where circumstances permit either party to make or demand delivery in lots, Section 2-307 of the UCC permits the seller to demand payment for each lot if it is feasible to apportion the price. Md. Code Ann., Com. Law § 2-307. What if the contract calls for delivery in installment, and one installment is defective—is that a material breach of the whole contract? No. Section 2-612 of the UCC says this:

- The buyer may reject any installment which is non-conforming if the non-conformity substantially impairs the value of that installment and cannot be cured or if the non-conformity is a defect in the required documents; but if the non-conformity does not fall within subsection (3) and the seller gives adequate assurance of its cure the buyer must accept that installment.
- Whenever non-conformity or default with respect to one or more installments substantially impairs the value of the whole contract there is a breach of the whole contract.

Md. Code Ann., Com. Law § 2-612.

Cure for Improper Delivery

Failure to make a perfect tender, unless otherwise agreed, is a material breach of the sales contract. However, before the defaulting seller is in complete default, she has a right to cure.

- Where any tender or delivery by the seller is rejected because non-conforming and the time for performance has not yet expired, the seller may seasonably notify the buyer of his intention to cure and may then within the contract time make a conforming delivery.
- Where the buyer rejects a non-conforming tender which the seller had reasonable grounds to believe would be acceptable with or without money allowance the seller may if he seasonably notifies the buyer have a further reasonable time to substitute a conforming tender.

Md. Code Ann., Com. Law § 2-508.

Buyer orders Santa Claus candles deliverable November 5; on October 25 the goods are delivered, but they're not right: they're Christmas *angel* candles instead. But the seller still has eleven days to cure, and the buyer must allow that. Buyer places an order exactly the same as the first order, and the order arrives on November 5 in the original manufacturer's packaging, but they're not right. "Well," says the seller, "I thought they'd be OK right out of the package. I'll get the correct ones to you right away." And the buyer would have a duty to allow that, if "right away" is a "further reasonable time."

The seller's duty is to make a timely delivery of conforming goods. Let's take a look now at the buyer's duties.

Performance by Buyer

General Duties of Buyer

The general duty of the buyer is this: inspection, acceptance, and payment. Md. Code Ann., Com. Law §§ 2-301, 2-513. But the buyer's duty does not arise unless the seller tenders delivery.

Inspection

Under Sections 2-513(1) and (2), the buyer has a qualified right to inspect goods. Md. Code Ann., Com. Law § 2-513. That means the buyer must be given the chance to look over the goods to determine whether they conform to the contract. If they do not, he may properly reject the goods and refuse to pay. The right to inspect is subject to three exceptions:

1. The buyer waives the right. If the parties agree that payment must be made before inspection, then the buyer must pay (unless the nonconformity is obvious without inspection). Payment under these circumstances does not constitute acceptance, and the buyer does not lose the right to inspect and reject later.
2. The delivery is to be made C.O.D. (cash on delivery).
3. Payment is to be made against documents of title.

If the buyer fails to inspect, or fails to discover a defect that an inspection would have revealed, he cannot later revoke his acceptance, subject to some exceptions.

Acceptance

Acceptance is clear enough: it means the buyer takes the goods. But the buyer's options on improper delivery need to be examined, because that's often a problem area.

The buyer may accept goods by words, silence, or action. Section 2-606(1) of the UCC defines acceptance as occurring in any one of three circumstances:

1. **Words.** The buyer, after a reasonable opportunity to inspect, tells the seller either that the goods conform or that he will keep them despite any nonconformity.
2. **Silence.** The buyer fails to reject, after a reasonable opportunity to inspect.
3. **Action.** The buyer does anything that is inconsistent with the seller's ownership, such as using the goods (with some exceptions) or selling the goods to someone else.

Once the buyer accepts, she is obligated to pay at the contract rate and loses the right to reject the goods. Md. Code Ann., Com. Law § 2-607. In short, she is stuck, subject to some exceptions set forth in Section 2-608.

Payment

The parties may specify in their contract what *payment* means and when it is to be made. If they don't, the UCC controls the transaction. Md Code Ann., Com. Law §§ 2-511, 2-512.

Section 2-511:

"(1) Unless otherwise agreed tender of payment is a condition to the seller's duty to tender and complete any delivery.

(2) Tender of payment is sufficient when made by any means or in any manner current in the ordinary course of business unless the seller demands payment in legal tender and gives any extension of time reasonably necessary to procure it.

(3) Subject to the provisions of this Act on the effect of an instrument on an obligation (Section 3-802), payment by check is conditional and is defeated as between the parties by dishonor of the check on due presentment."

Md. Code Ann., Com. Law § 2-511.

Section 2-512 states:

"(1) Where the contract requires payment before inspection, non-conformity of the goods does not excuse the buyer from so making payment unless

- (a) the non-conformity appears without inspection; or
- (b) despite tender of the required documents the circumstances would justify injunction against honor under the provisions of this Act (see Md. Code Ann., Com. Law § 5-114).

(2) Payment pursuant to subsection (1) does not constitute an acceptance of goods or impair the buyer's right to inspect or any of his remedies."

Md. Code Ann., Com. Law § 2-512.

A Buyer's Right on Nonconforming Delivery

Obviously if the delivery is defective, the disappointed buyer does not have to accept the goods: the buyer may (a) reject the whole, (b) accept the whole, or (c) accept any commercial unit and reject the rest or (d)—in two situations—revoke an acceptance already made. Md. Code Ann., Com. Law §§ 2-601, 2A-509.

Rejection and a Buyer's Duties after Rejection

Rejection is allowed if the seller fails to make a perfect tender. Md. Code Ann., Com. Law § 2-601. The rejection must be made within a reasonable time after delivery or tender. Once it is made, the buyer may not act as the owner of the goods. If he has taken possession of the goods before he rejects them, he must hold them with reasonable care to permit the seller to remove them. If the buyer is a merchant, then the buyer has a special duty to follow reasonable instructions from the seller for disposing of the rejected goods; if no instructions are forthcoming and the goods are perishable, then he must try to sell the goods for the seller's account and is entitled to a commission for his efforts. Whether or not he is a merchant, a buyer may store the goods, reship them to the seller, or resell them—and charge the seller for his services—if the seller fails to send instructions on the goods' disposition. Such storage, reshipping, and reselling are not acceptance or conversion by the buyer.

Acceptance of a Nonconforming Delivery

The buyer need not reject a nonconforming delivery. She may accept it with or without allowance for the nonconformity.

Acceptance of Part of a Nonconforming Delivery

The buyer may accept any commercial unit and reject the rest if she wants to. A commercial unit means "such a unit of goods as by commercial usage is a single whole for purposes of sale and division of which materially impairs its character or value on the market or in use. A commercial unit may be a single article (as a machine), a set of articles (as a suite of furniture or an assortment of sizes), a quantity (as a bale, gross, or carload), or any other unit treated in use or in the relevant market as a single whole." Md. Code Ann., Com. Law §§ 2-105 and 2A103(1).

Installment Sales

A contract for an installment sale complicates the answer to the question, "What right does the buyer have to accept or reject when the seller fails to deliver properly?" (An installment contract is one calling for delivery of goods in separate lots with separate acceptance for each delivery.) The general answer is found in Section 2-612, which permits the buyer to reject any nonconforming installment if the nonconformity cannot be cured if it substantially impairs the value of that particular installment. Md. Code Ann., Com. Law § 2-612. However, the seller may avoid rejection by giving the buyer adequate assurances that he will cure the defect, unless the particular defect substantially impairs the value of the whole contract. *Id.*

Suppose the Corner Gas Station contracts to buy 12,000 gallons of regular gasoline from Gasoline Seller, deliverable in twelve monthly installments of 1,000 gallons on the first of each month, with a set price payable three days after delivery. In the third month, Seller is short and can deliver only 500 gallons immediately and will not have the second 500 gallons until midmonth. May Corner Gas reject this tender? The answer depends on the circumstances. The nonconformity clearly cannot be cured, since the contract calls for the full 1,000 on a particular day. But the failure to make full delivery does not necessarily impair the value of that installment; for example, Corner Gas may know that it will not use up the 500 gallons until midmonth. However, if the failure will leave Corner Gas short before midmonth and unable to buy from another supplier unless it agrees to take a full 1,000 (more than it could hold at once if it also took Seller's 500 gallons), then Corner Gas is entitled to reject Seller's tender.

Is Corner Gas entitled to reject the entire contract on the grounds that the failure to deliver impairs the value of the contract as a whole? Again, the answer depends on whether the impairment was substantial. Suppose other suppliers are willing to sell only if Corner Gas agrees to buy for a year. If Corner Gas needed the extra gasoline right away, the contract would have been breached as whole, and Corner Gas would be justified in rejecting all further attempted tenders of delivery from Seller. Likewise, if the spot price of gasoline were rising so that month-to-month purchases from other suppliers might cost it more than the original agreed price with Seller, Corner Gas would be justified in rejecting further deliveries from Seller and fixing its costs with a supply contract from someone else. Of course, Corner Gas would have a claim against Seller for the difference between the original contract price and what it had to pay another supplier in a rising market (as you'll see later in this section).

Revocation

A revocation of acceptance means that although the buyer has accepted and exercised ownership of the goods, he can return the goods and get his money back. There are two circumstances in which the buyer can revoke an acceptance if the nonconformity "substantially impairs its value to him." Md. Code Ann., Com. Law § 2-608.

1. if the buyer reasonably thought the nonconformity would be cured and it is not within a reasonable time; or
2. without discovery of such nonconformity if his acceptance was reasonably induced by the difficulty of discovery before acceptance or by the seller's assurances. *Id.*

Consider two examples illustrated in the next paragraph. The first deals with item 1 and the second deals with item 2.

In August 1983, the Borsages purchased a furnished mobile home on the salesperson's assertion that it was "the Cadillac of mobile homes." But when they moved in, the Borsages discovered defects: water leaks, loose moldings, a warped dishwasher door, a warped bathroom door, holes in walls, defective heating and cooling systems, cabinets with chips and holes, furniture that fell apart, mold and mildew in some rooms, a closet that leaked rainwater, and defective doors and windows. They had not seen these defects at the time of purchase because they looked at the mobile home at night and there were no lights on in it. The Borsages immediately complained. Repairmen came by but left, only promising to return again. Others did an inadequate repair job by cutting a hole in the bottom of the home and taping up the hole with masking tape that soon failed, causing the underside of the home to pooch out. Yet more repairmen came by but made things worse by inadvertently poking a hole in the septic line and failing to fix it, resulting in a permanent stench. More repairmen came by, but they simply left a new dishwasher door and countertop at the home, saying they didn't have time to make the repairs. *North River Homes, Inc., v. Borsage, Mississippi,* 594 So.2d 1153 (Miss. 1992).

In June 1984, the Borsages provided the seller a long list of uncorrected problems; in October they stopped making payments. Nothing happened. In March 1986—thirty-one months after buying the mobile home—they told the seller to pick up the mobile home: they revoked their acceptance and sued for the purchase price. The defendant seller argued that the Borsages' failure to move out of the house for so long constituted acceptance. But they were repeatedly assured the problems would be fixed, and moreover they had no place else to live, and no property to put another mobile home on if they abandoned the one they had. The court had no problem validating the Borsages' revocation of acceptance, under the section noted earlier, if they ever had accepted it. The seller might have a right to some rental value, though. *Id.* at 1161-1162.

In April 1976, Clarence Miller ordered a new 1976 Dodge Royal Monaco station wagon from plaintiff Colonial Dodge. The car included a heavy-duty trailer package with wide tires. The evening of the day the Millers picked up the new car, Mrs. Miller noticed that there was no spare tire. The following morning, the defendant notified the plaintiff that he insisted on a spare tire, but when he was told there were no spare tires available (because of a labor strike), Mr. Miller told the plaintiff's salesman that he would stop payment on the check he'd given them and that the car could be picked up in front of his house. He parked it there, where it remained until the temporary registration sticker expired and it was towed by the police to an impound yard. Plaintiff sued for the purchase price, asserting that the missing spare tire did not "substantially impair the value of the goods to the buyer." On appeal to the Michigan Supreme Court, the plaintiff lost. "In this case the defendant's concern with safety is evidenced by the fact that he ordered the special package which included spare tires. The defendant's occupation demanded that he travel extensively, sometimes in excess of 150 miles per day on Detroit freeways, often in the early morning hours.…He was afraid of a tire going flat…at 3 a.m. Without a spare, he would be helpless until morning business hours. The dangers attendant upon a stranded motorist are common knowledge, and Mr. Miller's fears are not unreasonable." The court observed that although he had accepted the car before he discovered the nonconformity, that did not preclude revocation: the spare was under a fastened panel, concealed from view. *Colonial Dodge v. Miller*, 362 N.W.2d 704 (Mich. 1984).

Remedies

General Policy

The general policy of the Uniform Commercial Code (UCC) is to put the aggrieved party in a good position as if the other party had fully performed—as if there had been a timely delivery of conforming goods. The UCC provisions are to be read liberally to achieve that result if possible. Thus the seller has a number of potential remedies when the buyer breaches, and likewise the buyer has a number of remedies when the seller breaches.

Specifying Remedies

We have emphasized how the UCC allows people to make almost any contract they want (as long as it's not unconscionable). Just as the parties may specify details of performance in the contract, so they may provide for and limit remedies in the event of breach. Md. Code Ann., Com. Law §§ 2-719(1), 2A-503(1). The following would be a typical limitation of remedy: "Seller's sole obligation in the event goods are deemed defective by the seller is to replace a like quantity of nondefective goods." A remedy is optional unless it is expressly agreed that it is the exclusive remedy. Md. Code Ann., Com. Law §§ 2-719(1)(b), 2A-503(2).

But the parties are not free to eliminate all remedies. As the UCC comment to this provision puts it, "If the parties intend to conclude a contract for sale within this Article they must accept the legal consequence that there be at least a fair quantum of remedy for breach of the obligations or duties outlined in the contract." *Id.* at cmt. 1. In particular, the UCC lists three exemptions from the general rule that the parties are free to make their contract up any way they want as regards remedies:

1. When the circumstances cause the agreed-to remedy to fail or be ineffective, the default UCC remedy regime works instead. Md. Code Ann., Com. Law §§ 2-719(2), 2A-503(2).

2. Consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable. Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable, but limitation of damages where the loss is commercial is not. Md. Code Ann., Com. Law §§ 2-719(3), 2A-503(2).

3. The parties may agree to liquidated damages: "Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty." Md. Code Ann., Com. Law §§ 2-718. The Code's equivalent position on *leases* is interestingly slightly different. Section 2A-504(1) says damages may be liquidated "but only at an amount or by a formula that is reasonable in light of the then anticipated harm caused" by the breach.

Md. Code Ann., Com. Law § 2A-504(1). It leaves out anything about difficulties of proof or inconvenience of obtaining another adequate remedy.

Statute of Limitations

The UCC statute of limitations for breach of any sales contract is four years. Md. Code Ann., Com. Law § 2-725. The parties may "reduce the period of limitation to not less than one year but may not extend it." Md. Code Ann., Com. Law § 2-725. Section 2A-506(1) for leases is similar, but omits the prohibition against extending the limitation. Article 2-725(2) goes on: "A cause of action accrues when the breach occurs, regardless of the aggrieved party's lack of knowledge of the breach. A breach of warranty occurs when tender of delivery is made, except that where a warranty explicitly extends to future performance of the goods and discovery of the breach must await the time of such performance the cause of action accrues when the breach is or should have been discovered." Md. Code Ann., Com. Law § 2-725.

Seller's Remedies

Article 2 in General

Per section 2-703, where the buyer wrongfully rejects or revokes acceptance of goods or fails to make a payment due on or before delivery or repudiates with respect to a part or the whole, then with respect to any goods directly affected and, if the breach is of the whole contract, then also with respect to the whole undelivered balance, the aggrieved seller may:

- withhold delivery of such goods;
- stop delivery by any bailee;
- identify to the contract conforming goods not already identified;
- reclaim the goods on the buyer's insolvency;
- resell and recover damages;
- recover damages for non-acceptance or repudiation;
- in a proper case recover the price;
- cancel.

Items (1)–(4) address the seller's rights to deal with the goods; items (5)–(7) deal with the seller's rights as regards the price, and item (8) deals with the continued existence of the contract.

To illustrate the UCC's remedy provision, in this and the following section, we assume these facts: Howard, of Los Angeles, enters into a contract to sell and ship one hundred prints of a Pieter Bruegel painting, plus the original, to Bunker in Dallas. Twenty-five prints have already been delivered to Bunker, another twenty-five are en route (having been shipped by common carrier), another twenty-five are finished but haven't yet been shipped, and the final twenty-five are still in production. The original is hanging on the wall in Howard's living room. We will take up the seller's remedies if the buyer breaches and if the buyer is insolvent.

Remedies on Breach

Bunker, the buyer, breaches the contract. He sends Howard an e-mail stating that he won't buy and will reject the goods if delivery is attempted. Howard has the following cumulative remedies; election is not required.

Withhold Further Delivery

Howard may refuse to send the third batch of twenty-five prints that are awaiting shipment. Md. Code Ann., Com. Law § 2-703(a).

Stop Delivery

Howard may also stop the shipment. If Bunker is insolvent, and Howard discovers it, Howard would be permitted to stop any shipment in the possession of a carrier or bailee. Md. Code Ann., Com. Law §§ 2-702, 2-703(b). If Bunker is not insolvent, the UCC permits Howard to stop delivery only of carload, truckload, planeload, or larger shipment. Md. Code Ann., Com. Law § 2-705. The reason for limiting the right to bulk shipments in the case of non-insolvency is that stopping delivery burdens the carrier and requiring a truck, say, to stop and the driver to find a small part of the contents could pose a sizeable burden.

Identify to the Contract Goods in Possession

Howard could "identify to the contract" the twenty-five prints in his possession. Section 2-704(1) permits the seller to denote conforming goods that were not originally specified as the exact objects of the contract, if they are under his control or in his possession at the time of the breach. Md. Code Ann., Com. Law §§ 2-703(c), 2-704(1). Assume that Howard had five hundred prints of the Bruegel painting. The contract did not state which one hundred of those prints he was obligated to sell, but once Bunker breached, Howard could declare that those particular prints were the ones contemplated by the contract. He has this right whether or not the identified goods could be resold. Moreover, Howard may complete production of the twenty-five unfinished prints and identify them to the contract, too, if in his "reasonable commercial judgment" he could better avoid loss—for example, by reselling them. If continued production would be expensive and the chances of resale slight, the seller should cease manufacture and resell for scrap or salvage value.

Resell

Howard could resell the seventy-five prints still in his possession as well as the original. Md. Code Ann., Com. Law § 2-703(d). As long as he proceeds in good faith and in a commercially reasonable manner, per Section 2-706(2) and Section 2A-527(3), he is entitled to recover the difference between the resale price and the contract price, plus incidental damages (but less any expenses saved, like shipping expenses). Md. Code Ann., Com. Law §§ 2-706, 2A-527. "Incidental damages" include any reasonable charges or expenses incurred because, for example, delivery had to be stopped, new transportation arranged, storage provided for, and resale commissions agreed on.

The seller may resell the goods in virtually any way he desires as long as he acts reasonably. He may resell them through a public or private sale. If the resale is public—at auction—only identified goods can be sold, unless there is a market for a public sale of futures in the goods (as there is in agricultural commodities, for example). In a public resale, the seller must give the buyer notice unless the goods are perishable or threaten to decline in value speedily. The goods must be available for inspection before the resale, and the buyer must be allowed to bid or buy.

The seller may sell the goods item by item or as a unit. Although the goods must relate to the contract, it is not necessary for any or all of them to have existed or to have been identified at the time of breach. The seller does not owe the buyer anything if resale or re-lease results in a profit for the seller. Md. Code Ann., Com. Law §§ 2-706(6), 2A-527.

Recover Damages

The seller may recover damages equal to the difference between the market price (measured at the time and place for tender of delivery) and the unpaid contract price, plus incidental damages, but less any expenses saved because of the buyer's breach. Md. Code Ann., Com. Law § 2-703(e), 2-708. Suppose Howard's contract price was $100 per print plus $10,000 for the original and that the market price on the day Howard was to deliver the seventy-five prints was $75 (plus $8,000 for the original). Suppose too that the shipping costs (including insurance) that Howard saved when Bunker repudiated were $2,000 and that to resell them Howard would have to spend another $750. His damages, then, would be calculated as follows: original contract price ($17,500) less market price ($13,625) = $3,875 less $2,000 in saved expenses = $1,875 plus $750 in additional expenses = $2,625 net damages recoverable by Howard, the seller.

If the formula would not put the seller in as good a position as performance under the contract, then the measure of damages is lost profits—that is, the profit that Howard would have made had Bunker taken the original painting and prints at the contract price (again, deducting expenses saved and adding additional expenses incurred, as well as giving credit for proceeds of any resale). Md. Code Ann., Com. Law §§ 2-708(2), 2A-528(2). This provision becomes especially important for so-called lost volume sellers. Howard may be able to sell the remaining seventy-five prints easily and at the same price that Bunker had agreed to pay. Then why isn't Howard whole? The reason is that the second buyer was not a *substitute* buyer but an *additional* one; that is, Howard would have made that sale even if Bunker had not reneged on the contract. So Howard is still short a sale and is out a profit that he would have made had Bunker honored the contract.

Recover the Price

Howard—the seller—could recover from Bunker for the price of the twenty-five prints that Bunker holds. Md. Code Ann., Com. Law §§ 2-703(e), 2-709. Or suppose they had agreed to a shipment contract, so that the risk of loss passed to Bunker when Howard placed the other prints with the trucker and that the truck crashed en route and the cargo destroyed. Howard could recover the price. Or suppose there were no market for the remaining seventy- five prints and the original. Howard could identify these prints to the contract and recover the contract price. If Howard did resell some prints, the proceeds of the sale would have to be credited to Bunker's account and deducted from any judgment. Unless sold, the prints must be held for Bunker and given to him upon his payment of the judgment.

Cancel the Contract

When Bunker repudiated, Howard could declare the contract cancelled. This would also apply if a buyer fails to make a payment due on or before delivery. Cancellation entitles the non-breaching party to any remedies for the breach of the whole contract or for any unperformed balance. That is what happens when Howard recovers damages, lost profits, or the price. Md. Code Ann., Com. Law §§ 2-703(f), 2A-524(1)(a).

Note again that these UCC remedies are cumulative. That is, Howard could withhold future delivery *and* stop delivery en route, *and* identify to the contract goods in his possession, *and* resell, *and* recover damages, *and* cancel.

Remedies on Insolvency

The remedies apply when the buyer *breaches* the contract. In addition to those remedies, the seller has remedies when he learns that the buyer is insolvent, even if the buyer has not breached. Md. Code Ann., Com. Law § 2-702. Insolvency results, for example, when the buyer has "ceased to pay his debts in the ordinary course of business," or the buyer "cannot pay his debts as they become due." Md. Code Ann., Com. Law § 1-201(23).

Upon learning of Bunker's insolvency, Howard could refuse to deliver the remaining prints, unless Bunker pays cash not only for the remaining prints but for those already delivered. If Howard learned of Bunker's insolvency within ten days of delivering the first twenty-five prints, he could make a demand to reclaim them. Md. Code Ann., Com. Law § 2-702(2). If within three months prior to delivery, Bunker had falsely represented that he was solvent, the ten- day limitation would not cut off Howard's right to reclaim. *Id.* If he does seek to reclaim, Howard will lose the right to any other remedy with respect to those particular items. However, Howard cannot reclaim goods already purchased from Bunker by a customer in the ordinary course of business. The customer does not risk losing her print purchased several weeks before Bunker has become insolvent. Md. Code Ann., Com. Law § 2-702 (3).

In the lease situation, of course, the goods belong to the lessor—the lessor has title to them—so the lessor can repossess them if the lessee defaults. Md. Code Ann., Com. Law § 2A-525(2).

Buyer's Remedies

In this section, let us assume that Howard, rather than Bunker, breaches, and all other circumstances are the same. That is, Howard had delivered twenty-five prints, twenty-five more were en route, the original painting hung in Howard's living room, another twenty-five prints were in Howard's factory, and the final twenty-five prints were in production.

In General

Where the seller fails to make delivery or repudiates, or the buyer rightfully rejects or justifiably revokes, then with respect to any goods involved, and with respect to the whole if the breach goes to the whole contract, the buyer may

- cancel the contract, and
- recover as much of the price as has been paid; and
- "cover" and get damages; and
- recover damages for non-delivery.

Md. Code Ann., Com. Law § 2-711(1).

Where the seller fails to deliver or repudiates, the buyer may also:

- if the goods have been identified recover them; or
- in a proper case obtain specific performance or
- replevy the goods.

Md. Code Ann., Com. Law § 2-711(2).

On rightful rejection or justifiable revocation of acceptance, a buyer:

- has a security interest in goods in his possession or control for any payments made on their price and any expenses reasonably incurred in their inspection, receipt, transportation, care and custody and may hold such goods and resell them in like manner as an aggrieved seller.

Md. Code Ann., Com. Law § 2-711(3)

If the buyer has accepted non-conforming goods and notified seller of the non-conformity, buyer can

- recover damages for the breach; Md. Code Ann., Com. Law § 2-714

and in addition the buyer may

- recover incidental damages and
- recover consequential Md. Code Ann., Com. Law § 2-715

Thus the buyer's remedies can be divided into two general categories: (1) remedies for goods that the buyer does not receive or accept, when he has justifiably revoked acceptance or when the seller repudiates, and (2) remedies for goods accepted. Md. Code Ann., Com. Law §§ 2-711 – 2-716.

Goods Not Received

The UCC sets out buyer's remedies if goods are not received or if they are rightfully rejected or acceptance is rightfully revoked.

Cancel

If the buyer has not yet received or accepted the goods (or has justifiably rejected or revoked acceptance because of their nonconformity), he may cancel the contract and—after giving notice of his cancellation— he is excused from further performance. Md. Code Ann., Com. Law §§ 2-711(1), 2-106, 2A-508(1)(a), and 2A-505(1).

Recover the Price

Whether or not the buyer cancels, he is entitled to recover the price paid above the value of what was accepted.

Cover

In the example case, Bunker—the buyer—may "cover" and have damages: he may make a good-faith, reasonable purchase of substitute goods. Md. Code Ann., Com. Law § 2-712. He may then recover damages from the seller for the difference between the cost of cover and the contract price. This is the buyer's equivalent of the seller's right to resell. Thus Bunker could try to purchase seventy-five additional prints of the Bruegel from some other manufacturer. But his failure or inability to do so does not bar him from any other remedy open to him.

Sue for Damages for Nondelivery

Bunker could sue for damages for nondelivery. Under Section 2-713 of the UCC, the measure of damages is the difference between the market price at the time when the buyer learned of the breach and the contract price (plus incidental damages, less expenses saved). Md. Code Ann., Com. Law § 2-713. Suppose Bunker could have bought seventy- five prints for $125 on the day Howard called to say he would not be sending the rest of the order. Bunker would be entitled to $1,875—the market price ($9,375) less the contract price ($7,500). This remedy is available even if he did not in fact purchase the substitute prints. Suppose that at the time of breach, the original painting was worth $15,000 (Howard having just sold it to someone else at that price). Bunker would be entitled to an additional $5,000, which would be the difference between his contract price and the market price.

For leases, Section 2A-519(1), provides the following: “the measure of damages for non-delivery or repudiation by the lessor or for rejection or revocation of acceptance by the lessee is the present value, as of the date of the default, of the then market rent minus the present value as of the same date of the original rent, computed for the remaining lease term of the original lease agreement, together with incidental and consequential damages, less expenses saved in consequence of the lessor’s default.” Md. Code Ann., Com. Law § 2A-519(1).

Recover the Goods

If the goods are unique—as in the case of the original Bruegel—Bunker is entitled to specific performance—that is, recovery of the painting. This section is designed to give the buyer rights comparable to the seller’s right to the price and modifies the old common-law requirement that courts will not order specific performance except for unique goods. It permits specific performance “in other proper circumstances,” and these might include particular goods contemplated under output or requirements contracts or those peculiarly available from one market source. Md. Code Ann., Com. Law §§ 2- 716(1), 2A-521(1).

Even if the goods are not unique, the buyer is entitled to *replevy* them if they are identified to the contract and after good-faith effort he cannot recover them. Replevin is the name of an ancient common-law action for recovering goods that have been unlawfully taken; in effect it is not different from specific performance, and the UCC makes no particular distinction between them in Section 2-716. Section 2A-521 holds the same for leases. Md. Code Ann., Com. Law §§ 2-716, 2A-521. In our case, Bunker could replevy the twenty-five prints identified and held by Howard.

Bunker also has the right to recover the goods should it turn out that Howard is insolvent. Under Section 2-502, if Howard were to become insolvent within ten days of the day on which Bunker pays the first installment of the price due, Bunker would be entitled to recover the original and the prints, as long as he tendered any unpaid portion of the price. Md. Code Ann., Com. Law § 2-502.

For security interest in goods rightfully rejected, if the buyer rightly rejects nonconforming goods or revokes acceptance, he is entitled to a security interest in any goods in his possession. Md. Code Ann., Com. Law § 2-711(3). In other words, Bunker need not return the twenty-five prints he has already received unless Howard reimburses him for any payments made and for any expenses reasonably incurred in their inspection, receipt, transportation, care, and custody. If Howard refuses to reimburse him, Bunker may resell the goods and take from the proceeds the amount to which he is entitled. Md. Code Ann., Com. Law §§ 2-711(3), 2-706, 2A-508(5), 2A- 527(5).

Goods Accepted

The buyer does not have to reject nonconforming goods. She may accept them anyway or may effectively accept them because the time for revocation has expired. In such a case, the buyer is entitled to remedies as long as she notifies the seller of the breach within a reasonable time. Md. Code Ann., Com. Law §§ 2-714(1) and 2A-519(3). In our example, Bunker can receive three types of damages, all of which are outlined here.

Compensatory Damages

Bunker may recover damages for any losses that in the ordinary course of events stem from the seller’s breach. Suppose Howard had used inferior paper that was difficult to detect, and within several weeks of acceptance the prints deteriorated. Bunker is entitled to be reimbursed for the price he paid.

Consequential Damages

Bunker is also entitled to consequential damages. Md. Code Ann., Com. Law §§ 2-714(3), 2-715, and 2A-519(3). These are losses resulting from general or particular requirements of the buyer's needs, which the seller had reason to know and which the buyer could not reasonably prevent by cover or otherwise. Suppose Bunker is about to make a deal to resell the twenty-five prints that he accepted, only to discover that Howard used inferior ink that faded quickly. Howard knew that Bunker was in the business of retailing prints and therefore he knew or should have known that one requirement of the goods was that they be printed in long-lasting ink. Because Bunker will lose the resale, he is entitled to the profits he would have made. (If Howard had not wished to take the risk of paying for consequential damages, he could have negotiated a provision limiting or excluding this remedy.) The buyer has the burden of proving consequential damages, but the UCC does not require mathematical precision. Suppose customers come to Bunker's gallery and sneer at the faded colors. If he can show that he would have sold the prints were it not for the fading ink (perhaps by showing that he had sold Bruegels in the past), he would be entitled to recover a reasonable estimate of his lost profits.

In *De La Hoya v. Slim's Gun Shop,* 146 Cal. Rptr. 68 (Cal. App. Dep't Super. Ct. 1978), the plaintiff purchased a handgun from the defendant, a properly licensed dealer. While the plaintiff was using it for target shooting, he was questioned by a police officer, who traced the serial number of the weapon and determined that— unknown to either the plaintiff or the defendant—it had been stolen. The plaintiff was arrested for possession of stolen property and incurred, in 2010 dollars, $3,000 in attorney fees to extricate himself from the criminal charges. He sued the defendant for breach of the implied warranty of title and was awarded the amount of the attorney fees as consequential damages. On appeal the California court held it foreseeable that the plaintiff would get arrested for possessing a stolen gun, and "once the foreseeability of the arrest is established, a natural and usual consequence is that the [plaintiff] would incur attorney's fee." *Id.* at 72.

Incidental Damages

Section 2-715 allows incidental damages, which are "damages resulting from the seller's breach including expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach." Md. Code Ann., Com. Law § 2-715. Section 2A-520(1) of the UCC is similar for leases.

Excuses for Non-Performance

In contracts for the sale of goods, as in common law, things can go wrong. What then?

Casualty to Identified Goods

As always, the parties may agree what happens if the goods are destroyed before delivery. The default is Sections 2-613 and 2A-221(a) "where the contract requires for its performance goods identified when the contract is made, and the goods suffer casualty without fault of either party before the risk of loss passes to the buyer,…then (a) if the loss is total the contract is avoided; and (b) if the loss is partial the buyer may nevertheless accept them with due allowance for the goods' defects." Md. Code Ann., Com. Law §§ 2-613, 2A-221(a). Thus if Howard ships the original Bruegel to Bunker but the painting is destroyed, through no fault of either party, before delivery occurs, the parties are discharged. If the frame is damaged, Bunker could, if he wants, take the painting anyway, but at a discount.

The UCC's Take on Issues Affecting "Impossibility"

Impracticability

Sections 2-614(1) and 2A-404(1) require reasonable substitution for berthing, loading, and unloading facilities that become unavailable. They also require reasonable substitution for transportation and delivery systems that become "commercially impracticable"; if a practical alternative exists, "performance must be tendered and accepted." Md. Code Ann., Com. Law §§ 2-614, 2A-404. If Howard agreed to send the prints by rail, but a critical railroad bridge is unusable and no trains can run, delivery by truck would be required.
Section 2-615 says that the failure to deliver goods is not a breach of the seller's duty "if performance as agreed has become impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic government regulation or order whether or not it later proves to be invalid." Md. Code Ann., Com. Law § 2-615. Section 2A-405(b) is similar for leases.

Right to Adequate Assurances of Performance

Section 2-609, Comment 1, of the UCC observes that "the essential purpose of a contract…is actual performance [but] a continuing sense of reliance and security that the promised performance will be forthcoming when due is an important feature of the bargain." Thus the UCC says that if one party has "reasonable grounds for insecurity arise…either party may in writing demand adequate assurance and until he receives such assurance may if commercially reasonable suspend [his own] performance[.]" Md. Code Ann., Com. Law § 2-609, cmt. 1.

Anticipatory Repudiation

Obviously if a person repudiates the contract, it's clear she will not perform, but what if she repudiates before time for performance is due? Does the other side have to wait until nonperformance actually happens, or can he sue in anticipation of the other's default? Sections 2-610 and 2A-402 say the aggrieved party can do either: wait for performance or "resort to any remedy for breach." Md. Code Ann., Com. Law §§ 2-610 and 2A-402. Under sections 2-611 and 2A-403, the party who anticipatorily repudiated can "retract his repudiation unless the aggrieved party has, since the repudiation, cancelled or materially changed his position[.]" Md. Code Ann., Com. Law §§ 2-611 and 2A-403. Suppose that Howard has cause to suspect that if he does deliver the goods, Bunker won't pay. Howard may write to Bunker and demand—not request—assurances of adequate performance. If such assurances are not adequately forthcoming, Howard may assume that Bunker repudiated the contract and seek appropriate remedies.

Product Liability & Warranties

Figure 15 Broken Smart Phone Needs Repair

Products liability describes a type of claim, not a separate theory of liability. Products liability has strong emotional overtones—ranging from the pro-litigation position of consumer advocates to the conservative perspective of the manufacturers.

History of Products-Liability Law

The theory of caveat emptor—let the buyer beware—that pretty much governed consumer law from the early eighteenth century until the early twentieth century made some sense. A horse-drawn buggy is a fairly simple device: its workings are apparent; a person of average experience in the 1870s would know whether it was constructed well and made of the proper woods. Most foodstuffs 150 years ago were grown at home and "put up" in the home kitchen or bought in bulk from a local grocer, subject to inspection and sampling; people made home remedies for coughs and colds and made many of their own clothes. Houses and furnishings were built of wood, stone, glass, and plaster—familiar substances.

Entertainment was a book or a piano. The state of technology was such that the things consumed were, for the most part, comprehensible and—very important—mostly locally made, which meant that the consumer who suffered damages from a defective product could confront the product's maker directly. Local reputation is a powerful influence on behavior.

The free enterprise system confers great benefits, and no one can deny that: materialistically, compare the image sketched in the previous paragraph with circumstances today. But those benefits come with a cost, and the fundamental political issue always is who has to pay. Consider the following famous passage from Upton Sinclair's great novel *The Jungle*. It appeared in 1906. He wrote it to inspire labor reform; to his dismay, the public outrage focused instead on consumer protection reform. Here is his description of the sausage-making process in a big Chicago meatpacking plant:

> There was never the least attention paid to what was cut up for sausage; there would come all the way back from Europe old sausage that had been rejected, and that was moldy and white—it would be dosed with borax and glycerin, and dumped into the hoppers, and made over again for home consumption.
>
> There would be meat that had tumbled out on the floor, in the dirt and sawdust, where the workers had tramped and spit uncounted billions of consumption germs. There would be meat stored in great piles in rooms; and the water from leaky roofs would drip over it, and thousands of rats would race about on it. It was too dark in these storage places to see well, but a man could run his hand over these piles of meat and sweep off handfuls of the dried dung of rats. These rats were nuisances, and the packers would put poisoned bread out for them; they would die, and then rats, bread, and meat would go into the hoppers together. This is no fairy story and no joke; the meat would be shoveled into carts, and the man who did the shoveling would not trouble to lift out a rat even when he saw one—there were things that went into the sausage in comparison with which a poisoned rat was a tidbit. There was no place for the men to wash their hands before they ate their dinner, and so they made a practice of washing them in the water that was to be ladled into the sausage. There were the butt-ends of smoked meat, and the scraps of corned beef, and all the odds and ends of the waste of the plants, that would be dumped into old barrels in the cellar and left there.
>
> Under the system of rigid economy which the packers enforced, there were some jobs that it only paid to do once in a long time, and among these was the cleaning out of the waste barrels. Every spring they did it; and in the barrels would be dirt and rust and old nails and stale water—and cartload after cartload of it would be taken up and dumped into the hoppers with fresh meat, and sent out to the public's breakfast. Some of it they would make into "smoked" sausage—but as the smoking took time, and was therefore expensive, they would call upon their chemistry department, and preserve it with borax and color it with gelatin to make it brown. All of their sausage came out of the same bowl, but when they came to wrap it they would stamp some of it "special," and for this they would charge two cents more a pound. (Sinclair, 136)

It became clear from Sinclair's exposé that associated with the marvels of then-modern meatpacking and distribution methods was food poisoning: a true cost became apparent. When the true cost of some money-making enterprise (e.g., cigarettes) becomes inescapably apparent, there are two possibilities.

First, the legislature can in some way mandate that the manufacturer itself pay the cost; with the meatpacking plants, that would be the imposition of sanitary food-processing standards. Typically, Congress creates an administrative agency and gives the agency some marching orders, and then the agency crafts regulations dictating as many industry-wide reform measures as are politically possible. Second, the people who incur damages from the product (1) suffer and die or (2) access the machinery of the legal system and sue the manufacturer. If plaintiffs win enough lawsuits, the manufacturer's insurance company raises rates, forcing reform (as with high-powered muscle cars in the 1970s); the business goes bankrupt; or the legislature is pressured to act, either for the consumer or for the manufacturer.

If the industry has enough clout to blunt—by various means—a robust pro-consumer legislative response so that government regulation is too lax to prevent harm, recourse is had through the legal system. Thus for all the talk about the need for tort reform (discussed later in this chapter), the courts play a vital role in policing the free enterprise system by adjudicating how the true costs of modern consumer culture are allocated.

Obviously the situation has improved enormously in a century, but one does not have to look very far to find terrible problems today. Just watching TV and you will see countless legal advertisements for product liability lawsuits, asbestos claims, Zantac, Paraquat, Johnson & Johnson's talcum powder, Roundup, Risperdal, and opioid claims, just to name a few.

Products liability can also be a life-or-death matter from the manufacturer's perspective. In 2009, Bloomberg Business Week reported that the costs of product safety for manufacturing firms can be enormous: "Peanut Corp., based in Lynchberg, Va., has been driven into bankruptcy since health officials linked tainted peanuts to more than 600 illnesses and nine deaths. Mattel said the first of several toy recalls it announced in 2007 cut its quarterly operating income by $30 million. Earlier this decade, Ford Motor spent roughly $3 billion replacing 10.6 million potentially defective Firestone tires." (Orey 20). Businesses complain, with good reason, about the expenses associated with products-liability problems.

Current State of the Law

Although the debate has been heated and at times simplistic, the problem of products liability is complex and most of us regard it with a high degree of ambivalence. We are all consumers, after all, who profit greatly from living in an industrial society. In this chapter, we examine the legal theories that underlie products-liability cases that developed rapidly in the twentieth century to address the problems of product-caused damages and injuries in an industrial society.

In the typical products-liability case, three legal theories are asserted—a contract theory and two tort theories. The contract theory is warranty, governed by the UCC, and the two tort theories are negligence and strict products liability, governed by the common law. See Figure 17 "Major Products Liability Theories".

Figure 16 Major Products Liabilities Theories

Warranties

The UCC governs express warranties and various implied warranties, and for many years it was the only statutory control on the use and meanings of warranties. In 1975, after years of debate, Congress passed and President Gerald Ford signed into law the Magnuson-Moss Act, which imposes certain requirements on manufacturers and others who warrant their goods. 15 U.S.C. §§ 2301, et. seq. We will examine both the UCC and the Magnuson- Moss Act.

Types of Warranties

Express Warranties

Figure 17 "Money Back Guarantee"

An express warranty is created whenever the seller affirms that the product will perform in a certain manner. Formal words such as "warrant" or "guarantee" are not necessary. A seller may create an express warranty as part of the basis for the bargain of sale by means of (1) an affirmation of a fact or promise relating to the goods, (2) a description of the goods, or (3) a sample or model. Any of these will create an express warranty that the goods will conform to the fact, promise, description, sample, or model. Thus a seller who states that "the use of rustproof linings in the cans would prevent discoloration and adulteration of the Perform solution" has given an express warranty, whether he realized it or not. *Rhodes Pharmacal Co. v. Continental Can Co.*, 72 Ill. App. 2d 362 (Ill. App. Ct. 1976). Claims of breach of express warranty are, at base, claims of misrepresentation.

But the courts will not hold a manufacturer to every statement that could conceivably be interpreted to be an express warranty. Manufacturers and sellers constantly "puff" their products, and the law is content to let them inhabit that gray area without having to make good on every claim. The UCC states "an affirmation merely of the value of the goods or a statement purporting to be merely the seller's opinion or commendation of the goods does not create a warranty." Md. Code Ann., Com. Law §2-313(2) (LexisNexis 2021). Facts do.

It is not always easy, however, to determine the line between an express warranty and a piece of puffery. A salesperson who says that a strawberry huller is "great" has probably puffed, not warranted, when it turns out that strawberries run through the huller look like victims of a massacre. But consider the classic cases of the defective used car and the faulty bull. In the former, the salesperson said the car was in “A-1 shape” and “mechanically perfect.” *Wat Henry Pontiac Co. v. Bradley*, 202 Okla. 82 (Okla. 1949).

In the latter, the seller said not only that the bull calf would “put the buyer on the map” but that “his father was the greatest living dairy bull.” *Frederickson v. Hackney*, 159 Minn. 234 (Minn. 1924). The car, carrying the buyer’s seven-month-old child, broke down while the buyer was en route to visit her husband in the army during World War II. The court said that the salesperson had made an express warranty. The bull calf turned out to be sterile, putting the farmer on the judicial rather than the dairy map. *See* Frederickson, 198 N.W. at 807. The court said the seller’s spiel was trade talk, not a warranty that the bull would impregnate cows. *See id.*

Is there any qualitative difference between these decisions, other than the quarter century that separates them and the different courts that rendered them? Perhaps the most that can be said is that the more specific and measurable the statement’s standards, the more likely it is that a court will hold the seller to a warranty, and that a written statement is easier to construe as a warranty than an oral one. It is also possible that courts look, if only subliminally, at how reasonable the buyer was in relying on the statement, although this ought not to be a strict test. A buyer may be unreasonable in expecting a car to get 100 miles to the gallon, but if that is what the seller promised, that ought to be an enforceable warranty.

Implied Warranties

Express warranties are those over which the parties dickered—or could have. Express warranties go to the essence of the bargain. An implied warranty, by contrast, is one that circumstances alone, not specific language, compel reading into the sale. In short, an implied warranty is one created by law, acting from an impulse of common sense.

Implied Warranty of Merchantability

Section 2-314 of the UCC lays down the fundamental rule that goods carry an implied warranty of merchantability if sold by a merchant-seller. What is **merchantability**? Section 2-314(2) of the UCC says that merchantable goods are those that conform at least to the following six characteristics:

- Pass without objection in the trade under the contract description
- In the case of fungible goods, are of fair average quality within the description
- Are fit for the ordinary purposes for which such goods are used
- Run, within the variations permitted by the agreement, of even kind, quality, and quantity within each unit and among all units involved
- Are adequately contained, packaged, and labeled as the agreement may require
- Conform to the promise or affirmations of fact made on the container or label if any

Md. Code Ann. Com. Law § 2-314(2) (LexisNexis 2021).

For the purposes of Section 2-314(2)(c) of the UCC, selling and serving food or drink for consumption on or off the premises is a sale subject to the implied warranty of merchantability—the food must be “fit for the ordinary purposes” to which it is put. The problem is common: you bite into a cherry pit in the cherry-vanilla ice cream, or you choke on the clam shells in the chowder. Is such food fit for the ordinary purposes to which it is put? There are two schools of thought. One asks whether the food was natural as prepared. This view adopts the seller’s perspective. The other asks what the consumer’s reasonable expectation was.

The first test is sometimes said to be the “natural-foreign” test. If the substance in the soup is natural to the substance—as bones are to fish—then the food is fit for consumption. The second test, relying on reasonable expectations, tends to be the more commonly used test. *See Yong Cha Ha v. Marriott Corp.*, 656 F. Supp. 445

(D. Md. 1987) (adopting reasonable expectation test in finding no breach of warranty when customer found part of trachea or aorta in fried chicken).

Fitness for a Particular Purpose

Section 2-315 of the UCC creates another implied warranty. Whenever a seller, at the time she contracts to make a sale, knows or has reason to know that the buyer is relying on the seller's skill or judgment to select a product that is suitable for the particular purpose the buyer has in mind for the goods to be sold, there is an implied warranty that the goods are fit for that purpose. Md. Code Ann., Com. Law § 2-315 (LexisNexis 2021).

For example, you go to a hardware store and tell the salesclerk that you need a paint that will dry overnight because you are painting your front door and a rainstorm is predicted for the next day. The clerk gives you a slow-drying oil-based paint that takes two days to dry. The store breached an implied warranty of fitness for particular purpose.

Note the distinction between "particular" and "ordinary" purposes. Paint is made to color and when dry to protect a surface. That is its ordinary purpose, and had you said only that you wished to buy paint, no implied warranty of fitness would have been breached. It is only because you had a particular purpose in mind that the implied warranty arose. Suppose you had found a can of paint in a general store and told the same tale, but the proprietor had said, "I don't know enough about that paint to tell you anything beyond what's on the label; help yourself." Not every seller has the requisite degree of skill and knowledge about every product he sells to give rise to an implied warranty. Ultimately, each case turns on its particular circumstances.

Other Warranties

Article 2 contains other warranty provisions, though these are not related specifically to products liability. Thus, under UCC, Section 2-312, unless explicitly excluded, the seller warrants he is conveying *good title* that is rightfully his and that the goods are transferred free of any security interest or other lien or encumbrance. Md. Code Ann. Com. Law § 2-312 (LexisNexis 2021). In some cases (e.g., a police auction of bicycles picked up around campus and never claimed), the buyer should know that the seller does not claim title in himself, nor that title will necessarily be good against a third party, and so subsection (2) excludes warranties in these circumstances. But the circumstances must be so obvious that no reasonable person would suppose otherwise.

In *Menzel v. List*, an art gallery sold a painting by Marc Chagall that it purchased in Paris. *Menzel v. List*, 246 N.E.2d 742 (N.Y. 1969). The painting had been stolen by the Germans when the original owner was forced to flee Belgium in the 1930s. Now in the United States, the original owner discovered that a new owner had the painting and successfully sued for its return. The customer then sued the gallery, claiming that it had breached the implied warranty of title when it sold the painting. The court agreed and awarded damages equal to the appreciated value of the painting. *See id.* at 746. A good-faith purchaser who must surrender stolen goods to their true owner has a claim for breach of the implied warranty of title against the person from whom he bought the goods.

A second implied warranty, related to title, is that the merchant-seller warrants the goods are *free of any rightful claim by a third person* that the seller has infringed his rights (e.g., that a gallery has not infringed a copyright by selling a reproduction). Md. Code Ann. Com. Law § 2-312(3) (LexisNexis 2021). This provision only applies to a seller who regularly deals in goods of the kind in question. If you find an old print in your grandmother's attic, you do not warrant when you sell it to a neighbor that it is free of any valid infringement claims.

A third implied warranty in this context involves the course of dealing or usage of trade. Section 2-314(3) of the UCC says that unless modified or excluded implied warranties may arise from a course of dealing or usage of trade. Md. Code Ann. Com. Law § 2-314(3) (LexisNexis 2021). If a certain way of doing business is understood, it is not necessary for the seller to state explicitly that he will abide by the custom; it will be implied. A typical example is the obligation of a dog dealer to provide pedigree papers to prove the dog's lineage conforms to the contract.

Problems with Warranty Theory

In General

It may seem that a person asserting a claim for breach of warranty will have a good chance of success under an express warranty or implied warranty theory of merchantability or fitness for a particular purpose. In practice, though, claimants are in many cases denied recovery. Here are four general problems:

- The claimant must prove that there was a sale.
- The sale was of goods rather than real estate or services.
- The action must be brought within the four-year statute of limitations under Article 2-725, when the tender of delivery is made, not when the plaintiff discovers the defect.
- Under UCC, Section 2-607(3)(a) and Section 2A-516(3)(a), which covers leases, the claimant who fails to give notice of breach within a reasonable time of having accepted the goods will see the suit dismissed, and few consumers know enough to do so, except when making a complaint about a purchase of spoiled milk or about paint that wouldn't dry.

In addition to these general problems, the claimant faces additional difficulties stemming directly from warranty theory, which we take up later in this chapter.

Exclusion or Modification of Warranties

The UCC permits sellers to exclude or disclaim warranties in whole or in part. That's reasonable, given that the discussion here is about contract, and parties are free to make such contracts as they see fit. But a number of difficulties can arise.

Exclusion of Express Warranties

The simplest way for the seller to exclude express warranties is not to give them. To be sure, Section 2-316(1) of the UCC forbids courts from giving operation to words in fine print that negate or limit express warranties if doing so would unreasonably conflict with express warranties stated in the main body of the contract—as, for example, would a blanket statement that "this contract excludes all warranties express or implied." Md. Code Ann., Com. Law § 2-316(1) (LexisNexis 2021). The purpose of the UCC provision is to prevent customers from being surprised by unbargained for language.

Exclusion of Implied Warranties in General

Implied warranties can be excluded easily enough also, by describing the product with language such as "as is" or "with all faults." Nor is exclusion simply a function of what the seller says. The buyer who either examined or refused to examine the goods before entering into the contract may not assert an implied warranty concerning defects an inspection would have revealed.

Implied Warranty of Merchantability

Section 2-316(2) of the UCC permits the seller to disclaim or modify the implied warranty of merchantability, as long as the statement actually mentions "merchantability" and, if it is written, is "conspicuous." Note that the disclaimer need not be in writing, and—again—all implied warranties can be excluded as noted.

Implied Warranty of Fitness

Section 2-316(2) of the UCC permits the seller also to disclaim or modify an implied warranty of fitness. This disclaimer or modification must be in writing, however, and must be conspicuous. It need not mention fitness explicitly; general language will do. The following sentence, for example, is sufficient to exclude all implied warranties of fitness: "There are no warranties that extend beyond the description on the face of this contract."

Here is a standard disclaimer clause found in a Dow Chemical Company agreement: "Seller warrants that the goods supplied here shall conform to the description stated on the front side hereof, that it will convey good title, and that such goods shall be delivered free from any lawful security interest, lien, or encumbrance. SELLER MAKES NO WARRANTY OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR USE. NOR IS THERE ANY OTHER EXPRESS OR IMPLIED WARRANTY."

Conflict between Express and Implied Warranties

Express and implied warranties and their exclusion or limitation can often conflict. Section 2-317 of the UCC provides certain rules for deciding which should prevail. In general, all warranties are to be construed as consistent with each other and as cumulative. When that assumption is unreasonable, the parties' intention governs the interpretation, according to the following rules:

(a) exact or technical specifications displace an inconsistent sample or model or general language of description;
(b) a sample from an existing bulk displaces inconsistent general language of description;
(c) express warranties displace inconsistent implied warranties other than an implied warranty of fitness for a particular purpose. Md. Code Ann., Com. Law § 2-317 (LexisNexis 2021).

Any inconsistency among warranties must always be resolved in favor of the implied warranty of fitness for a particular purpose. This doesn't mean that warranty cannot be limited or excluded altogether. The parties may do so. But in cases of doubt whether it or some other language applies, the implied warranty of fitness will have a superior claim.

The Magnuson-Moss Act and Phantom Warranties

After years of debate over extending federal law to regulate warranties, Congress enacted the Magnuson-Moss Federal Trade Commission Warranty Improvement Act (more commonly referred to as the Magnuson-Moss Act) and President Ford signed it in 1975. The act was designed to clear up confusing and misleading warranties, where—as Senator Magnuson put it in introducing the bill—"purchasers of consumer products discover that their warranty may cover a 25-cent part but not the $100 labor charge or that there is full coverage on a piano so long as it is shipped at the purchaser's expense to the factory.…There is a growing need to generate consumer understanding by clearly and conspicuously disclosing the terms and conditions of the warranty and by telling the consumer what to do if his guaranteed product becomes defective or malfunctions." The Magnuson-Moss Act only applies to consumer products (for household and domestic uses); commercial purchasers are presumed to be knowledgeable enough not to need these protections, to be able to hire lawyers, and to be able to include the cost of product failures into the prices they charge.

The act has several provisions to meet these consumer concerns; it regulates the content of warranties and the means of disclosing those contents. The act gives the Federal Trade Commission (FTC) the authority to promulgate detailed regulations to interpret and enforce it. Under FTC regulations, any written warranty for a product costing a consumer more than ten dollars must disclose in a single document and in readily understandable language the following nine items of information:

1. The identity of the persons covered by the warranty, whether it is limited to the original purchaser or fewer than all who might come to own it during the warranty period.
2. A clear description of the products, parts, characteristics, components, or properties covered, and where necessary for clarity, a description of what is excluded.
3. A statement of what the warrantor will do if the product fails to conform to the warranty, including items or services the warranty will pay for and, if necessary for clarity, what it will not pay for.
4. A statement of when the warranty period starts and when it expires.
5. A step-by-step explanation of what the consumer must do to realize on the warranty, including the names and addresses of those to whom the product must be brought.
6. Instructions on how the consumer can be availed of any informal dispute resolution mechanism established by the warranty.
7. Any limitations on the duration of implied warranties—since some states do not permit such limitations, the warranty must contain a statement that any limitations may not apply to the particular consumer.
8. Any limitations or exclusions on relief, such as consequential damages—as above, the warranty must explain that some states do not allow such limitations.
9. The following statement: “This warranty gives you specific legal rights, and you may also have other rights which vary from state to state.”

15 U.S.C. § 2302 (2021).

In addition to these requirements, the act requires that the warranty be labeled either a full or limited warranty. A full warranty means (1) the defective product or part will be fixed or replaced for free, including removal and re-installation; (2) it will be fixed within a reasonable time; (3) the consumer need not do anything unreasonable (like shipping the piano to the factory) to get warranty service; (4) the warranty is good for anyone who owns the product during the period of the warranty; (5) the consumer gets money back or a new product if the item cannot be fixed within a reasonable number of attempts. But the full warranty may not cover the whole product: it may cover only the hard drive in the computer, for example; it must state what parts are included and excluded. A limited warranty is less inclusive. It may cover only parts, not labor; it may require the consumer to bring the product to the store for service; it may impose a handling charge; it may cover only the first purchaser. Both full and limited warranties may exclude consequential damages.

Disclosure of the warranty provisions prior to sale is required by FTC regulations; this can be done in a number of ways. The text of the warranty can be attached to the product or placed in close conjunction to it. It can be maintained in a binder kept in each department or otherwise easily accessible to the consumer. Either the binders must be in plain sight or signs must be posted to call the prospective buyer’s attention to them. A notice containing the text of the warranty can be posted, or the warranty itself can be printed on the product’s package or container.

Phantom warranties are addressed by the Magnuson-Moss Act. As we have seen, the UCC permits the seller to disclaim implied warranties. This authority often led sellers to give what were called phantom warranties—that is, the express warranty contained disclaimers of implied warranties, thus leaving the consumer with fewer rights than if no express warranty had been given at all. In the words of the legislative report of the act, “The bold print giveth, and the fine print taketh away.” The act abolished these phantom warranties by providing that if the seller gives a written warranty, whether express or implied, he cannot disclaim or modify implied warranties. Md. Code Ann., Com. Law § 2-316 (LexisNexis 2021). However, a seller who gives a limited warranty can limit implied warranties to the duration of the limited warranty, if the duration is reasonable.

A seller’s ability to disclaim implied warranties is also limited by state law in two ways. First, by amendment to the UCC or by separate legislation, some states prohibit disclaimers whenever consumer products are sold. A number of states have special laws that limit the use of the UCC implied warranty disclaimer rules in consumer sales. Some of these appear in amendments to the UCC and others are in separate statutes. The broadest approach is that of the nine states that prohibit the disclaimer of implied warranties in consumer sales (Massachusetts, Connecticut, Maine, Vermont, Maryland, the District of Columbia, West Virginia, Kansas, Mississippi, and, with respect to personal injuries only, Alabama). Md. Code Ann., Com. Law § 2-316.1 (LexisNexis 2021). There is a difference in these states whether the rules apply to manufacturers as well as retailers. Second, the UCC at 2-302 provides that unconscionable contracts or clauses will not be enforced. Md. Code Ann., Com. Law § 2-302 (LexisNexis 2021). Finally, UCC 2-719(3) provides that limitation of damages for personal injury in the sale of consumer goods is prima facie unconscionable, but limitation of damages where the loss is commercial is not. Md. Code Ann., Com. Law § 2-719(3) (LexisNexis 2021).

A first problem with warranty theory, then, is that it’s possible to disclaim or limit the warranty. The worst abuses of manipulative and tricky warranties are eliminated by the Magnuson-Moss Act, but there are several other reasons that warranty theory is not the panacea for claimants who have suffered damages or injuries as a result of defective products.

Privity

A second problem with warranty law (after exclusion and modification of warranties) is that of privity. **Privity** is the legal term for the direct connection between the seller and buyer, the two contracting parties. For decades, the doctrine of privity has held that one person can sue another only if they are in privity. That worked well in the days when most commerce was local and the connection between seller and buyer was immediate. But in a modern industrial (or postindustrial) economy, the product is transported through a much larger distribution system, as depicted in Figure 19 “Chain of Distribution”. Two questions arise: (1) Is the manufacturer or wholesaler (as opposed to the retailer) liable to the buyer under warranty theory? and (2) May the buyer’s family or friends assert warranty rights?

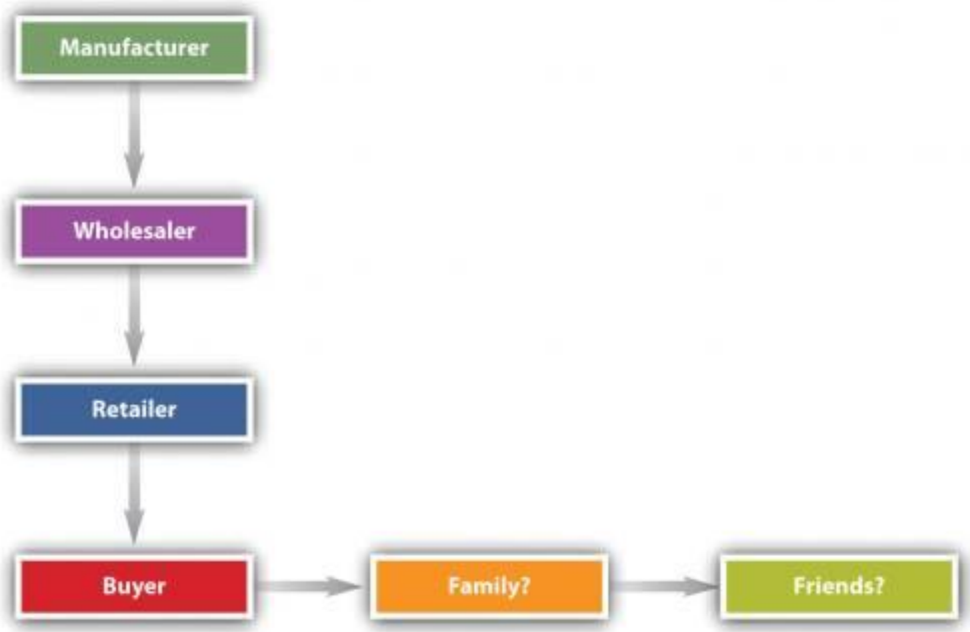


Figure 18 Chain of Distribution

Horizontal Privity

Suppose Carl Consumer buys a new lamp for his family's living room. The lamp is defective: Carl gets a serious electrical shock when he turns it on. Certainly Carl would be covered by the implied warranty of merchantability: he's in direct privity with the seller. But what if Carl's spouse Carlene is injured? She didn't buy the lamp; is she covered? Or suppose Carl's friend David, visiting for an afternoon, gets zapped. Is David covered? This gets to horizontal privity, noncontracting parties who suffer damages from defective goods, such as nonbuyer users, consumers, and bystanders. Horizontal privity determines to whose benefit the warranty "flows"—who can sue for its breach. In one of its rare instances of nonuniformity, the UCC does not dictate the result. It gives the states three choices, labeled in Section 2-318 as Alternatives A, B, and C. Md. Code Ann., Com. Law § 2-318 (LexisNexis 2021)

Alternative A says that a seller's warranty extends "to any natural person who is in the family or household of his buyer or who is a guest in his home" provided (1) it is reasonable to expect the person suffering damages to use, consume, or be affected by the goods and (2) the warranty extends only to damages for personal injury.

Alternative B "extends to any natural person who may reasonably be expected to use, consume, or be affected by the goods, and who is injured in person by breach of the warranty." Maryland follows Alternative B. Md. Code Ann., Com. Law § 2-318 (LexisNexis 2021). It is less restrictive than the first alternative: it extends protection to people beyond those in the buyer's home. For example, what if Carl took the lamp to a neighbor's house to illuminate a poker table: under Alternative B, anybody at the neighbor's house who suffered injury would be covered by the warranty. But this alternative does not extend protection to organizations; "natural person" means a human being.

Alternative C is the same as B except that it applies not only to any "natural person" but "to any person who is injured by breach of the warranty." This is the most far-reaching alternative because it provides redress for damage to *property* as well as for *personal* injury, and it extends protection to corporations and other institutional buyers.

One may incidentally note that having three different alternatives for when third-party non-purchasers can sue a seller or manufacturer for breach of warranty gives rise to unintended consequences. First, different outcomes are produced among jurisdictions, including variations in the common law. Second, the great purpose of the Uniform Commercial Code in promoting national uniformity is undermined. Third, battles over choice of law—where to file the lawsuit—are generated.

UCC, Section 2A-216, provides basically the same alternatives as applicable to the leasing of goods.

Vertical Privity

The traditional rule was that remote selling parties were not liable: lack of privity was a defense by the manufacturer or wholesaler to a suit by a buyer with whom these entities did not themselves contract. The buyer could recover damages from the retailer but not from the original manufacturer, who after all made the product and who might be much more financially able to honor the warranty. The UCC takes no position here, but over the last fifty years the judicial trend has been to abolish this vertical privity requirement. (See Figure 9.2 "Chain of Distribution"; the entities in the distribution chain are those in vertical privity to the buyer.) It began in 1958, when the Michigan Supreme Court overturned the old theory in an opinion written by Justice John D. Voelker. *Spence v. Three Rivers Builders & Masonry Supply, Inc.*, 90 N.W.2d 873, 880 (Mich. 1958) ("Under the modern doctrine there is little doubt that a person who has had no direct contractual relations with a manufacturer may nevertheless recover from such manufacturer for damages to property caused by the negligence of the manufacturer in the same manner that such a remote vendee or other third person can recover for personal injuries."

Contributory Negligence, Comparative Negligence, and Assumption of Risk

After disclaimers and privity issues are resolved, other possible impediments facing the plaintiff in a products-liability warranty case are issues of assumption of the risk, contributory negligence, and comparative negligence.

Courts uniformly hold that assumption of risk is a defense for sellers against a claim of breach of warranty, while there is a split of authority over whether comparative and contributory negligence are defenses. However, the courts' use of this terminology is often conflicting and confusing. The ultimate question is really one of causation: was the seller's breach of the warranty the cause of the plaintiff's damages?

The UCC is not markedly helpful in clearing away the confusion caused by years of discussion of assumption of risk and contributory negligence. Section 2-715(2)(b) of the UCC says that among the forms of consequential damage for which recovery can be sought is "injury to person or property *proximately* resulting from any breach of warranty" (emphasis added). Md. Code Ann., Com. Law § 2-715(2)(b) (LexisNexis 2021). But "proximately" is a troublesome word. Indeed, ultimately it is a circular word: it means nothing more than that the defendant must have been a direct enough cause of the damages that the courts will impose liability. Comment 5 to this section says, "Where the injury involved follows the use of goods without discovery of the defect causing the damage, the question of 'proximate' turns on whether it was reasonable for the buyer to use the goods without such inspection as would have revealed the defects. If it was not reasonable for him to do so, or if he did in fact discover the defect prior to his use, the injury would not proximately result from the breach of warranty." *Id.*

Obviously if a sky diver buys a parachute and then discovers a few holes in it, his family would not likely prevail in court when they sued to recover for his death because the parachute failed to function after he jumped at 5,000 feet. "[A]n individual using a product when he had actual knowledge of a defect or knowledge of facts which were so obvious that he must have known of a defect, is either no longer relying on the seller's express or implied warranty or has interjected an intervening cause of his own, and therefore a breach of such warranty cannot be regarded as the proximate cause of the ensuing injury." *Erdman v. Johnson Bros. Radio & Television Co.,* 260 Md. 190, 196-97, 271 A.2d 744, 747 (1970). But the general notion that it must have been reasonable for a buyer to use goods without inspection can make a warranty case difficult to prove.

Negligence

Negligence is the second theory raised in the typical products-liability case. It is a tort theory (as compared to breach of warranty, which is of course a contract theory), and it does have this advantage over warranty theory: privity is never relevant. A pedestrian is struck in an intersection by a car whose brakes were defectively manufactured. Under no circumstances would breach of warranty be a useful cause of action for the pedestrian—there is no privity at all. **Negligence** basically means lack of due care.

Typical Negligence Claims: Design Defects and Inadequate Warnings

Negligence theory in products liability is most useful in two types of cases: defective design and defective warnings.

Design Defects

Manufacturers can be, and often are, held liable for injuries caused by products that were defectively designed. The question is whether the designer used reasonable care in designing a product reasonably safe for its foreseeable use. The concern over reasonableness and standards of care are elements of negligence theory.

Defective-design cases can pose severe problems for manufacturing and safety engineers. More safety means more cost. Designs altered to improve safety may impair functionality and make the product less desirable to consumers. At what point safety comes into reasonable balance with performance, cost, and desirability (see Figure 20 "The Reasonable Design Balance") is impossible to forecast accurately, though some factors can be taken into account. For example, if other manufacturers are marketing comparable products whose design are intrinsically safer, the less-safe products are likely to lose a test of reasonableness in court.

Figure 19 The Reasonable Design Balance

Warning Defects

We noted that a product may be defective if the manufacturer failed to warn the user of potential dangers. Whether a warning should have been affixed is often a question of what is reasonably foreseeable, and the failure to affix a warning will be treated as negligence. The manufacturer of a weed killer with poisonous ingredients is certainly acting negligently when it fails to warn the consumer that the contents are potentially lethal.

The law governing the necessity to warn and the adequacy of warnings is complex. What is reasonable turns on the degree to which a product is likely to be misused as in the case of *Laaperi v. Sears, Roebuck & Co., Inc.*, 787 F.2d 726 (1st Cir. 1986). In *Laaperi* a smoke detector failed to alert Mr. Laaperi's family of a fire as the fire occurred as a result of a short in the electrical circuit on which the smoke detector was installed. The failure of the electrical circuit resulted in the failure of the smoke detector. In upholding the trial court's judgment for Mr. Laaperi, the court held that such a failure (for which the smoke detector was installed to detect) would not necessarily be obvious to the average purchaser. *See id.* at 731-32 ("…we think that the issue of obviousness to the average consumer of the danger of a fire-related power outage was one for the jury, not the court, to determine. In the present case, the jury was specifically instructed that if it found this danger to be obvious it should hold for defendants. It failed to do so." *Id.* at 732.)

Problems with Negligence Theory

Negligence is an ancient cause of action and, as was discussed in the torts section, it carries with it a number of well-developed defenses. Two categories may be mentioned: common-law defenses and preemption.

Common-Law Defenses against Negligence

Among the problems confronting a plaintiff with a claim of negligence in products-liability suits (again, these concepts are discussed in the torts section) are the following:

- Proving negligence at all: just because a product is defective does not necessarily prove the manufacturer breached a duty of care.
- Proximate cause: even if there was some negligence, the plaintiff must prove her damages flowed proximately from that negligence.
- Contributory and comparative negligence: the plaintiff's own actions contributed to the damages.
- Subsequent alteration of the product: generally the manufacturer will not be liable if the product has been changed.
- Misuse or abuse of the product: using a lawn mower to trim a hedge or taking too much of a drug are examples.
- Assumption of the risk: knowingly using the product in a risky way.

Preemption

Preemption (or "pre-emption") is illustrated by this problem: suppose there is a federal standard concerning the product, and the defendant manufacturer meets it, but the standard is not really very protective. (It is not uncommon, of course, for federal standard makers of all types to be significantly influenced by lobbyists for the industries being regulated by the standards.) Is it enough for the manufacturer to point to its satisfaction of the standard so that such satisfaction preempts (takes over) any common-law negligence claim? "We built the machine to federal standards: we can't be liable. Our compliance with the federal safety standard is an affirmative defense."

Preemption is typically raised as a defense in suits about

(1) cigarettes,

(2) FDA-approved medical devices,
(3) motor-boat propellers,
(4) pesticides, and
(5) motor vehicles.

This is a complex area of law. Questions inevitably arise as to whether there was federal preemption, express or implied. Sometimes courts find preemption and the consumer loses; sometimes the courts don't find preemption and the case goes forward. According to one lawyer who works in this field, there has been "increasing pressure on both the regulatory and congressional fronts to preempt state laws." That is, the usual defendants (manufacturers) push Congress and the regulatory agencies to state explicitly in the law that the federal standards preempt and defeat state law (Newsome et al. 2007).

Strict Liability in Tort

The warranties grounded in the Uniform Commercial Code (UCC) are often ineffective in assuring recovery for a plaintiff's injuries. The notice requirements and the ability of a seller to disclaim the warranties remain bothersome problems, as does the privity requirement in those states that continue to adhere to it.

Negligence as a products-liability theory obviates any privity problems, but negligence comes with a number of familiar defenses and with the problems of preemption.

To overcome the obstacles, judges have gone beyond the commercial statutes and the ancient concepts of negligence. They have fashioned a tort theory of products liability based on the principle of **strict products liability**. One court expressed the rationale for the development of the concept as follows: "The rule of strict liability for defective products is an example of necessary paternalism judicially shifting risk of loss by application of tort doctrine because [the UCC] scheme fails to adequately cover the situation. Judicial paternalism is to loss shifting what garlic is to a stew—sometimes necessary to give full flavor to statutory law, always distinctly noticeable in its result, overwhelmingly counterproductive if excessive, and never an end in itself." *Kaiser Steel Corp. v. Westinghouse Electric Corp.*, 55 Cal. App. 3d 737 (Cal. Ct. App. 1976). Paternalism or not, strict liability has become a very important legal theory in products-liability cases.

Strict Liability Defined

The formulation of strict liability that most courts use is Section 402A of the Restatement of Torts (Second), set out here in full:

> (1) One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if
>
> (a) the seller is engaged in the business of selling such a product, and
>
> (b) it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.
>
> (2) This rule applies even though
>
> (a) the seller has exercised all possible care in the preparation and sale of his product, and

(b) the user or consumer has not bought the product from or entered into any contractual relation with the seller.

Section 402A of the Restatement avoids the warranty booby traps. It states a rule of law not governed by the UCC, so limitations and exclusions in warranties will not apply to a suit based on the Restatement theory. And the consumer is under no obligation to give notice to the seller within a reasonable time of any injuries. Privity is not a requirement; the language of the Restatement says it applies to "the user or consumer," but courts have readily found that bystanders in various situations are entitled to bring actions under Restatement, Section 402A. The formulation of strict liability, though, is limited to physical harm. Many courts have held that a person who suffers economic loss must resort to warranty law.

Strict liability avoids some negligence traps, too. No proof of negligence is required. See Figure 21 "Differences between Warranty and Strict Liability".

	Warranty	Strict Liability
1. Notice of Defect from Buyer to Seller Required?	Yes	No
2. Disclaimer Possible?	Yes	No
3. Privity Required?	Sometimes	No

Figure 20 Differences between Warranty & Strict Liability

Section 402A Elements

Product in a Defective Condition

Sales of goods but not sales of services are covered under the Restatement, Section 402A. Furthermore, the plaintiff will not prevail if the product was safe for normal handling and consumption when sold. A glass soda bottle that is properly capped is not in a defective condition merely because it can be broken if the consumer should happen to drop it, making the jagged glass dangerous. Chocolate candy bars are not defective merely because you can become ill by eating too many of them at once. On the other hand, a seller would be liable for a product defectively packaged, so that it could explode or deteriorate and change its chemical composition. A product can also be in a defective condition if there is danger that could come from an anticipated wrongful use, such as a drug that is safe only when taken in limited doses. Under those circumstances, failure to place an adequate dosage warning on the container makes the product defective.

The plaintiff bears the burden of proving that the product is in a defective condition, and this burden can be difficult to meet. Many products are the result of complex feats of engineering. Expert witnesses are necessary to prove that the products were defectively manufactured, and these are not always easy to come by. This difficulty of proof is one reason why many cases raise the failure to warn as the dispositive issue, since in the right case that issue is far easier to prove. However, a plaintiff cannot prevail under strict liability merely because he was injured. It is not the fact of injury that is dispositive but the defective condition of the product.

Unreasonably Dangerous

The product must be not merely dangerous but unreasonably dangerous. Most products have characteristics that make them dangerous in certain circumstances. As the Restatement commentators note, "Good whiskey is not unreasonably dangerous merely because it will make some people drunk, and is especially dangerous to alcoholics; but bad whiskey, containing a dangerous amount of fuel oil, is unreasonably dangerous.…Good butter is not unreasonably dangerous merely because, if such be the case, it deposits cholesterol in the arteries and leads to heart attacks; but bad butter, contaminated with poisonous fish oil, is unreasonably dangerous." Restat 2d of Torts, §402A(i). Under Section 402A, "the article sold must be dangerous to an extent beyond that which would be contemplated by the ordinary consumer who purchases it, with the ordinary knowledge common to the community as to its characteristics." Restat 2d of Torts, §402A.

Even high risks of danger are not necessarily unreasonable. Some products are unavoidably unsafe; rabies vaccines, for example, can cause dreadful side effects. But the disease itself, almost always fatal, is worse. A product is unavoidably unsafe when it cannot be made safe for its intended purpose given the present state of human knowledge. Because important benefits may flow from the product's use, its producer or seller ought not to be held liable for its danger.

However, the failure to warn a potential user of possible hazards can make a product defective under Restatement, Section 402A, whether unreasonably dangerous or even unavoidably unsafe. The farmer need not warn those with common allergies to eggs, because it will be presumed that the person with an allergic reaction to common foodstuffs will be aware of them. But when the product contains an ingredient that could cause toxic effects in a substantial number of people and its danger is not widely known (or if known, is not an ingredient that would commonly be supposed to be in the product), the lack of a warning could make the product unreasonably dangerous within the meaning of Restatement, Section 402A. Many of the suits brought by asbestos workers charged exactly this point; "The utility of an insulation product containing asbestos may outweigh the known or foreseeable risk to the insulation workers and thus justify its marketing. The product could still be unreasonably dangerous, however, if unaccompanied by adequate warnings. An insulation worker, no less than any other product user, has a right to decide whether to expose himself to the risk. "*Borel v. Fibreboard Paper Products Corp.*, 493 F.2d 1076, 1105-06 (5th Cir. 1973). This rule of law came to haunt the Manville Corporation: it was so burdened with lawsuits, brought and likely to be brought for its sale of asbestos—a known carcinogen—that it declared Chapter 11 bankruptcy in 1982 and shucked its liability. *In re Johns-Manville Corp.*, 36 B.R.727 (Bankr. S.D.N.Y 1984).

Engaged in the Business of Selling

Restatement, Section 402A(1)(a), limits liability to sellers "engaged in the business of selling such a product." Restat 2d of Torts § 402A(1)(a). The rule is intended to apply to people and entities engaged in business, not to casual one-time sellers. The business need not be solely in the defective product; a movie theater that sells popcorn with a razor blade inside is no less liable than a grocery store that does so. But strict liability under this rule does not attach to a private individual who sells his own automobile. In this sense, Restatement, Section 402A, is analogous to the UCC's limitation of the warranty of merchantability to the merchant.

The requirement that the defendant be in the business of selling gets to the rationale for the whole concept of strict products liability: businesses should shoulder the cost of injuries because they are in the best position to spread the risk and distribute the expense among the public.

Reaches the User without Change in Condition

Restatement, Section 402A(1)(b), limits strict liability to those defective products that are expected to and do reach the user or consumer without substantial change in the condition in which the products are sold. A product that is safe when delivered cannot subject the seller to liability if it is subsequently mishandled or changed. The seller, however, must anticipate in appropriate cases that the product will be stored; faulty packaging or sterilization may be the grounds for liability if the product deteriorates before being used.

Liability Despite Exercise of All Due Care

Strict liability applies under the Restatement rule even though "the seller has exercised all possible care in the preparation and sale of his product." Restat 2d of Torts § 402A(2). This is the crux of "strict liability" and distinguishes it from the conventional theory of negligence. It does not matter how reasonably the seller acted or how exemplary is a manufacturer's quality control system—what matters is whether the product was defective and the user injured as a result. Suppose an automated bottle factory manufactures 1,000 bottles per hour under exacting standards, with a rigorous and costly quality-control program designed to weed out any bottles showing even an infinitesimal amount of stress. The plant is "state of the art," and its computerized quality-control operation is the best in the world. It regularly detects the one out of every 10,000 bottles that analysis has shown will be defective. Despite this intense effort, it proves impossible to weed out every defective bottle; one out of one million, say, will still escape detection. Assume that a bottle, filled with soda, finds its way into a consumer's home, explodes when handled, sends glass shards into his eye, and blinds him. Under negligence, the bottler has no liability; under strict liability, the bottler will be liable to the consumer.

Liability without Contractual Relation

Under Restatement, Section 402A(2)(b), strict liability applies even though the user has not purchased the product from the seller nor has the user entered into any contractual relation with the seller. In short, privity is abolished and the injured user may use the theory of strict liability against manufacturers and wholesalers as well as retailers. Here, however, the courts have varied in their approaches; the trend has been to allow bystanders recovery. The Restatement explicitly leaves open the question of the bystander's right to recover under strict liability.

Problems with Strict Liability

Strict liability is liability without proof of negligence and without privity. It would seem that strict liability is the "holy grail" of products-liability lawyers: the complete answer. Well, no, it's not the holy grail. It is certainly true that 402A abolishes the contractual problems of warranty. Restatement, Section 402A, Comment *m*, says,

> The rule stated in this Section is not governed by the provisions of the Uniform Commercial Code, as to warranties; and it is not affected by limitations on the scope and content of warranties, or by limitation to "buyer" and "seller" in those statutes. Nor is the consumer required to give notice to the seller of his injury within a reasonable time after it occurs, as provided by the Uniform Act. The consumer's cause of action does not depend upon the validity of his contract with the person from whom he acquires the product, and it is not affected by any disclaimer or other agreement, whether it be between the seller and his immediate buyer, or attached to and accompanying the product into the consumer's hands. In short, "warranty" must be given a new and different meaning if it is used in connection with this Section. It is much simpler to regard the liability here stated as merely one of strict liability in tort. Restat 2d of Torts § 402A, cmt. m.

Inherent in the Restatement's language is the obvious point that if the product has been altered, losses caused by injury are not the manufacturer's liability. Beyond that there are still some limitations to strict liability.

Disclaimers

Comment *m* specifically says the cause of action under Restatement, Section 402A, is not affected by disclaimer. But in *nonconsumer* cases, courts have allowed clear and specific disclaimers. In 1969, the Ninth Circuit observed: "In *Kaiser Steel Corp. v. Westinghouse Elec. Co.*, 127 Cal. Rptr. 838 (1976) the [California Supreme Court] court upheld the dismissal of a strict liability action when the parties, dealing from positions of relatively equal economic strength, contracted in a commercial setting to limit the defendant's liability. The court went on to hold that in this situation the strict liability cause of action does not apply at all. In reaching this conclusion, the court in *Kaiser* reasoned that strict liability 'is designed to encompass situations in which the principles of sales warranties serve their purpose "fitfully at best." It concluded that in such commercial settings the UCC principles work well and "to apply the tort doctrines of products liability will displace the statutory law rather than bring out its full flavor." *Idaho Power Co. v. Westinghouse Electric Corp.*, 596 F.2d 924, 928 (9th Cir. 1979).

Plaintiff's Conduct

Conduct by the plaintiff herself may defeat recovery in two circumstances.

Assumption of Risk

Courts have allowed the defense of assumption of the risk in strict products-liability cases. A plaintiff assumes the risk of injury, thus establishing defense to claim of strict products liability, when he is aware the product is defective, knows the defect makes the product unreasonably dangerous, has reasonable opportunity to elect whether to expose himself to the danger, and nevertheless proceeds to make use of the product. The rule makes sense.

Misuse or Abuse of the Product

Where the plaintiff does not know a use of the product is dangerous but nevertheless uses for an incorrect purpose, a defense arises, but only if such misuse was not foreseeable. If it was, the manufacturer should warn against that misuse. In *Eastman v. Stanley Works*, a carpenter used a framing hammer to drive masonry nails; the claw of the hammer broke off, striking him in the eye. *Eastman v. Stanley Works*, 180 Ohio App. 3d 844 (Ohio App. 2009). He sued. The court held that while a defense does exist "where the product is used in a capacity which is unforeseeable by the manufacturer and completely incompatible with the product's design…misuse of a product suggests a use which was unanticipated or unexpected by the product manufacturer, or unforeseeable and unanticipated [but] it was not the case that reasonable minds could only conclude that appellee misused the [hammer]. Though the plaintiff's use of the hammer might have been *unreasonable*, unreasonable use is not a defense to a strict product-liability action or to a negligence action." *Id.* at 780-781.

Limited Remedy

The Restatement says recovery under strict liability is limited to "physical harm thereby caused to the ultimate user or consumer, or to his property," but not other losses and not economic losses. In *Atlas Air v. General Electric*, a New York court held that the "economic loss rule" (no recovery for economic losses) barred strict products-liability and negligence claims by the purchaser of a used airplane against the airplane engine manufacturer for damage to the plane caused by an emergency landing necessitated by engine failure, where the purchaser merely alleged economic losses with respect to the plane itself, and not damages for personal injury (recovery for damage to the engine was allowed). *Atlas Air v. General Electric*, 791 N.Y.S.2d 620 (N.Y. App. Div. 2005).

But there are exceptions. In *Duffin v. Idaho Crop Imp. Ass'n*, the court recognized that a party generally owes no duty to exercise due care to avoid purely economic loss, but if there is a "special relationship" between the parties such that it would be equitable to impose such a duty, the duty will be imposed.

Duffin v. Idaho Crop Imp. Ass'n, 895 P.2d 1195 (Idaho 1995). A special relationship "refers to those situations where the relationship between the parties is such that it would be equitable to impose such a duty. In other words, there is an extremely limited group of cases where the law of negligence extends its protections to a party's economic interest.*" Id.* at 1201.

The Third Restatement

The law develops. What seemed fitting in 1964 when the Restatement (Second) announced the state of the common-law rules for strict liability in Section 402A seemed, by 1997, not to be tracking common law entirely closely. The American Law Institute came out with the Restatement (Third) in that year. The Restatement changes some things. Most notably it abolishes the "unreasonably dangerous" test and substitutes a "risk-utility test." That is, a product is not defective unless its riskiness outweighs its utility. More important, the Restatement (Third), Section 2, now requires the plaintiff to provide a reasonable alternative design to the product in question. In advancing a reasonable alternative design, the plaintiff is not required to offer a prototype product. The plaintiff must only show that the proposed alternative design exists and is superior to the product in question. The Restatement (Third) also makes it more difficult for plaintiffs to sue drug companies successfully. One legal scholar commented as follows on the Restatement (Third):

> The provisions of the Third Restatement, if implemented by the courts, will establish a degree of fairness in the products liability arena. If courts adopt the Third Restatement's elimination of the "consumer expectations test," this change alone will strip juries of the ability to render decisions based on potentially subjective, capricious and unscientific opinions that a particular product design is unduly dangerous based on its performance in a single incident. More important, plaintiffs will be required to propose a reasonable alternative design to the product in question. Such a requirement will force plaintiffs to prove that a better product design exists other than in the unproven and untested domain of their experts' imaginations (3rd Restatement of Torts).

Of course some people put more faith in juries than is evident here. The new Restatement has been adopted by a few jurisdictions and some cases the adopting jurisdictions incorporate some of its ideas, but courts appear reluctant to abandon familiar precedent.

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Agency

An agent is a person who acts in the name of and on behalf of another, having been given and assumed some degree of authority to do so. Most organized human activity—and virtually all commercial activity— is carried on through agency. No corporation would be possible, even in theory, without such a concept. We might say "General Motors is building cars in China," for example, but we can't shake hands with General Motors. "GM" as people say, exists and works through agents. Likewise, partnerships and other business organizations rely extensively on agents to conduct their business. Indeed, it is not an exaggeration to say that agency is the cornerstone of enterprise organization. In a partnership, each partner is a general agent, while under corporation law the officers and all employees are agents of the corporation.

The existence of agents does not, however, require a whole new law of torts or contracts. A tort is no less harmful when committed by an agent; a contract is no less binding when negotiated by an agent. What does need to be taken into account, though, is the manner in which an agent acts on behalf of his principal (the person or entity for whom the agent works) and toward a third party.

Types of Agents

There are five types of agents.

Table 14 Five Types of Agents

Type of Agent	Definition
General Agent	Broad range of authority to carry out actions in the name of the principal.
Special Agent	Authority to act only in a specifically designated instance.
Agency Coupled with an Interest	Agent whose reimbursement depends on its continuing to have authority to act as an agent.
Subagent	An agent appointed by another agent- may or may not be authorized by the principal.
Employee or Servant	Duties are under the control of the employer, principal, or agent.

General Agent

The general agent possesses the authority to carry out a broad range of transactions in the name and on behalf of the principal. The general agent may be the manager of a business or may have a more limited role—for example, as a purchasing agent or as a life insurance agent authorized to sign up customers for the home office. In either case, the general agent has authority to alter the principal's legal relationships with third parties. One who is designated a general agent has the authority to act in any way required by the principal's business. To restrict the general agent's authority, the principal must spell out the limitations explicitly, and even so the principal may be liable for any of the agent's acts in excess of his authority.

Normally, the general agent is a business agent, but there are circumstances under which an individual may appoint a general agent for personal purposes. One common form of a personal general agent is the person who holds a power of attorney. This is a delegation of authority to another to act in his stead; it can be accomplished by executing a simple form. Ordinarily, the power of attorney is used for a special purpose—for example, to sell real estate or securities in the absence of the owner. But a person facing a lengthy operation and recuperation in a hospital might give a general power of attorney to a trusted family member or friend. *King v. Bankerd*, 303 Md. 98, 492 A.2d 608 (1985) (power of attorney is strictly construed to only grant powers clearly expressed in document.)

Special Agent

The special agent is one who has authority to act only in a specifically designated instance or in a specifically designated set of transactions. For example, a real estate broker is usually a special agent hired to find a buyer for the principal's land. Suppose Sam, the seller, appoints an agent Alberta to find a buyer for his property. Alberta's commission depends on the selling price, which, Sam states in a letter to her, "in any event may be no less than $150,000." If Alberta locates a buyer, Bob, who agrees to purchase the property for $160,000, her signature on the contract of sale will not bind Sam. As a special agent, Alberta had authority only to find a buyer; she had no authority to sign the contract. *Straw v. Jones*, 264 Md. 95, 285 A.2d 659 (1972) (limitations on agent authority).

Agency Coupled with an Interest

An agent whose reimbursement depends on his continuing to have the authority to act as an agent is said to have an agency coupled with an interest if he has a property interest in the business. A literary or author's agent, for example, customarily agrees to sell a literary work to a publisher in return for a percentage of all monies the author earns from the sale of the work. The literary agent also acts as a collection agent to ensure that his commission will be paid. By agreeing with the principal that the agency is coupled with an interest, the agent can prevent his own rights in a particular literary work from being terminated to his detriment.

Subagent

To carry out her duties, an agent will often need to appoint her own agents. These appointments may or may not be authorized by the principal. An insurance company, for example, might name a general agent to open offices in cities throughout a certain state. The agent will necessarily conduct her business through agents of her own choosing. These agents are subagents of the principal if the general agent had the express or implied authority of the principal to hire them. For legal purposes, they are agents of both the principal and the principal's general agent, and both are liable for the subagent's conduct although normally the general agent agrees to be primarily liable.

Servant (Employee)

The final category of agent is the servant, who we now call an employee. Until the early nineteenth century, any employee whose work duties were subject to an employer's control was called a servant; we would not use that term so broadly in modern English. The Restatement (Second) of Agency, Section 2, defines a servant as "an agent employed by a master [employer] to perform service in his affairs whose physical conduct in the performance of the service is controlled or is subject to the right to control by the master." Restat 2d of Agency § 2.

Independent Contractor- Not An Agent

Not every contract for services necessarily creates a master-servant relationship. There is an important distinction made between the status of a servant and that of an independent contractor. According to the Restatement (Second) of Agency, Section 2, "an independent contractor is a person who contracts with another to do something for him but who is not controlled by the other nor subject to the other's right to control with respect to his physical conduct in the performance of the undertaking." As the name implies, the independent contractor is legally autonomous. *Id.*

A plumber salaried to a building contractor is an employee and agent of the contractor. But a plumber who hires himself out to repair pipes in people's homes is an independent contractor. If you hire a lawyer to settle a dispute, that person is not your employee or your servant; she is an independent contractor. The terms "agent" and "independent contractor" are not necessarily mutually exclusive. In fact, by definition, "… an independent contractor is an agent in the broad sense of the term in undertaking, at the request of another, to do something for the other. As a general rule the line of demarcation between an independent contractor and a servant is not clearly drawn." Restatement (Second) of Agency, Section 2.

This distinction between agent and independent contractor has important legal consequences for taxation, workers' compensation, and liability insurance. For example, employers are required to withhold income taxes from their employees' paychecks. But payment to an independent contractor, such as the plumber for hire, does not require such withholding. Deciding who is an independent contractor is not always easy; there is no single factor or mechanical answer.

In *Robinson v. New York Commodities Corp.*, 58 A.D.2d 924 (N.Y. App. Div. 3rd 1977) an injured salesman sought workers' compensation benefits, claiming to be an employee of the New York Commodities Corporation. But the state workmen's compensation board ruled against him, citing a variety of factors. The claimant sold canned meats, making rounds in his car from his home. The company did not establish hours for him, did not control his movements in any way, and did not reimburse him for mileage or any other expenses or withhold taxes from its straight commission payments to him. He reported his taxes on a form for the self-employed and hired an accountant to prepare it for him. The court agreed with the compensation board that these facts established the salesman's status as an independent contractor. *Id.* at 725-26.

The factual situation in each case determines whether a worker is an employee or an independent contractor. Neither the company nor the worker can establish the worker's status by agreement. As the North Dakota Workmen's Compensation Bureau put it in a bulletin to real estate brokers, "It has come to the Bureau's attention that many employers are requiring that those who work for them sign 'independent contractor' forms so that the employer does not have to pay workmen's compensation premiums for his employees. Such forms are meaningless if the worker is in fact an employee."

In addition to determining a worker's status for tax and compensation insurance purposes, it is sometimes critical for decisions involving personal liability insurance policies, which usually exclude from coverage accidents involving employees of the insureds. *General Accident Fire & Life Assurance Corp v. Pro Golf Association*, 352 N.E.2d 441 (Ill. App. 1976) involved such a situation. The insurance policy in question covered members of the Professional Golfers Association. Gerald Hall, a golf pro employed by the local park department, was afforded coverage under the policy, which excluded "bodily injury to any employee of the insured arising out of and in the course of his employment by the insured." That is, no employee of Hall's would be covered (rather, any such person would have coverage under workers' compensation statutes).

Bradley Martin, age thirteen, was at the golf course for junior league play. At Hall's request, he agreed to retrieve or "shag" golf balls to be hit during a lesson Hall was giving; he was—as Hall put it—to be compensated "either through golf instructions or money or hotdogs or whatever." During the course of the lesson, a golf ball hit by Hall hit young Martin in the eye. If Martin was an employee, the insurance company would be liable; if he was not an employee, the insurance company would not liable. The trial court determined he was not an employee. The evidence showed: sometimes the boys who "shagged" balls got paid, got golfing instructions, or got food, so the question of compensation was ambiguous. Martin was not directed in how to perform (the admittedly simple) task of retrieving golf balls, no control was exercised over him, and no equipment was required other than a bag to collect the balls: "We believe the evidence is susceptible of different inferences.…We cannot say that the decision of the trial court is against the manifest weight of the evidence." *Id.* at 443.

A. Formation & Duties

Forming Agency Relationships

Agency Created by Agreement

Most agencies are created by contract. Thus the general rules of contract law covered in Unit 2 govern the law of agency. Therefore, three contract principles are especially important: consideration, a writing, and contractual capacity.

Consideration

Agencies created by consent—agreement—are not necessarily contractual. It is not uncommon for one person to act as an agent for another without consideration. For example, Abe asks Byron to run some errands for him: to buy some lumber on his account at the local lumberyard. Such a gratuitous agency gives rise to no different results than the more common contractual agency. Most oral agency contracts are legally binding; the law does not require that they be reduced to writing. In practice, many agency contracts are written to avoid problems of proof.

Writing

An agency may be created by a writing, by conduct or by inference. *Green v. Hall*, 355 Md. 488, 735 A.2d 1039 (1999); *Brooks v. Euclid Systems Corp.*, 151 Md. App. 487, 827 A.2d 887 (2003) However, there are situations where an agency contract must be in writing: (1) if the agreed-on purpose of the agency cannot be fulfilled within one year or if the agency relationship is to last more than one year; (2) in many states, an agreement to pay a commission to a real estate broker; (3) in many states, authority given to an agent to sell real estate; and (4) in several states, contracts between companies and sales representatives. Even when the agency contract is not required to be in writing, contracts that agents make with third parties often must be in writing. Thus Section 2-201 of the Uniform Commercial Code specifically requires contracts for the sale of goods for the price of $500 or more to be in writing and "signed by the party against whom enforcement is sought or by his authorized agent." Md. Code Ann., Com. Law § 2-201 (LexisNexis 2021).

Capacity

A contract is void or voidable when one of the parties lacks capacity to make one. If both principal and agent lack capacity—for example, a minor appoints another minor to negotiate or sign an agreement— there can be no question of the contract's voidability. But suppose only one or the other lacks capacity. Generally, the law focuses on the principal. If the principal is a minor or otherwise lacks capacity, the contract can be avoided even if the agent is fully competent. There are, however, situations in which the capacity of the agent is important. Thus a mentally incompetent agent cannot bind a principal.

Agency Created by Operation of Law

Most agencies are made by contract, but agency also may arise by implication or operation of law.

Implied Agency

In areas of social need, courts have declared an agency to exist in the absence of an agreement. The agency relationship then is said to have been implied "by operation of law." Children in most states may purchase necessary items—food or medical services—on the parent's account. Long-standing social policy deems it desirable for the head of a family to support his dependents, and the courts will put the expense on the family head in order to provide for the dependents' welfare. The courts achieve this result by supposing the dependent to be the family head's agent, thus allowing creditors to sue the family head for the debt. Implied agencies also arise where one person behaves as an agent would and the "principal," knowing that the "agent" is behaving so, acquiesces, allowing the person to hold himself out as an agent. Such are the basic facts in *Weingart v. Directoire Restaurant, Inc*., 75 Misc. 2d 1004 (N.Y. App. Term 1973).

Apparent Agency

Apparent agency exists where "…the principal held the agent out to the public as possessing sufficient authority to embrace the particular act in question, or knowingly permitted him to act as having such authority; and (2) that the person dealing with the agent knew of the facts and acting in good faith had reason to believe and did believe that the agent possessed the necessary authority." *Cefaratti v. Aranow*, 141 A.3d 752, 758 (Conn. 2016).

Suppose Arthur is Paul's agent, employed through October 31. On November 1, Arthur buys materials at Lumber Yard—as he has been doing since early spring—and charges them to Paul's account. Lumber Yard, not knowing that Arthur's employment terminated the day before, bills Paul. Will Paul have to pay? Yes, because the termination of the agency was not communicated to Lumber Yard. It appeared that Arthur was an authorized agent.

Duties of the Agent

The agent owes the principal duties in two categories: the fiduciary duty and a set of general duties imposed by agency law. But these general duties are not unique to agency law; they are duties owed by any employee to the employer.

Fiduciary Duty

In a nonagency contractual situation, the parties' responsibilities terminate at the border of the contract. There is no relationship beyond the agreement. This literalist approach is justified by the more general principle that we each should be free to act unless we commit ourselves to a particular course. But the agency relationship is more than a contractual one, and the agent's responsibilities go beyond the border of the contract. Agency imposes a higher duty than simply to abide by the contract terms. It imposes a fiduciary duty. The law infiltrates the contract creating the agency relationship and reverses the general principle that the parties are free to act in the absence of agreement. As a fiduciary of the principal, the agent stands in a position of special trust. *Buxton v. Buxton*, 363 Md. 634, 770 A.2d 152 (2001). His responsibility is to subordinate his self-interest to that of his principal. The fiduciary responsibility is imposed by law. The absence of any clause in the contract detailing the agent's fiduciary duty does not relieve him of it. The duty contains several aspects-detailed below.

Duty to Avoid Self-Dealing

A fiduciary may not lawfully profit from a conflict between his personal interest in a transaction and his principal's interest in that same transaction. An agent therein owes a duty of loyalty to his principal. *King v. Bankerd*, 303 Md. 98, 492 A.2d 608 (1985). A broker hired as a purchasing agent, for instance, may not sell to his principal through a company in which he or his family has a financial interest. The penalty for breach of fiduciary duty is loss of compensation and profit and possible damages for breach of trust.

Duty to Preserve Confidential Information

To further his objectives, a principal will usually need to reveal a number of secrets to his agent—how much he is willing to sell or pay for property, marketing strategies, and the like. Such information could easily be turned to the disadvantage of the principal if the agent were to compete with the principal or were to sell the information to those who do. The law therefore prohibits an agent from using for his own purposes or in ways that would injure the interests of the principal, information confidentially given or acquired. An agent may "not … use or communicate confidential information of the principal for the agent's own purpose." Restat 3d of Agency § 8.05. This prohibition extends to information gleaned from the principal though unrelated to the agent's assignment.

Nor may the agent use confidential information after resigning his agency. Though he is free, in the absence of contract, to compete with his former principal, he may not use information learned in the course of his agency, such as trade secrets and customer lists. *Bacon v. Volvo Service Center, Inc*., 266 Ga. App. 543 (Ga. Ct. App. 2004) deals with an agent's breach of the duty of confidentiality.

Other Duties

In addition to fiduciary responsibility (and whatever special duties may be contained in the specific contract) the law of agency imposes other duties on an agent. These duties are not necessarily unique to agents: a nonfiduciary employee could also be bound to these duties on the right facts.

Duty of Skill and Care

An agent is usually taken on because he has special knowledge or skills that the principal wishes to tap. The agent is under a legal duty to perform his work with the care and skill that is "standard in the locality for the kind of work which he is employed to perform" and to exercise any special skills, if these are greater or more refined than those prevalent among those normally employed in the community. Restat 3d of Agency § 8.08. In short, the agent may not lawfully do a sloppy job.

Duty of Good Conduct

In the absence of an agreement, a principal may not ordinarily dictate how an agent must live his private life. An overly fastidious florist may not instruct her truck driver to steer clear of the local bar on his way home from delivering flowers at the end of the day. But there are some jobs on which the personal habits of the agent may have an effect. The agent is not at liberty to act with impropriety or notoriety, so as to bring disrepute on the business in which the principal is engaged. A lecturer at an anti-alcohol clinic may be directed to refrain from frequenting bars. A bank cashier who becomes known as a gambler may be fired. In short, an agent must refrain from conduct that is likely to damage his principal's enterprise. Restat 3d of Agency § 8.10.

Duty to Keep and Render Accounts

The agent must keep accurate financial records, take receipts, and otherwise act in conformity to standard business practices. Restat 3d of Agency ¶ 8.12.

Duty to Act Only as Authorized

An agent should act only within the scope of his actual authority. Restat 3d of Agency § 8.09. This duty states a truism but is one for which there are limits. A principal's wishes may have been stated ambiguously or may be broad enough to confer discretion on the agent. As long as the agent acts reasonably under the circumstances, he will not be liable for damages later if the principal ultimately repudiates what the agent has done:

Duty to Obey

As a general rule, the agent must obey reasonable directions concerning the manner of performance. Restat 3d of Agency § 8.09. What is reasonable depends on the customs of the industry or trade, prior dealings between agent and principal, and the nature of the agreement creating the agency. A principal may prescribe uniforms for various classes of employees, for instance, and a manufacturing company may tell its sales force what sales pitch to use on customers. On the other hand, certain tasks entrusted to agents are not subject to the principal's control; for example, a lawyer may refuse to permit a client to dictate courtroom tactics.

Duty to Give Information

Because the principal cannot be every place at once—that is why agents are hired, after all—much that is vital to the principal's business first comes to the attention of agents. If the agent has actual notice or reason to know of information that is relevant to matters entrusted to him, he has a duty to inform the principal. Restat 3d of Agency § 8.11. This duty is especially critical because information in the hands of an agent is, under most circumstances, imputed to the principal, whose legal liabilities to third persons may hinge on receiving information in timely fashion. Service of process, for example, requires a defendant to answer within a certain number of days; an agent's failure to communicate to the principal that a summons has been served may bar the principal's right to defend a lawsuit. The imputation to the principal of knowledge possessed by the agent is strict: even where the agent is acting adversely to the principal's interests—for example, by trying to defraud his employer—a third party may still rely on notification to the agent, unless the third party knows the agent is acting adversely.

Table 15 Summary of Agent's Duties to Principal

Agent's Duties to Principal
Duty to Avoid Self-Dealing (aka Loyalty)
Duty to Preserve Confidential Information
Duty of Skill and Care
Duty of Good Conduct
Duty to Keep and Render Accounts
Duty to Act Only as Authorized
Duty to Obey
Duty to Give Information

"Shop Rights" Doctrine

In *Grip Nut Co. v. Sharp*, 150 F.2d 192 (7th Cir. 1945), Sharp made a deal with Grip Nut Company that in return for a salary and bonuses as company president, he would assign to the company any inventions he made. When the five-year employment contract expired, Sharp continued to serve as chief executive officer, but no new contract was negotiated concerning either pay or rights to inventions. During the next ten years, Sharp invented a number of new products and developed new machinery to manufacture them; patent rights went to the company. However, he made one invention with two other employees and they assigned the patent to him. A third employee invented a safety device and also assigned the patent to Sharp. At one time, Sharp's son invented a leak proof bolt and a process to manufacture it; these, too, were assigned to Sharp. These inventions were developed in the company's plants at its expense. When Sharp died, his family claimed the rights to the inventions on which Sharp held assignments and sued the company, which used the inventions, for patent infringement. The family reasoned that after the expiration of the employment contract, Sharp was employed only in a managerial capacity, not as an inventor.

The court disagreed and invoked the shop rights doctrine, under which an invention "developed and perfected in [a company's] plant with its time, materials, and appliances, and wholly at its expense" may be used by the company without payment of royalties. "Because the servant uses his master's time, facilities and materials to attain a concrete result, the employer is entitled to use that which embodies his own property and to duplicate it as often as he may find occasion to employ similar appliances in his business." *Id.* at197.

Principal's Duty to Agent

In this category, we may note that the principal owes the agent duties in contract, tort, and—statutorily—workers' compensation law.

Contract Duties

The fiduciary relationship of agent to principal does not run in reverse—that is, the principal is not the agent's fiduciary. Nevertheless, the principal has a number of contractually related obligations toward his agent. A principal has a duty to act in accordance with the express and implied terms of any contract between the principal and the agent. Restat 3d of Agency ¶ 8.13.

Duty to Deal Fairly and in Good Faith

A principal has a duty to deal with the agent fairly and in good faith, including a duty to provide the agent with information about risks of physical harm or pecuniary loss that the principal knows, has reason to know, or should know are present in the agent's work but unknown to the agent. Restat 3d of Agency, § 8.15.

Duty to Indemnify or Reimburse

Agents commonly spend money pursuing the principal's business. Unless the agreement explicitly provides otherwise, the principal has a duty to indemnify or reimburse the agent. Restat 3d of Agency § 8.14. A familiar form of indemnity is the employee expense account.

B. Scope of Agent Authority

Types of Authority

There are three types of authority: express, implied, and apparent.

Express Authority

The strongest form of authority is that which is expressly granted, often in written form. The principal consents to the agent's actions, and the third party may then rely on the document attesting to the agent's authority to deal on behalf of the principal. One common form of express authority is the standard signature card on file with banks allowing corporate agents to write checks on the company's credit. The principal bears the risk of any wrongful action of his agent, as demonstrated in *Allen A. Funt Productions, Inc. v. Chemical Bank*, 63 A.D.2d 629(N.Y. App. Div. 1978). Allen A. Funt submitted to his bank through his production company various certificates permitting his accountant to use the company's checking accounts. Allen Funt (1914–99) was an American television producer, director, and writer, best known as the creator and host of *Candid Camera* from the 1940s to 1980s, which was broadcast as either a regular show or a series of specials. Its most notable run was from 1960 to 1967 on CBS. For several years the accountant embezzled money from the company by writing checks to himself and depositing them in his own account. The company sued its bank, charging it with negligence, apparently for failing to monitor the amount of money taken by the accountant. But the court dismissed the negligence complaint, citing a state statute based on the common-law agency principle that a third party is entitled to rely on the express authorization given to an agent; in this case, the accountant drew checks on the account within the monetary limits contained in the signature cards on file with the bank. *See id.* at 95.

Letters of introduction and work orders are other types of express authority.

Implied Authority

Not every detail of an agent's work can be spelled out. It is impossible to delineate step-by-step the duties of a general agent; at best, a principal can set forth only the general nature of the duties that the agent is to perform. Even a special agent's duties are difficult to describe in such detail as to leave him without discretion. If express authority were the only valid kind, there would be no efficient way to use an agent, both because the effort to describe the duties would be too great and because the third party would be reluctant to deal with him.

But the law permits authority to be "implied" by the relationship of the parties, the nature and customs of the business, the circumstances surrounding the act in question, the wording of the agency contract, and the knowledge that the agent has facts relevant to the assignment. The general rule is that the agent has implied or "incidental" authority to perform acts incidental to or reasonably necessary to carry out the transaction. Thus if a principal instructs her agent to "deposit a check in the bank today," the agent has authority to drive to the bank unless the principal specifically prohibits the agent from doing so.

The theory of implied authority is especially important to business in the realm of the business manager, who may be charged with running the entire business operation or only a small part of it. In either event, the business manager has a relatively large domain of implied authority. He can buy goods and services; hire, supervise, and fire employees; sell or junk inventory; take in receipts and pay debts; and in general, direct the ordinary operations of the business. The full extent of the manager's authority depends on the circumstances—what is customary in the particular industry, in the particular business, and among the individuals directly concerned.

On the other hand, a manager does not have implicit authority to undertake unusual or extraordinary actions on behalf of his principal. In the absence of express permission, an agent may not sell part of the business, start a new business, change the nature of the business, incur debt (unless borrowing is integral to the business, as in banking, for example), or move the business premises. For example, the owner of a hotel appoints Andy as manager; Andy decides to rename the hotel and commissions an artist to prepare a new logo for the hotel's stationery. Andy has no implied authority to change the name or to commission the artist, though he does have implied authority to engage a printer to replenish the stationery supply—and possibly to make some design changes in the letterhead.

Even when there is no implied authority, in an emergency the agent may act in ways that would, in the normal course, require specific permission from the principal. If unforeseen circumstances arise and it is impracticable to communicate with the principal to find out what his wishes would be, the agent may do what is reasonably necessary in order to prevent substantial loss to his principal.

During World War II, Eastern Wine Corporation marketed champagne in a bottle with a diagonal red stripe that infringed the trademark of a French producer. The French company had granted licenses to an American importer to market its champagne in the United States. The contract between producer and importer required the latter to notify the French company whenever a competitor appeared to be infringing its rights and to recommend steps by which the company could stop the infringement. The authority to institute suit was not expressly conferred, and ordinarily the right to do so would not be inferred. Because France was under German occupation, however, the importer was unable to communicate with the producer, its principal. The court held that the importer could file suit to enjoin Eastern Wine from continuing to display the infringing red diagonal stripe, since legal action was "essential to the preservation of the principal's property." *G. H. Mumm Champagne v. Eastern Wine Corp.*, 52 F.Supp. 167 (S.D.N.Y. 1943).

Apparent Authority

In the agency relationship, the agent's actions in dealing with third parties will affect the legal rights of the principal. What the third party knows about the agency agreement is irrelevant to the agent's legal authority to act. That authority runs from principal to agent. As long as an agent has authorization, either express or implied, she may bind the principal legally. Thus the seller of a house may be ignorant of the buyer's true identity; the person he supposes to be the prospective purchaser might be the agent of an undisclosed principal. Nevertheless, if the agent is authorized to make the purchase, the seller's ignorance is not a ground for either seller or principal to void the deal.

But if a person has no authority to act as an agent, or an agent has no authority to act in a particular way, is the principal free from all consequences? The answer depends on whether or not the agent has apparent authority—that is, on whether or not the third person reasonably believes from the principal's words, written or spoken, or from his conduct that he has in fact consented to the agent's actions. *See Adobe Systems, Inc. v. Gardiner*, 300 F. Supp. 3d 718 (D. Md. 2018) (applying Maryland law). Apparent authority is a manifestation of authority communicated to the third person; it runs from principal to third party, not to the agent.

Apparent authority is sometimes said to be based on the principle of estoppel. Estoppel is the doctrine that a person will not now be allowed to deny a promise or assertion she previously made where there has been detrimental reliance on that promise or assertion. Estoppel is commonly used to avoid injustice. It may be a substitute for the requirement of consideration in contract (making the promise of a gift enforceable where the donee has relied upon the promise), and it is sometimes available to circumvent the requirement of a writing under the Statute of Frauds.

Apparent authority can arise from prior business transactions. On July 10, Meggs sold to Buyer his business, the right to use the trade name Rose City Sheet Metal Works, and a list of suppliers he had used. Three days later, Buyer began ordering supplies from Central Supply Company, which was on Meggs's list but with which Meggs had last dealt four years before. On September 3, Central received a letter from Meggs notifying it of Meggs's sale of the business to Buyer. Buyer failed to pay Central, which sued Meggs. The court held that Rose City Sheet Metal Works had apparent authority to buy on Meggs's credit; Meggs was liable for supplies purchased between July 10 and September 3. *Meggs v. Central Supply Co.*, 159 Ind. App. 431 (Ind. Ct. App. 1974). In such cases, and in cases involving the firing of a general manager, actual notice should be given promptly to all customers.

Ratification

Even if the agent possessed no actual authority and there was no apparent authority on which the third person could rely, the principal may still be liable if he ratifies or adopts the agent's acts before the third person withdraws from the contract. Ratification usually relates back to the time of the undertaking, creating authority after the fact as though it had been established initially. Ratification is a voluntary act by the principal. Faced with the results of action purportedly done on his behalf but without authorization and through no fault of his own, he may affirm or disavow them as he chooses.

To ratify, the principal may tell the parties concerned or by his conduct manifest that he is willing to accept the results as though the act were authorized. Or by his silence he may find under certain circumstances that he has ratified. Note that ratification does not require the usual consideration of contract law. The principal need be promised nothing extra for his decision to affirm to be binding on him.

A ratification of a transaction is not effective unless it precedes the occurrence of circumstances that would cause the ratification to have adverse and inequitable effects on the rights of third parties. These circumstances include:

(1) any manifestation of intention to withdraw from the transaction made by the third party;

(2) any material change in circumstances that would make it inequitable to bind the third party, unless the third party chooses to be bound; and

(3) a specific time that determines whether a third party is deprived of a right or subjected to a liability. Restat 3d of Agency, § 4.05.

C. Agent Liability

Agent's Personal Liability for Torts and Contracts

Tort Liability

That a principal is held vicariously liable and must pay damages to an injured third person does not excuse the agent who actually committed the tortious acts. A person is always liable for his or her own torts (unless the person is insane, involuntarily intoxicated, or acting under extreme duress). *See Lampton v. LaHood*, 94 Md. App. 461, 483, 617 A.2d 1142, 1152 (1993) (agent for disclosed principal not liable, except for own misconduct). The agent is personally liable for his wrongful acts and must reimburse the principal for any damages the principal was forced to pay, as long as the principal did not authorize the wrongful conduct. However, the agent directed to commit a tort by his principal remains liable for his own conduct but is not obliged to repay the principal.

Liability as an agent can be burdensome, sometimes perhaps more burdensome than as a principal. The principal normally purchases insurance to cover against wrongful acts of agents, but liability insurance policies frequently do not cover the agent's personal liability if the agent is named in a lawsuit individually. Thus doctors' and hospitals' malpractice policies protect a doctor from both her own mistakes and those of nurses and others that the doctor would be responsible for; nurses, however, might need their own coverage. In the absence of insurance, an agent is at serious risk in this lawsuit-conscious age. The risk is not total. The agent is not liable for torts of other agents unless he is personally at fault—for example, by negligently supervising a junior or by giving faulty instructions.

For example, an agent, the general manager for a principal, hires Brown as a subordinate. Brown is competent to do the job but by failing to exercise proper control over a machine negligently injures Ted, a visitor to the premises. The principal and Brown are liable to Ted, but the agent is not. However, if the agent had given improper instructions to Brown on the operation of the machinery, the agent would also be liable.

Contract Liability

It makes sense that an agent should be liable for her own torts; it would be a bad social policy indeed if a person could escape tort liability based on her own fault merely because she acted in an agency capacity. It also makes sense that—as is the general rule—an agent is not liable on contracts she makes on the principal's behalf; because, the agent is not a party to a contract made by the agent on behalf of the principal. No public policy would be served by imposing liability, and in many cases it would not make sense.

Suppose an agent contracts to buy $25 million of rolled aluminum for a principal, an airplane manufacturer. The agent personally could not reasonably perform such contract, and it is not intended by the parties that she should be liable. (Although the rule is different in England, where an agent residing outside the country is liable even if it is clear that he is signing in an agency capacity.) But there are three exceptions to this rule: (1) if the principal is undisclosed or partially disclosed, (2) if the agent lacks authority or exceeds it, or (3) if the agent entered into the contract in a personal capacity. We consider each situation.

Agent for Undisclosed or Partially Disclosed Principal

An agent need not, and frequently will not, inform the person with whom he is negotiating that he is acting on behalf of a principal. The secret principal is usually called an "undisclosed principal." Or the agent may tell the other person that he is acting as an agent but not disclose the principal's name, in which event the principal is "partially disclosed." To understand the difficulties that may occur, consider the following hypothetical but common example. A real estate developer known for building amusement parks wants to acquire several parcels of land to construct a new park. He wants to keep his identity secret to hold down the land cost. If the landowners realized that a major building project was about to be launched, their asking price would be quite high. So the developer obtains two options to purchase land by using two secret agents—Betty and Clem.

Betty does not mention to sellers that she is an agent; therefore, to those sellers the developer is an undisclosed principal. Clem tells those with whom he is dealing that he is an agent but refuses to divulge the developer's name or his business interest in the land. Thus the developer is, to the sellers, a partially disclosed principal. Suppose the sellers get wind of the impending construction and want to back out of the deal. Who may enforce the contracts against them?

The developer and the agents may sue to compel transfer of title. The undisclosed or partially disclosed principal may act to enforce his rights unless the contract specifically prohibits it or there is a representation that the signatories are not signing for an undisclosed principal. The agents may also bring suit to enforce the principal's contract rights because, as agents for an undisclosed or partially disclosed principal, they are considered parties to their contracts.

Now suppose the developer attempts to call off the deal. Whom may the sellers sue? if the principal is disclosed – then the agent is not liable on the contract. If the principal is undisclosed – then both the developer and the agent are liable. If the principal is partially disclosed, most states will hold the agent as a party to the contract and thus liable for nonperformance of the principal, unless the agent and third party agree otherwise. See the case of *Grinder v. Bryans Road & Bldg. Supply Co.*, 290 Md. 687, 707-08, 432 A.2d 453, 464 (1981) ("…a creditor who contracts with the agent for an undisclosed principal does not obtain alternative liability, that he may proceed to judgment against both, but that he is limited to one satisfaction.").

Lack of Authority in Agent

An agent who purports to make a contract on behalf of a principal, but who in fact has no authority to do so, is liable to the other party. See the case of Burkhouse v. Duke, 190 Md. 44, 46 57 A.2d 333, 334 (1948) in which the court held the agent would be personally liable for acting on his own behalf. The theory is that the agent has warranted to the third party that he has the requisite authority. The principal is not liable in the absence of apparent authority or ratification.

Agent Acting in Personal Capacity

An agent will be liable on contracts made in a personal capacity; for instance, when the agent personally guarantees repayment of a debt. The agent's intention to be personally liable is often difficult to determine on the basis of his signature on a contract. Generally, a person signing a contract can avoid personal liability only by showing that he was in fact signing as an agent. If the contract is signed Jones, Agent; then Jones can introduce evidence to show that there was never an intention to hold him personally liable. But if he signed Jones and neither his agency nor the principal's name is included, he will be personally liable.

D. Principal Liability

In previous sections we considered the relationships between agent and principal. Now we turn to relationships between third parties and the principal or agent. When the agent makes a contract for his principal or commits a tort in the course of his work, is the principal liable? What is the responsibility of the agent for torts committed and contracts entered into on behalf of his principal? How may the relationship be terminated so that the principal or agent will no longer have responsibility toward or liability for the acts of the other?

Principal's Contract Liability Requires That Agent Had Authority

The key to determining whether a principal is liable for contracts made by his agent is authority: was the agent authorized to negotiate the agreement and close the deal? Obviously, it would not be sensible to hold a contractor liable to pay for a whole load of lumber merely because a stranger wandered into the lumberyard saying, "I'm an agent for ABC Contractors; charge this to their account." To be liable, the principal must have authorized the agent in some manner to act in his behalf, and that authorization must be communicated to the third party by the principal.

Principal's Tort Liability

Direct Liability

There is a distinction between torts prompted by the principal himself and torts of which the principal was innocent. If the principal directed the agent to commit a tort or knew that the consequences of the agent's carrying out his instructions would bring harm to someone, the principal is liable. This is an application of the general common-law principle that one cannot escape liability by delegating an unlawful act to another.

The syndicate that hires a hitman is as culpable of murder as the man who pulls the trigger. Similarly, a principal who is negligent in his use of agents will be held liable for their negligence. This rule comes into play when the principal fails to supervise employees adequately, gives faulty directions, or hires incompetent or unsuitable people for a particular job. Imposing liability on the principal in these cases is readily justifiable since it is the principal's own conduct that is the underlying fault; the principal here is directly liable.

Vicarious Liability

But the principle of liability for one's agent is much broader, extending to acts of which the principal had no knowledge, that he had no intention to commit nor involvement in, and that he may in fact have expressly prohibited the agent from engaging in. *See Baltimore Police Dept. v. Cherkes*, 140 Md. App. 282, 780 A.2d 410 (2001). This is the principle of respondeat superior("let the master answer") or the master-servant doctrine, which imposes on the principal vicarious liability (*vicarious* means "indirectly, as, by, or through a substitute") under which the principal is responsible for acts committed by the agent within the scope of the employment (see Figure 20 Principal's Tort Liability).

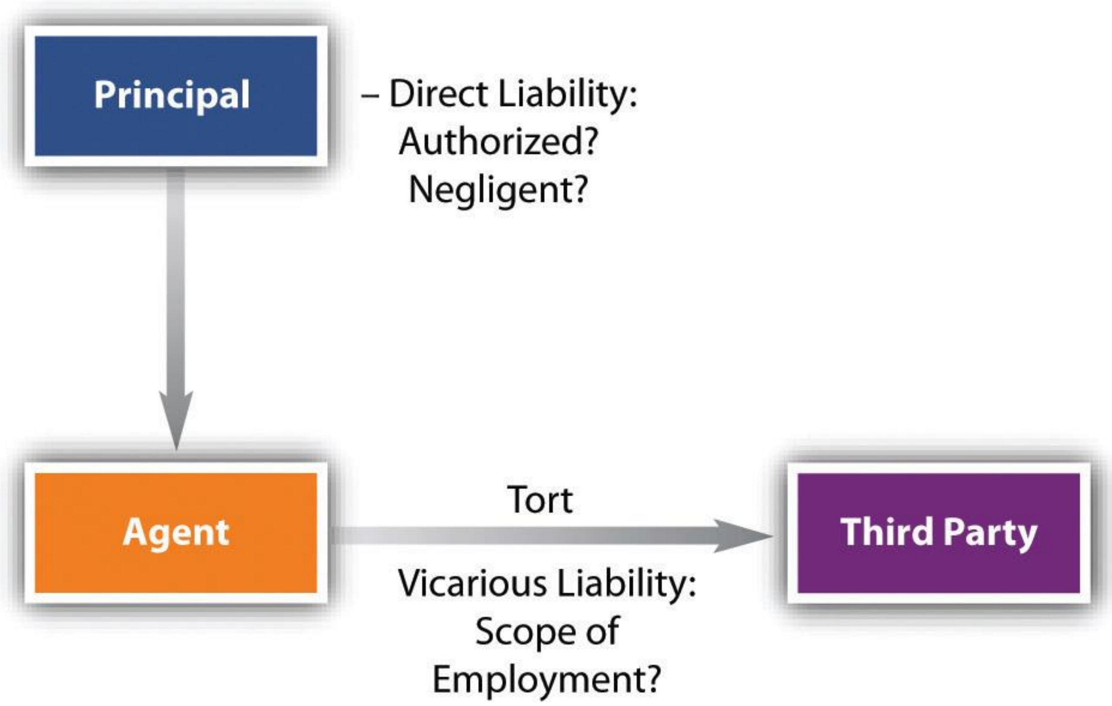

Figure 21 Principal's Tort Liability

The modern basis for vicarious liability is sometimes termed the "deep pocket" theory: the principal (usually a corporation) has deeper pockets than the agent, meaning that it has the wherewithal to pay for the injuries traceable one way or another to events it set in motion. A million-dollar industrial accident is within the means of a company or its insurer; it is usually not within the means of the agent—employee—who caused it.

The "deep pocket" of the defendant-company is not always very deep, however. For many small businesses, in fact, the principle of respondeat superior is one of life or death. One example was the closing in San Francisco of the much-beloved Larraburu Brothers Bakery—at the time, the world's second largest sourdough bread maker. The bakery was held liable for $2 million in damages after one of its delivery trucks injured a six-year-old boy. The bakery's insurance policy had a limit of $1.25 million, and the bakery could not absorb the excess. The Larraburus had no choice but to cease operations. (See http://www.outsidelands.org/larraburu.php.)

Respondeat superior raises three difficult questions: (1) What type of agents can create tort liability for the principal? (2) Is the principal liable for the agent's intentional torts? (3) Was the agent acting within the scope of his employment? We will consider these questions in turn.

Agents for Whom Principals Are Vicariously Liable

In general, the broadest liability is imposed on the master in the case of tortious physical conduct by a servant. If the servant acted within the scope of his employment—that is, if the servant's wrongful conduct occurred while performing his job—the master will be liable to the victim for damages unless, as we have seen, the victim was another employee, in which event the workers' compensation system will be invoked. Vicarious tort liability is primarily a function of the employment relationship and not agency status.

Ordinarily, an individual or a company is not vicariously liable for the tortious acts of independent contractors. The plumber who rushes to a client's house to repair a leak and causes a traffic accident does not subject the homeowner to liability. But there are exceptions to the rule. Generally, these exceptions fall into a category of duties that the law deems nondelegable. In some situations, one person is obligated to provide protection to or care for another. The failure to do so results in liability whether or not the harm befell the other because of an independent contractor's wrongdoing. Thus a homeowner has a duty to ensure that physical conditions in and around the home are not unreasonably dangerous. If the owner hires an independent contracting firm to dig a sewer line and the contractor negligently fails to guard passersby against the danger of falling into an open trench, the homeowner is liable because the duty of care in this instance cannot be delegated. (The contractor is, of course, liable to the homeowner for any damages paid to an injured passerby.)

Liability for Agent's Intentional Torts

In the nineteenth century, a principal was rarely held liable for intentional wrongdoing by the agent if the principal did not command the act complained of. The thought was that one could never infer authority to commit a willfully wrongful act. Today, liability for intentional torts is imputed to the principal if the agent is acting to further the principal's business. See the very disturbing *Lyon v. Carey,* 533 F.2d 649 (Cir. Ct. App. DC 1976). in which the court held the employer (principal) liable for civil damages when employee sexually assaulted customer's sister during a furniture delivery.

Deviations from Employment

The general rule is that a principal is liable for torts only if the servant committed them "in the scope of employment." Restat 3d of Agency § 7.07(1). But determining what this means is not easy.

The "Scope of Employment" Problem

It may be clear that the person causing an injury is the agent of another. But a principal cannot be responsible for every act of an agent. If an employee is following the letter of his instructions, it will be easy to determine liability. But suppose an agent deviates in some way from his job. The classic test of liability was set forth in an 1833 English case, *Joel v. Morrison*. *Joel v. Morrison,* 6 Carrington & Payne 501 (1833). The plaintiff was run over on a highway by a speeding cart and horse. The driver was the employee of another, and inside was a fellow employee. There was no question that the driver had acted carelessly, but what he and his fellow employee were doing on the road where the plaintiff was injured was disputed. For weeks before and after the accident, the cart had never been driven in the vicinity in which the plaintiff was walking, nor did it have any business there. The suggestion was that the employees might have gone out of their way for their own purposes. As the great English jurist Baron Parke put it, "If the servants, being on their master's business, took a detour to call upon a friend, the master will be responsible.…But if he was going on a frolic of his own, without being at all on his master's business, the master will not be liable." In applying this test, the court held the employer liable.

The test is thus one of degree, and it is not always easy to decide when a detour has become so great as to be transformed into a frolic. For a time, a rather mechanical rule was invoked to aid in making the decision. The courts looked to the servant's purposes in "detouring." If the servant's mind was fixed on accomplishing his own purposes, then the detour was held to be outside the scope of employment; hence the tort was not imputed to the master. But if the servant also intended to accomplish his master's purposes during his departure from the letter of his assignment, or if he committed the wrong while returning to his master's task after the completion of his frolic, then the tort was held to be within the scope of employment. "An employee acts within the scope of employment when performing work assigned by the employer or engaging in a course of conduct subject to the employer's control. An employee's act is not within the scope of employment when it occurs within an independent course of conduct not intended by the employee to serve any purpose of the employer." Restat 3d of Agency, § 7.07.

This test is not always easy to apply. If a hungry deliveryman stops at a restaurant outside the normal lunch hour, intending to continue to his next delivery after eating, he is within the scope of employment. But suppose he decides to take the truck home that evening, in violation of rules, in order to get an early start the next morning. Suppose he decides to stop by the beach, which is far away from his route. Does it make a difference if the employer knows that his deliverymen do this? It depends.

The Zone of Risk Test

Court decisions in the last forty years have moved toward a different standard, one that looks to the foreseeability of the agent's conduct. By this standard, an employer may be held liable for his employee's conduct even when devoted entirely to the employee's own purposes, as long as it was foreseeable that the agent might act as he did. This is the "zone of risk" test. The employer will be within the zone of risk for vicarious liability if the employee is where she is supposed to be, doing—more or less—what she is supposed to be doing, and the incident arose from the employee's pursuit of the employer's interest (again, more or less). That is, the employer is within the zone of risk if the servant is in the place within which, if the master were to send out a search party to find a missing employee, it would be reasonable to look. See *Cockrell v. Pearl River Valley Water Supply Dist.,* 865 So. 2d 357 (Miss. 2004).

Other Torts Governed by Statute or Regulation

There are certain types of conduct that statutes or regulation attempt to control by placing the burden of liability on those presumably in a position to prevent the unwanted conduct. An example is the "Dramshop Act," which in many states (about 22) subject the owner of a bar to liability if the bar continues to serve an intoxicated patron who later is involved in an accident while intoxicated. As noted, not all states have Dramshop Acts (only about 22); Maryland does not. See Warr v. JMGM Group, LLC, 433 Md. 170, 70 A.3d 347 (2013). Another example involves the sale of adulterated or short-weight foodstuffs: the employer of one who sells such may be liable, even if the employer did not know of the sales.

Principal's Criminal Liability

As a general proposition, a principal will not be held liable for an agent's unauthorized criminal acts if the crimes are those requiring specific intent. Thus a department store proprietor who tells his chief buyer to get the "best deal possible" on next fall's fashions is not liable if the buyer steals clothes from the manufacturer. A principal will, however, be liable if the principal directed, approved, or participated in the crime. Cases here involve, for example, a corporate principal's liability for agents' activity in antitrust violations—price-fixing is one such violation.

There is a narrow exception to the broad policy of immunity. Courts have ruled that under certain regulatory statutes and regulations, an agent's criminality may be imputed to the principal, just as civil liability is imputed under Dramshop Acts. These include pure food and drug acts, speeding ordinances, building regulations, child labor rules, and minimum wage and maximum hour legislation. Misdemeanor criminal liability may be imposed upon corporations and individual employees for the sale or shipment of adulterated food in interstate commerce, notwithstanding the fact that the defendant may have had no actual knowledge that the food was adulterated at the time the sale or shipment was made.

E. Terminating the Agency Relationship

The agency relationship is not permanent. Either by action of the parties or by law, the relationship will eventually terminate.

By Act of the Parties

Certainly the parties to an agency contract can terminate the agreement. As with the creation of the relationship, the agreement may be terminated either expressly or implicitly.

Express Termination

Many agreements contain specified circumstances whose occurrence signals the end of the agency. The most obvious of these circumstances is the expiration of a fixed period of time ("agency to terminate at the end of three months" or "on midnight, December 31"). An agreement may also terminate on the accomplishment of a specified act ("on the sale of the house") or following a specific event ("at the conclusion of the last horse race").

Mutual consent between the parties will end the agency. Restat 3d of Agency § 3.09. Moreover, the principal may revoke the agency or the agent may renounce it; such a revocation or renunciation of agency would be an express termination. *See Bucholtz v. Bert Goodman Signs, Inc.*, 234 Md. 471, 199 A.2d 915 (1964).

Even a contract that states the agreement is irrevocable will not be binding, although it can be the basis for a damage suit against the one who breached the agreement by revoking or renouncing it. As with any contract, a person has the power to breach, even in absence of the right to do so. If the agency is coupled with an interest, however, so that the authority to act is given to secure an interest that the agent has in the subject matter of the agency, then the principal lacks the power to revoke the agreement prior to its natural or contractual termination.

Implied Termination

There are a number of other circumstances that will spell the end of the relationship by implication. Unspecified events or changes in business conditions or the value of the subject matter of the agency might lead to a reasonable inference that the agency should be terminated or suspended, or "upon the occurrence of circumstances on the basis of which the agent should reasonably conclude that the principal no longer would assent to the agent's taking action on the principal's behalf." Restat 3d of Agency, § 3.09.

For example, the principal desires the agent to buy silver but the silver market unexpectedly rises and silver doubles in price overnight. Other circumstances that end the agency include disloyalty of the agent (e.g., he accepts an appointment that is adverse to his first principal or embezzles from the principal), bankruptcy of the agent or of the principal, the outbreak of war (if it is reasonable to infer that the principal, knowing of the war, would not want the agent to continue to exercise authority), and a change in the law that makes a continued carrying out of the task illegal or seriously interferes with it.

By Operation of Law

Aside from the express termination (by agreement of both or upon the insistence of one), or the necessary or reasonable inferences that can be drawn from their agreements, the law voids agencies under certain circumstances. The most frequent termination by operation of law is the death of a principal or an agent. *See Rosebrook v. Eastern Shore Emergency Physicians*, LLC, 221 Md. App. 1, 108 A.2d 423 (2015). The death of an agent also terminates the authority of subagents he appointed, unless the principal expressly consented to the continuing validity of their appointment. Similarly, if the agent or principal loses capacity to enter into an agency relationship, it is suspended or terminated. And, the agency terminates if its purpose becomes illegal.

Even though authority terminated, whether by action of the parties or operation of law, the principal may still be subject to liability. Apparent authority in many instances will still exist; this is called lingering authority. Restat 3d of Agency § 3.11. It is imperative for a principal on termination of authority to notify all those who may still be in a position to deal with the agent. The only exceptions to this requirement are when termination is effected by death, loss of the principal's capacity, or an event that would make it impossible to carry out the object of the agency.

Business Ethics

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

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

In talking about morality, we often use the word *good*; but that word can be confusing. If we say that Microsoft is a "good company," we may be making a statement about the investment potential of Microsoft stock, or their preeminence in the market, or their ability to win lawsuits or appeals or to influence administrative agencies. Less likely, though possibly, we may be making a statement about the civic virtue and corporate social responsibility of Microsoft. In the first set of judgments, we use the word *good* but mean something other than ethical or moral; only in the second instance are we using the word *good* in its ethical or moral sense.

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

There are three key points here:

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

Here is a cautionary note: for individuals, it is far from easy to recognize an ethical problem, have a clear and usable decision-making process to deal with it, and then have the moral courage to do what's right. All of that is even more difficult within a business organization, where corporate employees vary in their motivations, loyalties, commitments, and character. There is no universally accepted way for developing an organization where employees feel valued, respected, and free to openly disagree; where the actions of top management are crystal clear; and where all the employees feel loyal and accountable to one another.
Before talking about how ethics relates to law, we can conclude that ethics is the study of morality—"right" and "wrong"—in the context of everyday life, organizational behaviors, and even how society operates and is governed.

How Do Law and Ethics Differ?

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

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

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

Individuals and organizations have reputations. (For an individual, moral reputation is most often tied to others' perceptions of his or her character: is the individual honest, diligent, reliable, fair, and caring? The reputation of an organization is built on the goodwill that suppliers, customers, the community, and employees feel toward it. Although an organization is not a person in the usual sense, the goodwill that people feel about the organization is based on their perception of its better qualities by a variety of stakeholders: customers or clients, suppliers, investors, employees, government officials.

The goodwill of an organization is to a great extent based on the actions it takes and on whether the actions are favorably viewed. (This goodwill is usually specifically counted in the sale of a business as an asset that the buyer pays. While it is difficult to place a monetary value on goodwill, a firm's good reputation will generally call for a higher evaluation in the final accounting before the sale. Legal troubles or a reputation for having legal troubles will only lessen the price for a business and will even lessen the value of the company's stock as bad legal news comes to the public's attention.) Another reason to think about ethics in connection with law is that the laws themselves are meant to express some moral view. If there are legal prohibitions against cheating the Medicare program, it is because people (legislators or their agents) have collectively decided that cheating Medicare is wrong. If there are legal prohibitions against assisting someone to commit suicide, it is because there has been a group decision that doing so is immoral. Thus the law provides some important cues as to what society regards as right or wrong.

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

Why Should an Individual or a Business Entity Be Ethical?

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

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

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

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

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

Captive Customers

Ann Marie Wagoner studies at the University of Alabama (UA). She pays $1,200 a year for books, which is exasperating, but what really ticks her off is the text for her composition class. Called *A Writer's Reference (Custom Publication for the University of Alabama)*, it's the same *Writer's Reference* sold everywhere else, with slight modifications: there are thirty-two extra pages describing the school's particular writing program, the Alabama *A* is emblazoned on the front cover, there's an extra $6 on the price tag (compared with the price of the standard version when purchased new), and there's an added sentence on the back: "This book may not be bought or sold used." The modifications are a collective budget wrecker. Because she's forced to buy a new copy of the customized Alabama text, she ends up paying about twice what she'd pay for a used copy of the standard, not-customized book that's available at Chegg.com and similar used-book dealers.

For the extra money, Wagoner doesn't get much—a few additional text pages and a school spirit cover. Worse, those extra pages are posted free on the English department's website, so the cover's the only unambiguous benefit. Even there, though, it'd be cheaper to just buy a UA bumper sticker and paste it across the front. It's hard to see, finally, any good reason for the University of Alabama English Department to snare its own students with a textbook costing so much.

Things clear up when you look closely at the six-dollar difference between the standard new book cost and the customized UA version. Only half that money stays with the publisher to cover specialized printing costs. The other part kicks back to the university's writing program, the one requiring the book in the first place. It turns out there's a quiet moneymaking scheme at work here: the English department gets some straight revenue, and most students, busy with their lives, don't notice the royalty details. They get their books, roll their eyes at the cash register, and get on with things.

Wagoner noticed, though. According to an extensive article in the *Wall Street Journal*, she calls the cost of new custom books "ridiculous." She's also more than a little suspicious about why students aren't more openly informed about the royalty arrangement: "They're hiding it so there isn't a huge uproar."John Hechinger, "As Textbooks Go 'Custom,' Students Pay: Colleges Receive Royalties for School-Specific Editions; Barrier to Secondhand Sales," *Wall Street Journal*, July 10, 2008, accessed May 11, 2011, http://online.wsj.com/article/SB121565135185141235.html.

While it may be true that the Tuscaloosa university is hiding what's going on, they're definitely not doing a very good job since the story ended up splattered across the *Wall Street Journal*. One reason the story reached one of the United States' largest circulation dailies is that a lot of universities are starting to get in on the cash. Printing textbooks within the kickback model is, according to the article, the fastest growing slice of the $3.5 billion college textbook market.

The money's there, but not everyone is eager to grab it. James Koch, an economist and former president of Old Dominion University and the University of Montana, advises schools to think carefully before tapping into customized-textbook dollars because, he says, the whole idea "treads right on the edge of what I would call unethical behavior. I'm not sure it passes the smell test" (Hechinger).

What Is Business Ethics?

What does it mean to say a business practice doesn't "pass the smell test"? And what would happen if someone read the article and said, "Well, to me it smells all right"? If no substance fills out the idea, if there's no elaboration, then there probably wouldn't be much more to say. The two would agree to disagree and move on. Normally, that's OK; no one has time to debate everything. But if you want to get involved—if you're like Wagoner, who sounds angry about what's going on and maybe wants to change it—you'll need to do more than make comments about how things hit the nose.

Doing *business ethics* means providing reasons for how things ought to be in the economic world. This requires the following:

- ***Arranging values to guide decisions.*** There needs to be a clearly defined and well-justified set of priorities about what's worth seeking and protecting and what other things we're willing to compromise or give up. For example, what's more important and valuable: consumers (in this case students paying for an education) getting their books cheaply or protecting the right of the university to run the business side of its operation as it sees fit?
- ***Understanding the facts.*** To effectively apply a set of values to any situation, the situation itself must be carefully defined. Who, for example, is involved in the textbook conflict? Students, clearly, as well as university administrators. What about parents who frequently subsidize their college children? Are they participants or just spectators? What about those childless men and women in Alabama whose taxes go to the university? Are *they* involved? And how much money are we talking about? Where does it go? Why? How and when did all this get started?
- ***Constructing arguments.*** This shows how, given the facts, one action serves our values better than other actions. While the complexities of real life frequently disallow absolute proofs, there remains an absolute requirement of comprehensible reasoning. Arguments need to make sense to outside observers. In simple, practical terms, the test of an ethical argument resembles the test of a recipe for a cook: others need to be able to follow it and come to the same result. There may remain disagreements about facts and values at the end of an argument in ethics, but others need to understand the reasoning marking each step taken on the way to your conclusion.

Finally, the last word in ethics is a determination about right and wrong. This actual result, however, is secondary to the process: the verdict is only the remainder of forming and debating arguments. That's why doing ethics isn't brainwashing. Conclusions are only taken seriously if composed from clear values, recognized facts, and solid arguments.

Bringing Ethics to Kickback Textbooks

The *Wall Street Journal* article on textbooks and kickbacks to the university is a mix of facts, values, and arguments. They can be sorted out; an opportunity to do the sorting is provided by one of the article's more direct assertions: Royalty arrangements involving specially made books may violate colleges' conflict-of-interest rules because they appear to benefit universities more than students.

A conflict of interest occurs when a university pledges to serve the interest of students but finds that *its own* interest is served by not doing that. It doesn't sound like this is a good thing (in the language of the article, it smells bad). But to reach that conclusion in ethical terms, the specific values, facts, and arguments surrounding this conflict need to be defined.

Start with the values. The priorities and convictions underneath the conflict-of-interest accusation are clear. When a university takes tuition money from a student and promises to do the best job possible in providing an education to the student, then it better *do* that. The truth matters. When you make a promise, you've got to fulfill it. Now, this fundamental value is what makes a conflict of interest worrisome. If we didn't care about the truth at all, then a university promising one thing and doing something else wouldn't seem objectionable. In the world of poker, for example, when a player makes a grand show of holding a strong hand by betting a pile of chips, no one calls him a liar when it's later revealed that the hand was weak. The truth isn't expected in poker, and bluffing is perfectly acceptable. Universities aren't poker tables, though. Many students come to school expecting honesty from their institution and fidelity to agreements. To the extent these values are applied, a conflict of interest becomes both possible and objectionable.

With the core value of honesty established, what are the facts? The "who's involved?" question brings in the students buying the textbooks, the company making the textbooks (Bedford/St. Martin's in Boston), and the University of Alabama. As drawn from the UA web page, here's the school's purpose, the reason it exists in the first place: "The University of Alabama is a student-centered research university and an academic community united in its commitment to enhancing the quality of life for all Alabamians." Moving to the financial side, specific dollar amounts should be listed (the textbook's cost, the cost for the non-customized version). Also, it may be important to note the financial context of those involved: in the case of the students, some are comfortably wealthy or have parents paying for everything, while others live closer to their bank account's edge and are working their way through school.

Finally, the actual book-selling operation should be clearly described. In essence, what's going on is that the UA English Department is making a deal with the Bedford/St. Martin's textbook company. The university proposes, "If you give us a cut of the money you make selling textbooks, we'll let you make more money off our students." Because the textbooks are customized, the price goes up while the supply of cheap used copies (that usually can be purchased through the Internet from stores across the nation) goes way down. It's much harder for UA students to find used copies, forcing many to buy a new version. This is a huge windfall for Bedford/St. Martin's because, for them, every time a textbook is resold used, they lose a sale. On the other side, students end up shelling out the maximum money for each book because they have to buy new instead of just recycling someone else's from the previous year. Finally, at the end of the line there is the enabler of this operation, the English department that both requires the book for a class and has the book customized to reduce used-copy sales. They get a small percentage of Bedford/St. Martin's extra revenue.

With values and facts established, an argument against kickback textbooks at Alabama can be drawn up. By customizing texts and making them mandatory, UA is forcing students to pay extra money to take a class: they have to spend about thirty dollars extra, which is the difference between the cost of a new, customized textbook and the standard version purchased used. Students generally don't have a lot of money, and while some pass through school on the parental scholarship, others scrape by and have to work a McJob to make ends meet. So for at least some students, that thirty dollars directly equals time that could be spent studying, but that instead goes to flipping burgers. The customized textbooks, consequently, hurt these students' academic learning in a measurable way. Against that reality there's the university's own claim to be a "student-centered" institution. Those words appear untrue, however, if the university is dragging its own students out of the library and forcing them to work extra hours. To comply with its own stated ideals—to serve the *students'* interests—UA should suspend the kickback textbook practice. It's important to do that, finally, because fulfilling promises is valuable; it's something worth doing.

Argument and Counterargument

The conclusion that kickback textbooks turn universities into liars doesn't end debate on the question. In fact, because well developed ethical positions expose their reasoning so openly (as opposed to "it doesn't smell right"), they tend to invite responses. One characteristic, in other words, of good ethical arguments is that, paradoxically but not contradictorily, they tend to provoke counterarguments.

Broadly, there are three ways to dispute an argument in ethics. You can attack the facts, values, and reasoning. In the textbook case, disputing the facts might involve showing that students who need to work a few extra hours to afford their books *don't* subtract that time from their studying; actually, they subtract it from late-night hours pounding beers in dank campus bars. The academic damage done, therefore, by kickback textbooks is zero. Pressing this further, if it's true that increased textbook prices translate into less student partying, the case could probably be made that the university actually serves students' interests—at least those who drink too much beer—by jacking up the prices.

The values supporting an argument about kickback textbooks may, like the facts, be disputed. Virginia Tech, for example, runs a text-customization program like Alabama's. According to Tech's English Department chair Carolyn Rude, the customized books published by Pearson net the department about $20,000 a year. Some of that cash goes to pay for instructors' travel stipends. These aren't luxury retreats to Las Vegas or Miami; they're gatherings of earnest professors in dull places for discussions that reliably put a few listeners to sleep. When instructors—who are frequently graduate students—attend, they're looking to burnish their curriculum vitae (aka resumes) and get some public responses to their work. Possibly, the trip will help them get a better academic job later on. Regardless, it won't do much for the undergraduates at Virginia Tech. In essence, the undergrads are being asked to pay a bit extra for books to help graduate students hone their ideas and advance professionally.

Can that tradeoff be justified? With the right values, yes. It must be conceded that Virginia Tech is probably rupturing a commitment to serve the undergrads' interest. Therefore, it's true that a certain amount of dishonesty shadows the process of inflating textbook costs. If, however, there's a higher value than truth, that won't matter so much. Take this possibility: what's right and wrong isn't determined by honesty and fidelity to commitments, but the general welfare. The argument here is that while it's true that undergrads suffer a bit because they pay extra, the instructors receiving the travel stipends benefit a lot. Their knowledge grows, their career prospects improve, and in sum, they benefit so much that it entirely outweighs the harm done to the undergrads. As long as this value—the greatest total good—frames the assessment of kickback textbooks, the way is clear for Tech or Alabama to continue the practice. It's even recommendable.

The final ground on which an ethical argument can be refuted is the reasoning. Here, the facts are accepted, as well as the value that universities are duty bound to serve the interests of the tuition-paying undergraduate students since that's the commitment they make on their web pages. What can still be debated, however, is the extent to which those students may actually *be* benefitted by customizing textbooks. Looking at the *Wall Street Journal* article, several partially developed arguments are presented on this front. For example, at Alabama, part of the money collected from the customized texts underwrites teaching awards, and that, presumably, motivates instructors to perform better in the classroom, which ends up serving the students' educational interests. Similarly, at Virginia Tech, part of the revenue is apportioned to bring in guest speakers, which should advance the undergraduate educational cause. The broader argument is that while it's true that the students are paying more for their books than peers at other universities, the sequence of reasoning doesn't necessarily lead from that fact to the conclusion that there's a reproachable conflict of interest. It can also reach the verdict that students' educational experience is improved; instead of a conflict of interest, there's an elevated commitment to student welfare inherent in the kickback practice.

Conclusion. There's no irrefutable answer to the question about whether universities ought to get involved in kickback textbooks. What is clear, however, is that there's a difference between responding to them by asserting that something doesn't smell right, and responding by uniting facts, values, and reasoning to produce a substantial ethical argument.

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A. Ends v. Means

In business ethics, do the means justify the ends, or do the ends justify the means? Is it better to have a set of rules telling you what you ought to do in any particular situation and then let the chips fall where they may, or should you worry more about how things are going to end up and do whatever's necessary to reach that goal?

Eddy Lepp ran an organic medicine business in Northern California. His herbal product soothed nausea and remedied vomiting, especially as suffered by chemo patients. He had a problem, though. While his business had been OK'd by California regulators, federal agencies hadn't approved: on the national level, selling his drug was breaking the law. On the other hand, *not* selling his remedy had a significant downside: it was consigning his clients to debilitating suffering. So when federal agents came knocking on his door, he had to make a decision.

If the means justify the ends—if you should follow the rules no matter the consequences—then when the agents ask Lepp point blank whether he's selling the medicine, the ethical action is to admit it. He should tell the truth even though that will mean the end of his business. On the other hand, if the ends justify the means—if your ethical interest focuses on the consequences of an act instead of what you actually do— then the ethics change. If there's a law forcing people to suffer unnecessarily, it should be broken. And when the agents ask him whether he's selling, he's going to have an ethical reason to lie.

Across the entire field of traditional ethics, this is a foundational distinction. Is it what you do that matters, or the consequences? It's hard to get oriented in ethics without making a preliminary decision between these two. No one can make the decision for you, but before anyone can make it, an understanding of how each works should be reached.

B. Rights Theories

An ethics based on rights is similar to an ethics based on duties, which we will cover later. In both cases specific principles provide ethical guidance for your acts, and those principles are to be obeyed regardless of the consequences further down the line. Unlike duties, however, rights-based ethics concentrate their force in delineating your possibilities. The question isn't so much *What are you morally required to do*; it's more about defining exactly where and when you're free to do whatever you want and then deciding where you need to stop and make room for other people to be free too. Stated slightly differently, ***duties tend to be ethics as what you can't do, and rights tend to be about what you can do.***

My Property, My Religion, My Nonprofit Organization, My Health Care, My Grass

Let's look at Eddy Lepp again. Charles Edward "Eddy" Lepp is in jail now, in a prison not too far away from the site of the business that got him in trouble: Eddy's Medicinal Gardens and Ministry. What was Eddy Lepp, the gardener and minister, up to on his twenty-acre property near a lake in California, about a hundred miles north from San Francisco? Here are the highlights:

- **Ministry.** Lepp claims—and there doesn't seem to be anyone who disputes him—that he's an authentic Rastafarian reverend.
- **Rastafarianism.** Developed over the last century in Africa and the Caribbean, the religion works within the basic structure of Christianity but contains important innovations. Haile Selassie I was the emperor of Ethiopia from 1930 to 1974 and, according to the faith, was also the reincarnation of Jesus Christ. Further, marijuana—called *ganja* by believers—accompanies religious meetings and ceremonies; it brings adherents closer to God.
- **Lepp's Medicinal Gardens.** In fact, this wasn't a garden so much as a collective farm. Lepp oversaw the work of volunteers—their numbers totaling about two hundred—and did some harvesting and planting himself. Many of the farm's marijuana leaves were smoked by the 2,500 members of his zonked-out church as part of Rastafarian celebrations and meetings, and the rest was, according to Lepp, distributed to individuals with serious health problems.
- **Marijuana and health care.** Studies indicate that in some patients marijuana may alleviate nausea and vomiting, especially as connected with chemotherapy. There's also a list of further symptoms and maladies the drug could relieve, according to some evidence. It should be noted here that many suspect the persons conducting these studies (not to mention the patients receiving the testing) are favorably predisposed toward marijuana in the first place, and the prejudice may contaminate conclusions. What's certain is that from a strictly medical perspective, the question about marijuana's utility remains controversial. Among those who are convinced, however, smoking is a good remedy. That's why in California patients have been granted a legal right to possess and use marijuana medicinally, as long as they've got a doctor's approval. Unfortunately for Lepp, California law can't bar federal prosecutions, and it was the US Drug Enforcement Administration from all the way out in Washington, DC, that eventually came after him. (Egelko and Larson)

Nearing 70 and out of prison since 2016, Eddy Lepp is one of those guys who never really left Woodstock. Before being incarcerated, he slumped around in tie-dyes and jeans. He liked wearing a hat emblazoned with the marijuana leaf. Out on his semirural farm, he passed the days smoking joints and listening to Bob Marley music. Everyone seems to like Eddy. A longtime activist for the legalization of marijuana, he's even something of a folk hero in Northern California. At his sentencing, the crowd (chanting "free Eddy!") spilled out into the courthouse hallways. The judge didn't seem to mind the spectacle, and she went out of her way to say she didn't want to hit him with ten years of jail time, but federal guidelines gave her no choice.

What's a Right?

One definition of a **right** in ethics is *a justified claim against others*. I have the right to launch a gardening business or a church enterprise or both on my property, and you're not allowed to simply storm in and ruin things. You do have the right, however, to produce *your own* garden company and church on your property. On my side, I have the right to free speech, to say whatever I want no matter how outrageous and you can't stop me. You can, however, say whatever you want, too; you can respond to my words with whatever comes into your head or just ignore me completely. A right, in sum, is something you may do if you wish, and others are morally obligated to permit your action.

Duties tend to be *protective* in nature; they're about assuring that people aren't mistreated. Rights are the flip side; they're *liberating* in nature, they're about assuring that you're as free as possible. Because rights theory maximizes choices in the name of ethics, it's not surprising that Lepp built his court defense on that ground. Lepp fought the law by maintaining that his medical gardens business and church operations involved *his* land and *his* religion. It wasn't that he had a right to grow pot or pray to a specific God; that had nothing to do with it. The point is he had a right *to do whatever* he wanted on that land, and *believe in whatever* he wanted in his mind. That's what rights are about. As opposed to duties that fix on specific acts, rights ethics declares that there are places (like my land) where the acts don't matter. As long as no one else's rights are being infringed on, I'm free.

Finally, duties tend to be community oriented: they're about how we get along with others. Rights tend to center on the individual and what he or she can do regardless of whether anyone else is around or not.

What Are the Characteristics of Rights?

English philosopher John Locke (1632–1704) maintained that rights are

- **Universal.** The fundamental rights don't transform as you move from place to place or change with the years.
- **Equal.** They're the same for all, men and women, young and old.
- **Inalienable.** They can't be taken, they can't be sold, and they can't be given away. We can't *not* have them. This leads to a curious paradox at the heart of rights theory. Freedom is a bedrock right, but we're *not* free to sell ourselves into slavery. We can't because freedom is the *way* we are; since freedom is part of my essence, it can't go away without me disappearing too.

What Rights Do I Have?

The right to life is just what it sounds like: Lepp, you, and I should be able to go through our days without worrying about someone terminating our existence. This right is so deeply embedded in our culture that it almost seems unnecessary to state, but we don't need to stretch too far away from our time and place to find scenes of the right's trampling. Between the world wars, Ukraine struggled for independence from Joseph Stalin's neighboring Russia. Stalin sealed the borders and sent troops to destroy all food in the country. Millions died from starvation. Less dramatically but more contemporaneously, the right to life is cited as an argument against capital punishment.

The right to freedom guarantees individuals that they may do as they please, assuming their actions don't encroach on the freedom of others. In a business environment, this assures entrepreneurs like Lepp may mount whatever business operation they choose. Lepp's garden and ministry were surely unorthodox, but that can't be a reason for its prohibition. Similarly, *within* a company, the right to freedom protects individuals against abuse. No boss can demand more from an employee than what that employee freely agreed—frequently through a signed contract—to provide.

From the right to freedom, other rights seem to derive naturally. The right to free speech is tremendously important in the commercial world. Lepp's messages to his Rasta flock may have provoked skepticism in some listeners, but no one doubts that he had a right to voice his ideas. The right to religious expression also follows from basic freedom. It guaranteed Lepp the space he needed to pioneer his particular brand of gardening Rastafarianism in Northern California. His is, obviously, a weird case, but the right works in more traditional workplaces, too. Emily Bazar (2008) reported a case where Muslim workers were fired from their jobs in several meatpacking plants in the Midwest because they left the production line in the middle of the day without authorization to go outside and pray. The workers' response? They filed a lawsuit claiming their right to religious expression had been violated.

No doubt it had been. But the company's response is also weighty. According to the article, "The problem with the Muslim prayer request is that it's not one day or annual, it's every day and multiple times. Further, those times shift over the course of the year based on the sun's position." (Bazar)

The result, according to the company, is that scheduling becomes very difficult, and those who aren't Muslim find it nearly impossible to keep working when they're getting abandoned so frequently during the day. Here we're confronted with a very basic conflict of rights. While no one doubts that freedom exists to practice a religion, isn't it also true that the company—or the company owners if we want to cast this in personal terms—have a right to set up a business in whatever manner they choose, with breaks scheduled for certain times and worker responsibilities strictly defined? In the end, the question about Muslim workers leaving the work floor to pray isn't about one *kind* of religion or another; it's not Christians against Muslims or something similar. The question is about which right takes precedence: the owners' right to set up and run a company as they wish or the employees' right to express their beliefs how and when they choose.

From an ethical perspective—which doesn't necessarily correlate with a legal one—the resolution to this dilemma and any clash about conflicting rights runs through the question of whether there's a way to protect the basic rights of *both* groups. It runs that way because rights are fundamentally about that, about maximizing freedom. In this case, it seems that firing the workers *does* achieve that goal. The owners' initiative inside their company is protected, and the workers are now able to pray when they desire.

To be sure, other ethical approaches will yield different outcomes, but in the midst of rights theory where individual liberty is the guiding rule and the maximization of freedom is the overriding goal, it's difficult for other concerns to get traction. So it may be that the *community as a whole* is better served by looking for a solution that allows Muslims to maintain their prayer schedule *while also* allowing the plant to continue functioning in a normal way. Even if that's true, however, it's not going to affect a rights-theory resolution very much because this kind of ethics privileges what *you* and *I* can do over what *we* can do together. It's an ethics of individualism.

The right to pursue happiness sits beside the right to life and the right to freedom at the foundation of rights ethics. The pursuit gives final direction and meaning to the broad theory. Here's how: it doesn't do much good to be alive if you're not free, so freedom orients the right to life. It also doesn't do much good to be free if you can't pursue happiness, so the right to pursue happiness orients freedom. That's the organizing reasoning of ethical rights; it's how the theory holds together. This reasoning leaves behind, however, the difficult question as to exactly where the pursuit of happiness leads.

Rights in Conflict

The deepest internal problems with rights ethics arise when rights conflict. Abortion is a quick, hot-button example. On one side (pro-life), support comes from the initial principle: a human being, born or not, has a right to life, which may not be breached. On the other side (pro-choice), every person's original freedom over themselves and their bodies ends all discussion. Now, one of the reasons this debate is so intractable is that both sides find equally strong support *within the same basic ethical framework*. There's no way to decide without infringing on one right or the other.

A complementary case arose around Lepp's Rasta religious gatherings. Though many of his neighbors didn't care, there were a few who objected to having what were essentially mini-Woodstocks on the land next door. It was impossible, of course, for Lepp to entirely contain the noise, the smoke from fires, the traffic congestion, and the rest entirely on his property. The question is, when does my right to do what I want on my land need to be curtailed so that your right to dominion over yours isn't soiled?

Broadening further, there's the question about Lepp growing marijuana for medicinal purposes. On one side, a rights theory supports his inclination to grow what he wants on his land and sell the fruits of his labors to other adults for their consenting use. His is a farming business like any other. But on the other side, a theory of rights can extend into the realm of positive requirements. The right to the pursuit of happiness implies a right to health, and this may require government oversight of medical products so that society as a whole may be protected from fraudulent claims or harmful substances. The question of marijuana shoots up right here. What happens when socially sanctioned entities like the US Food and Drug Administration decide that marijuana is harmful and should therefore be prohibited? Which rights trump the others, the negative right to freedom or the positive right to oversee medical substances?

Examples multiply easily. I have the right to free speech, but if I falsely yell "fire!" in a crowded theater and set off a life-threatening stampede, what's happening to everyone else's negative right to life and positive right to health?

What Justifies a Right?

One justification for an ethics of rights is comparable with the earlier-noted idea about duties being part of the logic of the universe. Both duties and rights exist because that's the way things *are* in the moral world. Just like the laws of physics tell us how far a ball will fly when thrown at a certain speed, so too the rules of rights tell us what ought to happen and not happen in ethical reality. The English philosopher John Locke subscribed to this view when he called our rights "natural." He meant that they're part of who we are and what we do and just by living we incarnate them.

Another justification for an ethics of rights is to derive them from the idea of duties. Kant reappears here, especially his imperative to treat others as ends and not as means to ends. If we *are* ends in ourselves, if we possess basic dignity, then that dignity must be reflected somehow: it must have some content, some meaning, and the case can be made that the content is our possession of certain autonomous rights.

Advantages and Drawbacks of an Ethics Based on Rights

Because of its emphasis on individual liberties, rights theory is very attractive to open-roaders and individualists. One of the central advantages of a rights ethics is that it clears a broad space for you and me and everyone else to be ourselves or make ourselves in any way we choose. On the other side of that strength, however, there's a disadvantage: centering ethics on the individual leaves little space of agreement about how we can live together. An ethics of rights doesn't do a lot to help us resolve our differences, it does little to promote tolerance, and it offers few guarantees that if I do something beneficial for you now, you'll do something beneficial for me later on.

Another strong advantage associated with an ethics of rights is simplicity in the sense that basic rights are fairly easy to understand and apply. The problem, however, with these blunt and comprehensible rights comes when two or more of them conflict. In those circumstances it's hard to know which rights trump the others. In the case of Lepp's business—the Medicinal Gardens—it's hard to be sure when his use of his land infringed on the rights of neighbors to enjoy their land, and it's difficult to know when the health product he offered—marijuana—should be prohibited in the name of the larger right to health for all individuals in a society. Most generally, it's difficult to adjudicate between claims of freedom: where does mine stop and yours begin?

C. Duty-Based Ethics

"Should I steal that?" "No, stealing's wrong." Basic ethics.

There are things that are right and others that are wrong, and the discussion ends. This level of clarity and solidity is the main strength of an ethics based on duties. We all have a duty not to steal, so we shouldn't do it. More broadly, when we're making moral decisions, the key to deciding well is understanding what our duties are and obeying them. An ethics based on duties is one where certain rules tell us what we ought to do, and it's our responsibility to know and follow those rules.

The Madoff Family

If we're supposed to obey our duties, then what exactly *are* they? That's a question Andrew Madoff faced in December 2008 when he learned that some—maybe most, maybe all—of the money he and his family had been donating to the charitable Lymphoma Research Foundation and similar medical investigation enterprises was, in fact, stolen.

It was big money—in the millions—channeled to dedicated researchers hot on the trail of a remedy for lymphoma, a deadly cancer. Andrew, it should be noted, wasn't only a cancer altruist; he was also a victim, and the charitable money started flowing to the researchers soon after he was diagnosed. It's unclear whether Andrew knew the money was stolen, but there's no doubt that his dad did. Dad— Bernard "Bernie" Madoff—was the one who took it. This was the largest Ponzi scheme in history. A Ponzi scheme—named after the famous perpetrator Charles Ponzi—makes suckers of investors by briefly delivering artificially high returns on their money. The idea is simple: You take $100 from client A, promising to invest the money cleverly and get a massive profit. You spend $50 on yourself, and at the end of the year, you send the other $50 back to the client along with a note saying that the original $100 investment is getting *excellent* results and another $50 should come in next year and every year from then on. Happy client A recommends friends, who become clients B, C, and D. They bring in a total of $300, so it's easy to make good on the original promise to send a $50 return the next year to client A. And you've now got $250 remaining from these three new clients, $150 of which you will soon return to them ($50 for each of the three new clients), leaving you with $100 to spend on yourself. The process repeats, and it's not long before people are lining up to hand over their money. Everyone makes off like bandits.

Bandit is the right term for Madoff, who ran his Ponzi empire for around fifteen years. So many people handed over so much cash, and the paper trail of fake stock-purchase receipts and the rest grew so complicated that it's impossible to determine exact numbers of victims and losses. Federal authorities have estimated the victims were around five thousand and the losses around $65 billion, which works out to about $13 million squeezed from each client.

Madoff had, obviously, rich clients. He met them at his home in New York City; at his mansion in hyperwealthy Palm Beach, Florida; or on his fifty-five-foot yacht cleverly named *Bull*. He impressed them with a calm demeanor and serious knowledge. While it's true that he was mostly taking clients' money and sticking it in his wallet, the investments he *claimed* to engineer were actually quite sophisticated; they had to do with buying stock in tandem with options to buy and sell that same stock on the futures market. He threw in technical words like "put" and "call" and left everyone thinking he was either crazy or a genius. Since he was apparently making money, "genius" seemed the more likely reality. People also found him trustworthy. He sat on the boards of several Wall Street professional organizations and was known on the charity circuit as a generous benefactor. Health research was a favorite, especially after Andrew's cancer was diagnosed.

Exactly how much money Madoff channeled to Andrew and other family members isn't clear. By late 2008, however, Andrew knew that his father's investment company had hit a rough patch. The stock market was crashing, investors wanted their money back, and Madoff was having trouble rounding up the cash, which explains why Andrew was surprised when his father called him in and said he'd decided to distribute about $200 million in bonuses to family members and employees.

It didn't make sense. How could there be a cash-flow crisis but still enough cash to pay out giant bonuses? The blunt question—according to the Madoff family—broke Madoff down. He spilled the truth: there was little money left; it was all a giant lie. The next day, Andrew reported the situation to the authorities.

Madoff pled guilty in 2009 to multiple counts of money laundering, securities fraud, and other felonies. He was sentenced to 150 years in jail. He died in prison on April 14, 2021 after serving just 12 years. Madoff claimed his scheme was his project alone and his children had no knowledge or participation in it, despite the fact that they were high-level executives in his fraudulent company. Stubbornly, he refused to cooperate with prosecutors interested in determining the extent to which the children may have been involved. His estate was seized. His wife, though, was left with a small sum—$2.5 million—to meet her day-to-day living expenses. Bilked investors got nearly nothing.

What Do I Owe Myself? Historically Accumulated Duties to the Self

Over centuries of thought and investigation by philosophers, clergy, politicians, entrepreneurs, parents, students—by just about everyone who cares about how we live together in a shared world—a limited number of duties have recurred persistently. Called perennial duties, these are basic obligations we have as human beings; they're the fundamental rules telling us how we should act. If we embrace them, we can be confident that in difficult situations we'll make morally respectable decisions.

Broadly, this group of perennial duties falls into two sorts:

- Duties to ourselves
- Duties to others

Duties to the self begin with our responsibility to develop our abilities and talents. The abilities we find within us, the idea is, aren't just gifts; it's not only a strike of luck that some of us are born with a knack for math, or an ear for music, or the ability to shepherd conflicts between people into agreements. All these skills are also responsibilities. When we receive them, *they come with the duty to develop them*, to not let them go to waste in front of the TV or on a pointless job.

Most of us have a feeling for this. It's one thing if a vaguely clumsy girl in a ballet class decides to not sign up the next semester and instead use the time trying to boost her GPA, but if someone who's really good— who's strong, and elegant, and a natural—decides to just walk away, of course the coach and friends are going to encourage her to think about it again. She has something that so few have, it's a shame to waste it; it's a kind of betrayal of her own uniqueness. This is the spot where the ethics come in: the idea is that she really *should* continue her development; it's a responsibility she has to herself because she really can develop.

What about Andrew Madoff, the cancer sufferer? He not only donated money to cancer research charities but also dedicated his time, serving as chairman of the Lymphoma Research Foundation (until his dad was arrested). This dedication *does* seem like a duty because of his unique situation: as a sufferer, he perfectly understood the misery caused by the disease, and as a wealthy person, he could muster a serious force against the suffering. When he did, he fulfilled the duty to exploit his particular abilities.

The other significant duty to oneself is nearly a corollary of the first: the duty to do ourselves no harm. At root, this means we have a responsibility to maintain ourselves healthily in the world. It doesn't do any good to dedicate hours training the body to dance beautifully if the *rest* of the hours are dedicated to alcoholism and Xanax. Similarly, Andrew should not only fight cancer publicly by advocating for medical research but also fight privately by adhering to his treatment regime.

What Do I Owe Others? Historically Accumulated Duties to Others

The duties we have to ourselves are the most immediate, but the most commonly referenced duties are those we have to others. Avoid wronging others is the guiding duty to those around us. It's difficult, however, to know exactly what it means to wrong another in every particular case. It does seem clear that Madoff wronged his clients when he pocketed their money. The case of his wife is blurrier, though. She was allowed to keep more than $2 million after her husband's sentencing. She claims she has a right to it because she never knew what her husband was doing, and anyway, at least that much money came to her from other perfectly legal investment initiatives her husband undertook. So she can make a case that the money is hers to keep and she's not wronging anyone by holding onto it. Still, it's hard not to wonder about investors here who lost everything, including their homes.

Honesty is the duty to tell the truth and not leave anything important out. On this front, obviously, Madoff wronged his investors by misleading them about what was happening with their money.

Respect others is the duty to treat others as equals in human terms. This doesn't mean treating everyone the same way. When a four-year-old asks where babies come from, the stork is a fine answer. When adult investors asked Madoff where the profits came from, what they got was more or less a fairy tale. Now, the first case is an example of respect: it demonstrates an understanding of another's capacity to comprehend the world and an attempt to provide an explanation matching that ability. The second is a lie; but more than that, it's a sting of disrespect. When Madoff invented stories about where the money came from, he disdained his investors as beneath him, treating them as unworthy of the truth.

Beneficence is the duty to promote the welfare of others; it's the Good Samaritan side of ethical duties. With respect to his own family members, Madoff certainly fulfilled this obligation: every one of them received constant and lavish amounts of cash. There's also beneficence in Andrew's work for charitable causes, even if there's a self-serving element, too. By contrast, Madoff displayed little beneficence for his clients.

Gratitude is the duty to thank and remember those who help us. One of the curious parts of Madoff's last chapter is that in the end, at the sentencing hearing, a parade of witnesses stood up to berate him. But even though Madoff had donated millions of dollars to charities over the years, not a single person or representative of a charitable organization stood up to say something on his behalf. That's ingratitude, no doubt.

But there's more here than ingratitude; there's also an important point about all ethics guided by basic duties: *the duties don't exist alone*. They're all part of a single fabric, and sometimes they pull against each other. In this case, the duty Madoff's beneficiaries probably felt to a man who'd given them so much was overwhelmed by the demand of another duty: the duty to respect others, specifically those who lost everything to Madoff. It's difficult to imagine a way to treat people more disdainfully than to thank the criminal who stole their money for being so generous, albeit with stolen money. Those who received charitable contributions from Madoff were tugged in one direction by gratitude to him and in another by respect for his many victims. All the receivers opted, finally, to respect the victims.

Fidelity is the duty to keep our promises and hold up our end of agreements. The Madoff case is littered with abuses on this front. On the professional side, there's the financier who didn't invest his clients' money as he'd promised; on the personal side, there's Madoff who, during this period, had a 20 year long affair with an investor, Sheryl Weinstein (who was also married at the time) breaking wedding vows. From one end to the other in terms of fidelity, this is an ugly case.

Reparation is the duty to compensate others when we harm them. Madoff's wife, Ruth, obviously didn't feel much of this. She walked away with $2.5 million. The judge overseeing the case, on the other hand, filled in some of what Ruth lacked. To pay back bilked investors, the court seized her jewelry, her art, and her mink and sable coats. Those things, along with the couple's three multimillion-dollar homes, the limousines, and the yacht, were all sold at public auction.

The Concept of Fairness

The final duty to be considered—fairness—requires more development than those already listed because of its complexity. According to Aristotle, fairness is treating equals equally and unequals unequally. The *treat equals equally* part means, for a professional investor like Madoff, that all his clients get the same deal: those who invest equal amounts of money at about the same time should get an equal return. So even though Madoff was sleeping with one of his investors, this shouldn't allow him to treat her account distinctly from the ones belonging to the rest. Impartiality must govern the operation.

The other side of fairness is the requirement to *treat unequals unequally*. Where there's a meaningful difference between investors—which means a difference pertaining to the investment and not something extraneous like a romantic involvement—there should correspond a proportional difference in what investors receive. Under this clause, Madoff could find justification for allowing two distinct rates of return for his clients. Those that put up money at the beginning when everything seemed riskier could justifiably receive a higher payout than the one yielded to more recent participants. Similarly, in any company, if layoffs are necessary, it might make sense to say that those who've been working in the organization longest should be the last ones to lose their jobs. In either case, the important point is that *fairness doesn't mean everyone gets the same treatment; it means that rules for treating people must be applied equally*. If a corporate executive decides on layoffs according to a last-in-first-out process, that's fine, but it would be unfair to make exceptions.

One of the unique aspects of the idea of fairness as a duty is its hybrid status between duties to the self and duties to others. While it would seem strange to say that we have a duty of gratitude or fidelity to ourselves, it clearly makes sense to assert that we should be fair to ourselves. Impartiality—the rule of no exceptions—means no exceptions. So a stock investor who puts his own money into a general fund he runs should receive the same return as everyone else. A poor investment that loses 10 percent should cost him no more than 10 percent (he has to be fair to himself), and one that gains 10 percent shouldn't net him any more than what the others receive (he has to be fair to others).

Balancing the Duties

Duties include those to:

- develop abilities and talents,
- do ourselves no harm,
- avoid wronging others,
- honesty,
- respect others,
- beneficence,
- gratitude,
- fidelity,
- reparation, and
- fairness.

Taken on their own, each of these plugs into normal experience without significant problems. Real troubles come, though, when more than one duty seems applicable and they're pulling in different directions.

Take Andrew Madoff, for example. Lying in bed at night and taking his ethical duties seriously, what should he do in the wake of the revelation that his family business was in essence a giant theft? On one side, there's an argument that he should just keep on keeping on by maintaining his life as a New York financier. The route to *justifying* that decision starts with a duty to himself:

- **Develop abilities and talents.** As an expert in finance, someone with both knowledge of and experience in the field, Andrew should continue cultivating and perfecting his talents, at least those he had acquired on the legitimate side of the family's dealings. Beyond the duty to himself, Andrew can further buttress his decision to keep his current life going by referencing a duty to others:
- **Beneficence.** This may demand that Andrew continue along the lines he'd already established because they enabled his involvement with cancer research. He's got money to donate to the cause and his very personal experience with the disease allows rare insight into what can be done to help sufferers. To the extent that's true, beneficence supports Andrew's decision to go on living as he had been. On the other side, what's the duty-based argument in favor of Andrew taking a different path by breaking away from his old lifestyle and dedicating all his energy and time to doing what he can for the jilted investors the family business left behind?
- **Respect.** The duty to treat others as equals demands that Andrew take seriously the abilities and lives of all those who lost everything. Why should *they* be reduced to powerlessness and poverty while he continues maximizing his potential as a stock buyer and nonprofit leader? Respecting others and their losses may mean leaving his profession and helping them get back on their feet.
- **Reparation.** This duty advances as the proposal for Andrew to liquidate his assets and divide the money as fairly as possible among the ruined investors. It may be that Andrew didn't orchestrate the family Ponzi scheme, but wittingly or not, he participated and benefitted from it, and that opens the way to the duty to repayment.

So which path should Andrew follow? There's no certain answer. What duties *do* allow Andrew—or anyone considering his situation—to achieve is a solid footing for making a reasonable and defendable decision. From there, the ethical task is to weigh the various duties and choose which ones pull harder and make the stronger demand.

What Are the Advantages and Drawbacks of an Ethics Based on Duties?

One of the principal advantages of working with an ethics of duties is simplicity: duties are fairly easy to understand and work with. We all use them every day. For many of us these duties are the first thing coming to mind when we hear the word ethics. Straightforward rules about honesty, gratitude, and keeping up our ends of agreements—these are the components of a common education in ethics, and most of us are well experienced in their use. The problem, though, comes when the duties pull against each other: when one says yes and the other says no. Unfortunately, there's no hard-and-fast rule for deciding which duties should take precedence over the others.

D. Duty-Based Ethics - Categorical Imperative

German philosopher Immanuel Kant (1724–1804) accepted the basic proposition that a theory of duties— a set of rules telling us what we're obligated to do in any particular situation—was the right approach to ethical problems. What he set out to add, though, was a stricter mechanism for the use of duties in our everyday experience. He wanted a way to get all these duties we've been talking about to work together, to produce a unified recommendation, instead of leaving us confused between loyalty to one principle and another. At least on some basic issues, Kant set out to produce ethical certainty.

Lying is about as primary as issues get in ethics, and the Madoff case is shot through with it: Bernie Madoff always claimed that the Ponzi scheme wasn't the original idea. He sought money from investors planning to score big with complicated financial maneuvers. He took a few losses early on, though, and faced the possibility of everyone just taking their cash and going home. That's when he started channeling money from new investors to older ones, claiming the funds were the fruit of his excellent stock dealing. He always intended, Madoff says, to get the money back, score some huge successes, and they'd let him get on the straight and narrow again. It never happened. But that doesn't change the fact that Madoff thought it would. He was lying temporarily, and for the good of everyone in the long run.

As previously discussed, Weinstein, who had a 20-year affair with Madoff, also invested her family's life savings with him. When the Ponzi scheme came undone, she lost everything. To get some money back, she considered writing a tell-all, and that led to a heart-wrenching decision between money and her personal life. Her twenty-year dalliance was not widely known, and things could have remained that way: her husband and son could've gone on without the whole world knowing that the husband was a cuckold and the son the product of a poisoned family. But they needed money because they'd lost everything, including their home, in Madoff's scam. So does she keep up the false story or does she turn the truth into a profit opportunity?

What does Kant say about all this? The answer is his categorical imperative. An imperative is something you need to do. A **hypothetical** imperative is something you need to do, but only in certain circumstances; for example, I have to eat, but only in those circumstances where I'm hungry. A **categorical** imperative, by contrast, is something you need to do all the time: there are ethical rules that don't depend on the circumstances, and it's the job of the categorical imperative to tell us what they are. Here, we will consider two distinct expressions of Kant's categorical imperative, two ways that guidance is provided.

First Version of the Categorical Imperative

The first version or expression of the categorical imperative: Act in a way that the rule for your action could be universalized. When you're thinking about doing something, this means you should imagine that everyone did it all the time. Now, can this make sense? Can it happen? Is there a world you can imagine where everyone does this thing that you're considering at every opportunity? Take the case of Madoff asking himself, "Should I lie to keep investor money flowing in?" What we need to do is imagine this act as universalized: everyone lies all the time. Just imagine that. You ask someone whether it's sunny outside. It is sunny, but they say, "No, it's raining." The next day you ask someone else. Again, it's sunny, but they say, "No, it's snowing." This goes on day after day. Pretty soon, wouldn't you just give up listening to what people say? Here's the larger point: if everyone lies all the time, pretty soon people are going to stop listening to anyone. And if no one's listening, is it possible to lie to them?

What Kant's categorical imperative shows is that lying cannot be universalized. The act of lying can't survive in a world where everyone's just making stuff up all the time. Since no one will be taking anyone else seriously, you may try to sell a false story but no one will be buying.

Bringing this back to Madoff, as Kant sees it he has to make a basic decision: should I lie to investors to keep my operation afloat? The answer is no. According to the categorical imperative, it must be no, not because lying is directly immoral, but because lying cannot be universalized and therefore it's immoral. The same goes for Sheryl Weinstein as she wonders whether she should keep the lid on her family-wrecking affair. The answer is no because the answer is always no when the question is whether I should lie. You might want to respond by insisting, "She's already done the deed, and Bernie's in jail (now deceased) so it's not going to happen again. The best thing at this point would be for her to just keep her mouth shut and hold her family together as best she can." That's a fair argument. But for Kant it's also a loser because the categorical imperative gives the last word. There's no appeal. There's no lying, no matter what.

The first expression of the categorical imperative—act in such a way that the rule for your action could be universalized—is a consistency principle. Like the golden rule (treat others as you'd like to be treated), it forces you to ask how things would work if everyone else did what you're considering doing.

Objections to the First Version of the Categorical Imperative

One of the objections to this ethical guidance is that a reality without lying can be awfully uncomfortable. If your boss shows up for work on a Friday wearing one of those designer dresses that looks great on a supermodel and ridiculous everywhere else, and she asks what you think, what are you going to say? "Hideous"? Telling the truth no matter what, whether we're at work or anywhere else, is one of those things that sounds good in the abstract but is almost impossible to actually live by.

Then the problem gets worse. A deranged addict storms into your office announcing that he's just received a message from the heavens. While chewing manically on dirty fingernails, he relates that he's supposed to attack someone named Jones—anyone named Jones. "What," he suddenly demands, "is your name?" Unfortunately, you happen to be named Sam Jones. Now what?

Second Version of the Categorical Imperative

The second expression of the categorical imperative is: Treat people as an end, and never as a means to an end. To treat people as ends, not means is to never use anyone to get something else. People can't be tools or instruments, they can't be things you employ to get to what you really want. A simple example of using another as a means would be striking up a friendship with Chris because you really want to meet his wife who happens to be a manager at the advertising company you desperately want to work for.

It'd be hard to imagine a clearer case of this principle being broken than that of Madoff's Ponzi scheme. He used the money from each new investor to pay off the last one. That means every investor was nothing but a means to an end: everyone was nothing more than a way to keep the old investors happy and attract new ones.

Madoff's case of direct theft is clear cut, but others aren't quite so easy. If Weinstein goes ahead and writes her tell-all about life in bed with Madoff, is she using him as a means to her end (which is making money)? Is she using book buyers? What about her husband and the suffering he would endure? It can be difficult to be sure in every case exactly what it means to "use" another person.

Another example comes from Madoff's son, Andrew, who donated time and money to the cause of treating cancer. On one hand, this seems like a generous and beneficial treatment of others. It looks like he's valuing them as worthwhile and good people who deserve to be saved from a disease. On the other hand, though, when you keep in mind that Andrew too had cancer, you wonder whether he's just using other peoples' suffering to promote research so that he can be saved.

Summarizing, where the first of the categorical imperative's expressions was a consistency principle (treat others the way you want to be treated), this is a dignity principle: treat others with respect and as holding value in themselves. You will act ethically, according to Kant, as long as you never accept the temptation to treat others as a way to get something else.

Objections to the Second Version of the Categorical Imperative

The principal objection to this aspect of Kant's theory is that, like the previous, it sounds good in the abstract, but when you think about how it would actually work, things become difficult.

Almost all businesses require treating people as means and not as ends. In the grocery store, the cashier isn't waiting there to receive your respectful attention. She's there to run your items through the scanner and that's it. The same goes for the guy in the produce section setting up the banana display. Really, just paying someone to do a job—no matter what the job might be—is treating them as a means to an end, as little more than a way to get the work done.

If that's right, then you're not going too far by wondering whether the entire modern world of jobs and money would unravel if we all suddenly became Kantians. Paying a janitor to clean up after hours, a paralegal to proofread a lawyer's briefs, a day-care worker to keep peace among children at recess, all these treatments of others seem to fail Kant's test.

Defenders of Kant understand all this perfectly and can respond. One argument is that providing someone with a job is not treating them as a means to your ends; instead, by allowing them the opportunity to earn a living, you're actually supporting their projects and happiness. Seen this way, hiring people is not denigrating them, it's enabling. And far from being immoral in the Kantian sense, it's ethically recommendable.

E. Outcome-Based Ethics

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

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

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

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

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

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

1. **Mistake:** Failing to come up with lots of options that seem reasonable and then choosing the one that has the greatest benefit for the greatest number. Often, a decision maker seizes on one or two alternatives without thinking carefully about other courses of action. If the alternative does more good than harm, the decision maker assumes it's ethically okay.
2. **Mistake:** Assuming that the greatest good for you or your company is in fact the greatest good for all—that is, looking at situations subjectively or with your own interests primarily in mind.
3. **Mistake:** Underestimating the costs of a certain decision to you or your company. The now-classic Ford Pinto case demonstrates how Ford Motor Company executives drastically underestimated the legal costs of not correcting a feature on their Pinto models that they knew could cause death or injury. General Motors was often taken to task by juries that came to understand that the company would not recall or repair known and dangerous defects because it seemed more profitable not to. In 2010, Toyota learned the same lesson.
4. **Mistake:** Underestimating the cost or harm of a certain decision to someone else or some other group of people.
5. **Mistake:** Favoring short-term benefits, even though the long-term costs are greater.
6. **Mistake:** Assuming that all values can be reduced to money in comparing the risks to human health or safety against, say, the risks of job or profit losses, cost-benefit analyses will often try to compare apples to oranges and put arbitrary numerical values on human health and safety.

F. Corporate Social Responsibility

Acting in an ethical manner is one of the four components of the pyramid of corporate social responsibility (CSR), which is the concern of businesses for the welfare of society as a whole. It consists of obligations beyond those required by law or union contract. This definition makes two important points. First, CSR is voluntary. Beneficial action required by law, such as cleaning up factories that are polluting air and water, is not voluntary. Second, the obligations of CSR are broad. They extend beyond investors in the company to include workers, suppliers, consumers, communities, and society at large.

History of CSR

American President Calvin Coolidge said in the 1920s that "the chief business of the American people is business." It was a popular observation in a time of economic prosperity, when issues such as energy security and climate change were practically nonexistent. A century later, things are very different. Now, more than ever, private enterprise is being called upon to exercise social responsibility, especially when it comes to the environment. This trend reflects the view that companies ought to do more than simply meet the letter of the law and the bare minimum of ethical business behavior.

Figure 22 "Pollution!" by aguscr License CC BY 2.0

President Coolidge, like many American presidents before and since, kept government out of the affairs of business as much as possible. But starting in the 1960s and 1970s, the environmental impact of an ever-expanding economy was generating more and more protest from citizens. The result was a wave of legislation designed to reduce the pollution produced by business activity. Those laws had positive effects and are now vital parts of the American regulatory framework. But despite these regulations, controlling pollution continues to be a challenge. And now there are even larger problems on the horizon.

Even though businesses today are more efficient and use fewer resources to make goods—thanks to technological advances— many ecosystems continue to suffer. This is because the scale of economic activity grows every year, despite environmental improvements by individual enterprises. Starting a few years ago, many citizens in the U.S. and around the world began calls for more action from private enterprise on these social issues—beyond compliance with regulations and traditional charity-related work. The result was a new movement known as corporate social responsibility, or CSR.

CSR Defined

CSR can be simply and broadly defined as the ethical role of the corporation in society. The aim of CSR is to increase long-term profits and shareholder trust through positive public relations and high ethical standards to reduce business and legal risk by taking responsibility for corporate actions. It isn't enough for companies to generate a profit and merely meet the letter of the law in their business operations. Today, many U.S. citizens expect them to generate a profit *and* conduct themselves in an ethical and socially responsible manner.
CSR strategies encourage the company to make a positive impact on the environment and stakeholders—that is, all of the parties who have a stake in the performance and output of the corporation. Stakeholders include the company's employees, unions, investors, suppliers, consumers, local and national governments, and communities that may be affected by corporate activities such as construction, manufacturing, and pollution. For some companies, CSR means manufacturing their products in a way that doesn't harm the environment and protects the consumer from potentially hazardous materials.

Demands for Corporate Social Responsibility

There are several drivers pushing businesses toward corporate social responsibility include the following:

- Increased Pressure from Consumers
- Pressure from Shareholders and Investors
- Supply-Chain Pressure

Increased Pressure from Consumers

Consumers are demanding more from the businesses that get their hard-earned money. Businesses that are perceived as valuing more than the "bottom line" are gaining favor with the buying public. Consumers—especially those in North America—are likely to vote with their wallets against companies whose social and environmental performance is poor. Fifty-five percent of North American consumers reported that they would pay more for companies who behaved more responsibly. (Hayzlet)

Pressure from Shareholders and Investors

Although not a new concept, Socially Responsible Investing (SRI) has seen increased attention over the last several decades. In fact, investors have become more active in their demands of corporations in which they have holdings. Investor activities to move these organizations to a more responsible position have had fairly good results.

In a 2017 study, Barko, Cremers, and Renneboog measure the effect of investor activism on corporate performance. A global dataset of 660 companies were profiled in the study by market share, analyst coverage, stock returns, and liquidity. Not surprisingly, over the ten-year study the Environmental, Social, and Governance (ESG) rating of the companies targeted by activist investors showed improvement in those ratings after the engagement with those investors, versus non-targeted "matched firms."

Supply-Chain Pressure

As consumers pay closer attention to the social responsibility of retailers and service providers, visibility into their supply chains has also become a priority. For example, Apple has come under scrutiny and criticism for the poor working conditions and environmental hazards taking place at assembly facilities in China. Even though these facilities are outside of the U.S. and are separate corporate entities, Apple has spent considerable corporate resources defending its reliance on such suppliers. Other companies such as the Swedish international retailer of furniture and household goods are taking a proactive approach to CSR both internally and within the supply chain. A visit to the IKEA website allows consumers and interested parties to view the company's sustainability reports and their policy on "People and Planet."

Regardless of where the pressure originates, companies are finding that ignoring their social and environmental responsibility and impact is ultimately bad for business.

Examples of Corporate Social Responsibility

Not all companies approach CSR in the same way. Their approach depends upon their resources, available assets, and corporate culture. In addition, some companies perceive more benefit from one type of CSR than another. The personal beliefs and priorities of senior management/ownership can also influence the company's approach to social responsibility. Below are some different approaches to CSR.

Corporate Philanthropy

Corporate philanthropy refers to a corporation's gifts to charitable organizations. There is an implication that the corporation's donations have no strings attached, which is probably quite rare. At a minimum, most corporations expect that their donations will be publicly attributed to the corporation, thus generating positive public relations. When corporations make large cash gifts to universities or museums, they are usually rewarded with a plaque or with a building or library named after the donor. Such attributions burnish the corporation's public image, and in such cases we are not dealing with true corporate philanthropy, strictly speaking, but something more in the nature of marketing or public relations.

Cause-Related Marketing

Cause-related marketing (CRM) refers to a corporation's associating the sales of its products to a program of donations or support for a charitable or civic organization. An example is provided by the famous Red campaign, in which corporations such as Nike and Gap pledged to contribute profits from the sale of certain red-colored products to a program for African development and alleviation of AIDS-related social problems. The basic idea of cause-related marketing is that the corporation markets its brand at the same time that it promotes awareness of the given social problem or civic organization that addresses the social problem. Another well-known example is the pink ribbon symbol that promotes breast-cancer awareness and is used prominently in the marketing of special lines of products by many corporations, such as Estée Lauder, Avon, New Balance, and Self Magazine. In addition to marketing products with the pink-ribbon symbol, Estée Lauder has made support for breast cancer awareness one of the defining features of its corporate philanthropy. Thus, Estée Lauder also frequently refers to such charitable contributions, currently on the order of $150 million, in its corporate communications and public relations documents.

Sustainability

Sustainability has become such an important concept that it is frequently used interchangeably with CSR. Indeed, for some companies it seems that CSR is sustainability. This is perhaps not surprising, given the growing media attention on issues related to sustainability.
Sustainability is a concept derived from environmentalism; it originally referred to the ability of a society or company to continue to operate without compromising the planet's environmental condition in the future. In other words, a sustainable corporation is one that can sustain its current activities without adding to the world's environmental problems. Sustainability is therefore a very challenging goal, and many environmentalists maintain that no corporation today operates sustainably, since all use energy (leading to the gradual depletion of fossil fuels while emitting greenhouse gases) and all produce waste products like garbage and industrial chemicals. Whether or not true sustainability will be attainable anytime in the near future, the development and promotion of sustainability strategies has become virtually an obsession of most large corporations today, as their websites will attest in their inevitable reference to the corporation's sincere commitment to sustainability and responsible environmental practices. No corporation or corporate executive today will be heard to say that they do not really care about the environment. However, if we observe their actions rather than their words, we may have cause for doubt.

Social Entrepreneurship and Social Enterprise

Social entrepreneurship and social enterprise refer to the use of business organizations and techniques to attain laudable social goals. Blake Mycoskie decided to create TOMS Shoes largely as a reaction to his travels in Argentina, which had exposed him to terrible poverty that left many school-age children without shoes. An important part of the corporate mission of TOMS Shoes lies in its pledge to give away a free pair of shoes for every pair purchased by a customer. TOMS Shoes' model has been imitated by many others, including the popular online eyewear brand, Warby Parker.

The difference between social entrepreneurship and CSR is that, with social entrepreneurship, the positive social impact is built into the mission of the company from its founding. Other examples of social entrepreneurship include The Body Shop, Ben & Jerry's ice cream, and Newman's Own. The Body Shop was founded by noted activist Anita Roddick who insisted that all products be derived from ingredients that were natural, organic, and responsibly sourced. Her employment policies famously allowed every employee to take off one day a month from work to engage in social or community projects. Similarly, Ben & Jerry's was founded to promote the use of organic, locally-produced food. The company's founders insisted on a policy that executives earn no more than seven times the salary of factory line-workers (although this policy was eventually relaxed when it became difficult to recruit a competent CEO at those wages). Ben & Jerry's engaged in a number of high-profile political activities in which they encouraged their employees to participate, such as protesting the building of the Seabrook nuclear power plant in Vermont. Newman's Own was founded by film actor Paul Newman and his friend A. E. Hotchner with the goal of selling wholesome products and giving away 100 percent of the profits to charitable ventures. To date, Newman's Own has given away more than two hundred million dollars.

Social Marketing

Social marketing refers to the use of business marketing techniques in the pursuit of social goals. Often, governments and nonprofit organizations make use of social marketing to make their points more forcefully and effectively to a wide audience. Classic examples are the extremely powerful TV commercials warning of the dangers of unsafe driving or of failing to use seat belts. Cinematic techniques are employed to portray dramatic, arresting images of crumpled cars and bodies, children and mothers crying. The source of social marketing advertisements is usually a local government or nonprofit organization.

Social marketing is usually used to try to convince citizens to drive more safely, eat better, report child and domestic abuse, and avoid various forms of criminality and drug use. As with ordinary advertising, social marketing can seem overdone or maudlin, and some social marketing ads have been mocked or considered silly. For example, former First Lady Nancy Reagan participated in a social marketing campaign that urged young people to "Just Say No" to drugs, an approach that was ridiculed as simplistic by many. Noted radical activist Abbie Hoffman said that telling drug users to "just say no" to drugs was like telling manic-depressives to "just cheer up." Despite that, drug use in America declined over the time period that the campaign was in progress, though there is no evidence that any part of this decline was due to the campaign.

While there is no universally accepted definition of *social entrepreneur*, the term is typically applied to an individual who uses market-based ideas and practices to create "social value," the enhanced well-being of individuals, communities, and the environment. Unlike ordinary business entrepreneurs who base their decisions solely on financial returns, social entrepreneurs incorporate the objective of creating social value into their founding business models. Social entrepreneurship has become exceedingly popular in recent years and a number of prestigious business schools have created specific academic programs in the field. It is often said that social entrepreneurs are changing the world. They are lauded for their ability to effect far-reaching social change through innovative solutions that disrupt existing patterns of production, distribution, and consumption. Prominent social entrepreneurs are celebrated on magazine covers, praised at the World Economic Forum in Davos, and awarded millions of dollars in seed money from "angel" investors, and applauded as "harbingers of new ways of doing business."

The enthusiasm associated with social entrepreneurship is perhaps emblematic of increased global social awareness, which is evidenced by increased charitable giving worldwide. A 2012 study showed that 83 percent of Americans wish brands would support causes; 41 percent have bought a product because it was associated with a cause (a figure that has doubled since 1993); 94 percent said that, given the same price and quality, they were likely to switch brands to one that represented a cause; and more than 90 percent think companies should consider giving in the communities in which they do business.

Despite the eager reception from consumers, critics of social entrepreneurship have raised concerns about the creation of social value in a for-profit context. Thus, TOMS is sometimes mistaken for a charity because it donates shoes to children in developing countries, yet it is also in business to sell shoes. The company earns an estimated $300 million a year and has made Mr. Mycoskie a wealthy man. While companies are starting to look more like charities, nonprofits are also increasingly relying on business principles to survive an uncertain economy in which donors expect to see tangible results from their charitable contributions.

Our understanding of social entrepreneurship is complicated by the absence of any consensus on ways to measure social outcomes. As a result, there is little concrete statistical data available on the impact of social entrepreneurship. Indeed, there is not much agreement on a precise definition of social entrepreneurship, so it becomes difficult to say to what extent any given company is an example of social entrepreneurship. TOMS' Chief Giving Officer, Sebastian Fries, recently told the *New York Times* that the company is "not in the business of poverty alleviation." (Herrera) Does this mean that increased social value is merely a happy by-product of the business of selling shoes? If so, what makes Blake Mycoskie a social entrepreneur?

Some critics go so far as to suggest that social entrepreneurs are merely using public relations tactics to engage in social or environmental greenwashing—taking advantage of consumers' desire to do good. In some cases, it has been argued, social entrepreneurs can even do more harm than good. Lacking a full understanding of the socioeconomic and cultural dynamic of the developing countries in which they intervene, social enterprises can undermine fragile local markets and foster dependence on foreign assistance. But in the end, the individual impact of social entrepreneurial ventures may outweigh some of these concerns.

Controversies Surrounding CSR

From the beginning, CSR has been the subject of much debate. CSR's critics argue that the main responsibility of businesses is to maximize return to their shareholders. They point to the corporate legal system as the proper place for regulating businesses' conduct with society. And besides, businesses are already fulfilling a key public service by providing jobs and services that society needs.

Other critics assert that many so-called CSR activities are really just publicity stunts and corporate "greenwashing." **Greenwashing** refers to corporations that exaggerate or misstate the impact of their environmental actions or promote products as being "eco-friendly" when in fact they're not.

Supporters of CSR contend that there are significant profit-related benefits in socially responsible behavior. Companies are using their CSR activities to recruit and keep the best management talent and to establish partnerships with communities to increase company influence on legislation. And companies that make social responsibility an integrated part of their business actually are managing risk—a key part of corporate development strategy.

Despite the ongoing debate, trends indicate that CSR is gathering force and is here to stay. More and more leading companies in America and worldwide are releasing sustainability reports. Plus, new industries like clean energy provide social and economic benefits while fighting environmental problems like climate change. The result of that combination has been called one of the greatest commercial opportunities in history.
The importance and nature of CSR is the topic of ongoing debate and controversy. Consider the following:

CSR: Sincere Ethics or Hypocritical Public Relations?

- **Facts:** CSR is a rapidly growing field of study in universities and business schools, and most large corporations have adopted CSR programs.
- **The controversial aspect:** Is CSR a good thing or is it just corporate window dressing?
- **In favor of CSR:** CSR motivates corporations to address social problems, it energizes and rewards workers, it strengthens ties to the community, and it improves the image of the corporation.
- **Against CSR:** Surveys show that citizens are more concerned about corporations treating their workers well and obeying laws than about engaging in philanthropic activities, and CSR may allow corporations to distract consumers and legislators from the need to tightly regulate corporations.

Climate Change and CSR

- **Facts:** There is a scientific consensus that global warming and climate change represent an enormous threat facing mankind.
- **The controversial aspect:** Can corporate CSR really have a significant impact on climate change, or is it just a public relations vehicle for companies and a distraction from the need for stronger government action, such as through a carbon tax?

- **In favor of global warming–related CSR:** Corporations can have a major impact in the battle against global warming by reducing their large carbon footprints, by encouraging other corporations to follow suit, and by helping discover and develop alternative sources of energy.
- **Against global warming–related CSR:** Companies spend a lot of advertising money to boast about small measures against global warming, but many of these companies are in industries—such as fossil fuels or automobiles—that produce the most greenhouse gases to begin with; self-serving claims of climate-change concern are often simply greenwashing campaigns intended to distract us from the need for society to take more effective measures through taxation and regulation.

Corporate Lobbying and Governmental Influence

- **Facts:** Most large corporations spend money on lobbying and on seeking to influence legislators and regulators. In *Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010), the Supreme Court ruled that, as "corporate persons," corporations enjoy the same freedom of speech protections as ordinary citizens and are entitled to relief from strict government control of their rights to political speech.
- **The controversial aspect:** Many citizens are outraged to find that the justice system accords multinational corporations the same rights as ordinary people on the grounds that corporations are "persons." However, others point out that *The New York Times* and CNN are also corporations, and that it could have a chilling effect on freedom of speech if all corporations were legally-constrained from speaking out freely.
- **In favor of corporate lobbying:** As major employers and technological innovators, corporations benefit society. They should be free to oppose inefficient and cumbersome government regulations and taxation that can limit the benefits they provide. In this way, freedom of political speech is so important that we should be cautious about limiting it in any way.
- **Against corporate lobbying:** Corporations are not "persons" in the same sense that humans are, and therefore, they should not enjoy the same freedom of speech protection. Since corporations can become vastly wealthier than ordinary citizens, allowing them to participate in politics will enable them to bend laws and regulations to their will.

In each of the debates outlined above, there are intelligent and well-informed people on both sides of the issue. How CSR is defined and practiced differs for each enterprise. But for all those companies, the view seems to be that CSR programs are a good investment.

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G. Making Ethical Decisions

Josephson's Core Values Analysis and Decision Process

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

Studies from the Josephson Institute of Ethics in Marina del Rey, California, have identified six core values in our society, values that almost everyone agrees are important to them. When asked what values people hold dear, what values they wish to be known by, and what values they wish others would exhibit in their actions, six values consistently turn up: (1) trustworthiness, (2) respect, (3) responsibility, (4) fairness, (5) caring, and (6) citizenship.

- **Trustworthiness:** *Be honest*—tell the truth, the whole truth, and nothing but the truth; be sincere, forthright; don't deceive, mislead, or be tricky with the truth; don't cheat or steal, and don't betray a trust. *Demonstrate integrity*—stand up for what you believe, walk the walk as well as talking the talk; be what you seem to be; show commitment and courage. *Be loyal*—stand by your family, friends, co-workers, community, and nation; be discreet with information that comes into your hands; don't spread rumors or engage in harmful gossip; don't violate your principles just to win friendship or approval; don't ask a friend to do something that is wrong. *Keep promises*—keep your word, honor your commitments, and pay your debts; return what you borrow.
- **Respect:** Judge people on their merits, not their appearance; be courteous, polite, appreciative, and accepting of differences; respect others' right to make decisions about their own lives; don't abuse, demean, mistreat anyone; don't use, manipulate, exploit, or take advantage of others.
- **Responsibility:** Be accountable—think about the consequences on yourself and others likely to be affected before you act; be reliable; perform your duties; take responsibility for the consequences of your choices; set a good example and don't make excuses or take credit for other people's work. Pursue excellence: Do your best, don't quit easily, persevere, be diligent, make all you do worthy of

pride. Exercise self-restraint—be disciplined, know the difference between what you have a right to do and what is right to do.

- **Fairness:** Treat all people fairly, be open-minded; listen; consider opposing viewpoints; be consistent; use only appropriate considerations; don't let personal feelings improperly interfere with decisions; don't take unfair advantage of mistakes; don't take more than your fair share.
- **Caring:** Show you care about others through kindness, caring, sharing, compassion, and empathy; treat others the way you want to be treated; don't be selfish, mean, cruel, or insensitive to others' feelings.
- **Citizenship:** Play by the rules, obey laws; do your share, respect authority, stay informed, vote, protect your neighbors, pay your taxes; be charitable, help your community; protect the environment, conserve resources.

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

The importance of an individual's having these consistent qualities of character is well known. Often we remember the last bad thing a person did far more than any or all previous good acts.

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

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

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

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

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

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Employment Law

Employment law involves a variety of legal issues that we will explore in this Unit, including the nature of employment, employment discrimination, and a variety of statutes that impact the employer-employee relationship.

Employment at Will

At common law, an employee without a contract guaranteeing a job for a specific period was an employee at will and could be fired at any time and for any reason, or even for no reason at all. The various federal statutes we will examine have made inroads on the at-will doctrine. For example, the federal Occupational Safety and Health Act, prohibits employers from discharging employees who exercise their rights under that law. The courts and legislatures in more than forty states have made revolutionary changes in the at-will doctrine. They have done so under three theories: tort, contract, and duty of good faith and fair dealing. We will first consider the tort of wrongful discharge.

Courts have created a major exception to the employment-at-will rule by allowing the tort of wrongful discharge. *Wrongful discharge* means firing a worker for a bad reason. What is a bad reason? A bad reason can be (1) discharging an employee for refusing to violate a law, (2) discharging an employee for exercising a legal right, (3) discharging an employee for performing a legal duty, and (4) discharging an employee in a way that violates public policy.

Discharging an Employee for Refusing to Violate a Law

Some employers will not want employees to testify truthfully at trial. In one case, a nurse refused a doctor's order to administer a certain anesthetic when she believed it was wrong for that particular patient; the doctor, angry at the nurse for refusing to obey him, then administered the anesthetic himself. The patient soon stopped breathing. The doctor and others could not resuscitate him soon enough, and he suffered permanent brain damage. When the patient's family sued the hospital, the hospital told the nurse she would be in trouble if she testified. She did testify according to her oath in the court of law (i.e., truthfully), and after several months of harassment, was finally fired on a pretext. The hospital was held liable for the tort of wrongful discharge. As a general rule, you should not fire an employee for refusing to break the law.

Maryland recognized this tort in *Adler v. American Standard Corp.*, 291 Md. 31 (1981), though it did not find the facts of that case sufficiently compelling to support the discharged employee's claims against his former employer for his termination when the employee discovered and reported illegal practices, including alleged bribery by the company.

Discharging an Employee for Exercising a Legal Right

Suppose Bob Berkowitz files a claim for workers' compensation for an accident at Pacific Gas & Electric, where he works and where the accident that injured him took place. He is fired for doing so, because the employer does not want to have its workers' comp premiums increased. In this case, the right exercised by Berkowitz is supported by public policy: he has a legal right to file the claim, and if he can establish that his discharge was caused by his filing the claim, he will prove the tort of wrongful discharge. *Wholey v. Sears*, 803 A. 2d 482 (Md. 2002) (citing to *Finch v. Holladay-Tyler Printing, Inc.*, 322 Md. 197, 202 (1991) concerning terminations specifically for filing a workers' compensation claim).

Discharging an Employee for Performing a Legal Duty

Courts have long held that an employee may not be fired for serving on a jury. This is so even though courts do recognize that many employers have difficulty replacing employees called for jury duty. Jury duty is an important civic obligation, and employers are not permitted to undermine it.

Discharging an Employee in a Way That Violates Public Policy

This is probably the most controversial basis for a tort of wrongful discharge. There is an inherent vagueness in the phrase "basic social rights, duties, or responsibilities." This is similar to the exception in contract law: the courts will not enforce contract provisions that violate public policy. (For the most part, public policy is found in statutes and in cases.) But what constitutes public policy is an important decision for state courts. In *Wagenseller v. Scottsdale Memorial Hospital*, 710 P.2d 1025, 1085 (Ariz. 1985) (superseded by Arizona statute § 23-1501(A)(2), (3)(a)-(c) limiting the common law exceptions in that state of at-will employment), for example, a nurse who refused to "play along" with her coworkers on a rafting trip was discharged. The group of coworkers socialized at night, drinking alcohol; when the partying was near its peak, the plaintiff refused to be part of a group that bared their buttocks to the tune of "Moon River" (a composition by Henry Mancini that was popular in the 1970s). The court, at great length, considered that "mooning" was a misdemeanor under Arizona law and that therefore her employer could not discharge her for refusing to violate a state law.

Other courts have gone so far as to include professional oaths and codes as part of public policy. In *Rocky Mountain Hospital and Medical Services v. Mariani*, 916 P.2d 519 (Colo. 1996) the Colorado Supreme Court reviewed a lower court decision reversing a trial court's decision that refused relief to a certified public accountant who was discharged when she refused to violate her professional code. (Her employer had repeatedly required her to come up with numbers and results that did not reflect the true situation, using processes that were not in accord with her training and the code.) The Supreme Court had to decide if the professional code of Colorado accountants could be considered to be part of public policy. Given that accountants were licensed by the state on behalf of the public, and that the Board of Accountancy had published a code for accounting professionals and required an oath before licensing, the court noted the following:

> The Colorado State Board of Accountancy is established pursuant to section 12-2-103, 5A C.R.S. (1991). The Board is responsible for making appropriate rules of professional conduct, in order to establish and maintain a high standard of integrity in the profession of public accounting. § 12-2-104, 5A C.R.S. (1991). These rules of professional conduct govern every person practicing as a certified public accountant. Failure to abide by these rules may result in professional discipline. § 12-2-123, 5A C.R.S. (1991). The rules of professional conduct for accountants have an important public purpose. They ensure the accurate reporting of financial information to the public. They allow the public and the business community to rely with confidence on financial reporting. Rule 7.1, 3 C.C.R. 705-1 (1991). In addition, they ensure that financial information will be reported consistently across many businesses. The legislature endorsed these goals in section 12-2-101, 5A C.R.S.

The Colorado Supreme Court went on to note that the stated purpose of the licensing and registration of certified public accountants was to "provide for the maintenance of high standards of professional conduct by those so licensed and registered as certified public accountants." Further, the specific purpose of Rule 7.1 provided a clear mandate to support an action for wrongful discharge. Rule 7.1 is entitled "Integrity and Objectivity" and states, "A certificate holder shall not in the performance of professional services knowingly misrepresent facts, nor subordinate his judgment to others." The fact that Mariani's employer asked her to knowingly misrepresent facts was a sufficient basis in public policy to make her discharge wrongful. *Rocky Mountain Hospital and Medical Services v. Mariani*, 916 P.2d 519 (Colo. 1996).

However, not all violations of public policy will result in a successful abusive discharge claim. At issue before the *Makovi* court was a wrongful discharge based on the pregnancy of the employee – a clear violation of the numerous public policies against terminating an employee based on her sex. However, the Court of Special Appeals held that because the employee had not pursued the remedies available by statute, her tort of wrongful discharge was foreclosed. *Makovi v. Sherwin-Williams Co.*, 75 Md. App. 58 (1988).

Contract Modification of Employment at Will

Contract law can modify employment at will. Oral promises made in the hiring process may be enforceable even though the promises are not approved by top management. Employee handbooks may create implied contracts that specify personnel processes and statements that the employees can be fired only for a "just cause" or only after various warnings, notice, hearing, or other procedures.

Good Faith and Fair Dealing Standard

A few states, among them Massachusetts and California, have modified the at-will doctrine in a far-reaching way by holding that every employer entered into an implied covenant of good faith and fair dealing with its employees. That means, the courts in these states say, that it is "bad faith" and therefore unlawful to discharge employees to avoid paying commissions or pensions due them. Under this implied covenant of fair dealing, any discharge without good cause—such as incompetence, corruption, or habitual tardiness—is actionable. *Fortune v. National Cash Register Co.*, 364 NE 2d 1251 (Mass. 1977).; *Pugh v. See's Candies, Inc.*, 116 Cal. App. 3d 311, 328 (Cal. Court of Appeal 1st App. Div. 1981).

A. Employment Statutes

The employer-employee relationship changed from its common law roots. Over time, the federal and state governments passed laws and regulations that modify or expand the duties of employers to employees.

The following statutes and laws impact the employer-employee relationship:

- Health insurance benefits through group plans and the ACA, along with coverage continuation and portability under COBRA and HIPAA
- Retirement benefits, including ERISA plans, Social Security and Medicare
- The Family Medical Leave Act (FMLA)
- Unemployment Insurance
- Fair Labor Standards
- Occupational Safety Rules
- Plant Closing Act
- Workers Compensation laws
- Polygraph Protection Act

Affordable Care Act

The Affordable Care Act (ACA) establishes a number of changes in the health insurance markets for private insurance coverage, mandating that all US citizens have health insurance or face a tax penalty. This law is currently under debate in Congress as the Trump administration is seeking to remove the ACA. Provisions of the law, such as the tax mandating coverage for all Americans was removed in 2017 in the Trump Administration's Tax Cut and Jobs Act.

Health Insurance Portability & Accountability Act (HIPAA)

HIPAA is a federal law passed in 1996 that impacts a variety of aspects of health insurance and health care privacy, and includes a number of extensive regulations that establish rules for the safeguarding of patient information by covered entities and their subcontractors.

Consolidated Omnibus Budget Reconciliation Act (COBRA)

The Consolidated Omnibus Budget Reconciliation Act (COBRA) gives workers and their families who lose their health benefits the right to choose to continue group health benefits provided by their group health plan for limited periods of time under certain circumstances such as voluntary or involuntary job loss, reduction in the hours worked, transition between jobs, death, divorce, and other life events. Qualified individuals may be required to pay the entire premium for coverage up to 102 percent of the cost to the plan.

COBRA generally requires that group health plans sponsored by employers with 20 or more employees in the prior year offer employees and their families the opportunity for a temporary extension of health coverage (called continuation coverage) in certain instances where coverage under the plan would otherwise end.

Retirement Planning

Employee Retirement Income Security Act

More than half the US workforce is covered by private pension plans for retirement. One 1988 estimate put the total held in pension funds at more than $1 trillion, costing the federal Treasury nearly $60 billion annually in tax write-offs. As the size of the private pension funds increased dramatically in the 1960s, Congress began to hear shocking stories of employees defrauded out of pension benefits, deprived of a lifetime's savings through various ruses (e.g., by long vesting provisions and by discharges just before retirement). To put an end to such abuses, Congress, in 1974, enacted the Employee Retirement Income Security Act (ERISA).

In general, ERISA governs the vesting of employees' pension rights and the funding of pension plans. Within five years of beginning employment, employees are entitled to vested interests in retirement benefits contributed on their behalf by individual employers. Multiemployer pension plans must vest their employees' interests within ten years. A variety of pension plans must be insured through a federal agency, the Pension Benefit Guaranty Corporation, to which employers must pay annual premiums. The corporation may assume financial control of underfunded plans and may sue to require employers to make up deficiencies. The act also requires pension funds to disclose financial information to beneficiaries, permits employees to sue for benefits, governs the standards of conduct of fund administrators, and forbids employers from denying employees their rights to pensions. The act largely preempts state law governing employee benefits.

Medicare

Medicare is a health insurance program for:

- people age 65 or older,
- people under age 65 with certain disabilities, and
- people of all ages with End-Stage Renal Disease (permanent kidney failure requiring dialysis or a kidney transplant).

Medicare includes the following types of coverage:

Part A Hospital Insurance – Most people don't pay a premium for Part A because they or a spouse already paid for it through their payroll taxes while working. Medicare Part A (Hospital Insurance) helps cover inpatient care in hospitals, including critical access hospitals, and skilled nursing facilities (not custodial or long-term care). It also helps cover hospice care and some home health care. Beneficiaries must meet certain conditions to get these benefits.

Part B Medical Insurance – Most people pay a monthly premium for Part B. Medicare Part B (Medical Insurance) helps cover doctors' services and outpatient care. It also covers some other medical services that Part A doesn't cover, such as some of the services of physical and occupational therapists, and some home health care. Part B helps pay for these covered services and supplies when they are medically necessary.

Prescription Drug Coverage – Most people will pay a monthly premium for this coverage. Starting January 1, 2006, new Medicare prescription drug coverage will be available to everyone with Medicare. Everyone with Medicare can get this coverage that may help lower prescription drug costs and help protect against higher costs in the future. Medicare Prescription Drug Coverage is insurance. Private companies provide the coverage. Beneficiaries choose the drug plan and pay a monthly premium. Like other insurance, if a beneficiary decides not to enroll in a drug plan when they are first eligible, they may pay a penalty if they choose to join later.

Social Security

The Social Security Act is "an act to provide for the general welfare by establishing a system of Federal old-age benefits, and by enabling the several States to make more adequate provision for aged persons, blind persons, dependent and crippled children, maternal and child welfare, public health, and the administration of their unemployment compensation laws; to establish a Social Security Board; to raise revenue; and for other purposes." Social Security Act Preamble.
The Social Security Administration provides benefits to over 60 million people in the United States. Once eligible, a person who is retired receives a support payment from the SSA, calculated based on the person's prior earnings while employed.

Family Medical Leave Act

The Family and Medical Leave Act (FMLA) provides certain employees with up to 12 weeks of unpaid, job-protected leave per year. It also requires that their group health benefits be maintained during the leave. FMLA is designed to help employees balance their work and family responsibilities by allowing them to take reasonable unpaid leave for certain family and medical reasons. It also seeks to accommodate the legitimate interests of employers and promote equal employment opportunity for men and women.

FMLA applies to all public agencies, all public and private elementary and secondary schools, and companies with 50 or more employees. These employers must provide an eligible employee with up to 12 weeks of unpaid leave each year for any of the following reasons:

- for the birth and care of the newborn child of an employee;
- for placement with the employee of a child for adoption or foster care;
- to care for an immediate family member (spouse, child, or parent) with a serious health condition; or
- to take medical leave when the employee is unable to work because of a serious health condition.

Employees are eligible for leave if they have worked for their employer at least 12 months, at least 1,250 hours over the past 12 months, and work at a location where the company employs 50 or more employees within 75 miles. Whether an employee has worked the minimum 1,250 hours of service is determined according to FLSA principles for determining compensable hours or work.

Time taken off work due to pregnancy complications can be counted against the 12 weeks of family and medical leave. The Department of Labor administers FMLA; however, the Office of Personnel Management (OPM) administers FMLA for most federal employees.

Unemployment Insurance

Unemployment insurance is an employer funded insurance program which provides benefits to persons who are unemployed through no fault of their own and who are ready, willing and able to work. The money for unemployment insurance benefits comes from revenue paid by employers. In many states, including Maryland, no deductions are ever made from a worker's paycheck to pay for unemployment insurance benefits.

In order to qualify for unemployment insurance benefits, you must have worked and had sufficient wages paid to you during the "base period". The "standard base period" is a one year period made up of the first four months of the last four completed calendar quarters preceding the start of the benefit year. For example, if you file your claim in:

Table 16 Unemployment Filing and Base Periods

Month/Year	Your Base Period is the prior
January, February or March	October 1 to September 30
April, May or June	January 1 to December 31
July, August or September	April 1 to March 31
October, November or December	July 1 to June 30

If you are eligible for any amount of money on a "standard base period," regardless of the amount, that is the base period that will be used for your claim. However, if you are not eligible for any amount of money (monetarily ineligible) on a "standard base period," you may apply for an "alternate base period." An "alternate base period" is a one year period made up of the four most recently completed calendar quarters immediately preceding the start of the benefit year.

Regardless of which base period you will be using, you will be sent a Determination of Monetary Eligibility. This form will list all of your base period employer(s) and the wages that were reported by these employer(s) as paid to you during this period. The government uses these wages to determine your weekly benefit amount, which is also listed on the form. For workers claiming in Maryland, if you have worked outside of Maryland, worked for the Federal Government, or served in the Armed Services during your "base period", you must report this information when ling your initial claim.

Unemployment insurance weekly benefit amounts range from a minimum weekly benefit amount of $50 per week to a maximum weekly benefit amount of $430 per week. Your weekly benefit amount is determined by your wages during the base period.

If you are monetarily eligible for unemployment insurance benefits, you may receive up to 26 weeks of your weekly benefit amount (Basic Weekly Benefit Amount) during your benefit year. This is the maximum amount of benefits you may receive (Maximum Benefit Amount). If you are working part-time during any week and, therefore, you do not receive your full weekly bene t amount, the difference will remain in your balance and allow you to continue claiming weeks of unemployment insurance benefits up to your maximum benefit amount.

In addition to your weekly benefit amount, you may be eligible for dependents' allowances of $8 per dependent child for up to 5 dependent children. A dependent child is your son, daughter, stepson, stepdaughter, or legally adopted child (not grandchild or foster child) under 16 years of age whom you support. Only one parent may claim a dependent during any one-year period. You may only claim a dependent(s) when you first open your claim. You will be required to provide each dependent's Social Security number and birth date. The maximum amount of unemployment benefits payable during any one week, including any dependents' allowances, is $430 per week. Therefore, if your weekly benefit amount is $430, you will not receive any dependents' allowances.

You are eligible for 26 weeks of your weekly benefit amount. Once you exhaust 26 weeks of your weekly benefit amount, you will not be eligible again until your benefit claim year is over and you have had sufficient earnings to file a new Maryland unemployment insurance claim. If you have earnings from another state, you may be able to use those earnings to establish a new unemployment insurance claim against that state. The only time that benefits exceed 26 weeks of your weekly benefit amount is if a federal extension of benefits is available.

The Federal Plant-Closing Act

A prime source of new jobs across the United States is the opening of new industrial plants—which accounted for millions of jobs a year during the 1970s and 1980s. But for every 110 jobs thus created, nearly 100 were lost annually in plant closings during that period. In the mid-1980s alone, 2.2 million plant jobs were lost each year. As serious as those losses were for the national economy, they were no less serious for the individuals who were let go. Surveys in the 1980s showed that large numbers of companies provided little or no notice to employees that their factories were to be shut down and their jobs eliminated. Nearly a quarter of businesses with more than 100 employees provided no specific notice to their employees that their particular work site would be closed or that they would suffer mass layoffs. More than half provided two weeks' notice or less.

Because programs to support dislocated workers depend heavily on the giving of advance notice, a national debate on the issue in the late 1980s culminated in 1988 in Congress's enactment of the Worker Adjustment and Retraining Notification (WARN) Act, the formal name of the federal plant-closing act. Under this law, businesses with 100 or more employees must give employees or their local bargaining unit, along with the local city or county government, at least sixty days' notice whenever (1) at least 50 employees in a single plant or office facility would lose their jobs or face long-term layoffs or a reduction of more than half their working hours as the result of a shutdown and (2) a shutdown would require long- term layoffs of 500 employees or at least a third of the workforce. An employer who violates the act is liable to employees for back pay that they would have received during the notice period and may be liable to other fines and penalties.

An employer is exempted from having to give notice if the closing is caused by business circumstances that were not reasonably foreseeable as of the time the notice would have been required. An employer is also exempted if the business is actively seeking capital or business that if obtained, would avoid or postpone the shutdown and the employer, in good faith, believes that giving notice would preclude the business from obtaining the needed capital or business.

The Employee Polygraph Protection Act

Studies calling into question the reliability of various forms of lie detectors have led at least half the states and, in 1988, Congress to legislate against their use by private businesses. The Employee Polygraph Protection Act forbids private employers from using lie detectors (including such devices as voice stress analyzers) for any reason. Neither employees nor applicants for jobs may be required or even asked to submit to them. (The act has some exceptions for public employers, defense and intelligence businesses, private companies in the security business, and manufacturers of controlled substances.)

Use of polygraphs, machines that record changes in the subject's blood pressure, pulse, and other physiological phenomena, is strictly limited. They may be used in conjunction with an investigation into such crimes as theft, embezzlement, and industrial espionage, but in order to require the employee to submit to polygraph testing, the employer must have "reasonable suspicion" that the employee is involved in the crime, and there must be supporting evidence for the employer to discipline or discharge the employee either on the basis of the polygraph results or on the employee's refusal to submit to testing. The federal polygraph law does not preempt state laws, so if a state law absolutely bars an employer from using one, the federal law's limited authorization will be unavailable.

Occupational Safety and Health Act

In a heavily industrialized society, workplace safety is a major concern. Hundreds of studies for more than a century documented the gruesome toll taken by hazardous working conditions in mines, on railroads, and in factories from tools, machines, treacherous surroundings, and toxic chemicals and other substances. Studies in the late 1960s showed that more than 14,000 workers were killed and 2.2 million were disabled annually—at a cost of more than $8 billion and a loss of more than 250 million worker days. Congress responded in 1970 with the Occupational Safety and Health Act, the primary aim of which is "to assure so far as possible every working man and woman in the Nation safe and healthful working conditions."

The act imposes on each employer a general duty to furnish a place of employment free from recognized hazards likely to cause death or serious physical harm to employees. It also gives the Secretary of Labor the power to establish national health and safety standards. The standard-making power has been delegated to the Occupational Safety and Health Administration (OSHA), an agency within the US Department of Labor. The agency is authorized to inspect workplaces covered by the act whenever it receives complaints from employees or reports about fatal or multiple injuries. The agency may assess penalties and proceed administratively to enforce its standards. Criminal provisions of the act are enforced by the Justice Department.

During its first two decades, OSHA was criticized for not issuing standards very quickly: fewer than thirty national workplace safety standards were issued by 1990. But not all safety enforcement is in the hands of the federal government: although OSHA standards preempt similar state standards, under the act the Secretary may permit the states to come up with standards equal to or better than federal standards and may make grants to the states to cover half the costs of enforcement of the state safety standards.

Fair Labor Standards Act

In the midst of the Depression, Congress enacted, at President Roosevelt's urging, a national minimum wage law, the Fair Labor Standards Act of 1938 (FLSA). The act prohibits most forms of child labor and established a scale of minimum wages for the regular workweek and a higher scale for overtime. (The original hourly minimum was twenty-five cents, although the administrator of the Wage and Hour Division of the US Department of Labor, a position created by the act, could raise the minimum rate industry by industry.) The act originally was limited to certain types of work: that which was performed in transporting goods in interstate commerce or in producing goods for shipment in interstate commerce. Employers quickly learned that they could limit the minimum wage by, for example, separating the interstate and intrastate components of their production.

Within the next quarter century, the scope of the FLSA was considerably broadened, so that it now covers all workers in businesses that do a particular dollar-volume of goods that move in interstate commerce, regardless of whether a particular employee actually works in the interstate component of the business. It now covers between 80 and 90 percent of all persons privately employed outside of agriculture, and a lesser but substantial percentage of agricultural workers and state and local government employees. Violations of the act are investigated by the administrator of the Wage and Hour Division, who has authority to negotiate back pay on the employee's behalf. If no settlement is reached, the Labor Department may sue on the employee's behalf, or the employee, armed with a notice of the administrator's calculations of back wages due, may sue in federal or state court for back pay. Under the FLSA, a successful employee will receive double the amount of back wages due.

Workers' Compensation Laws

Since the beginning of the twentieth century, work-related injuries or illnesses have been covered under state workers' compensation laws that provide a set amount of weekly compensation for disabilities caused by accidents and illnesses suffered on the job. The compensation plans also pay hospital and medical expenses necessary to treat workers who are injured by, or become ill from, their work. In assuring workers of compensation, the plans eliminate the hazards and uncertainties of lawsuits by eliminating the need to prove fault. Employers fund the compensation plans by paying into statewide plans or purchasing insurance.

Other State Laws

Although it may appear that most employment law is federal, employment discrimination is largely governed by state law because Congress has so declared it. The Civil Rights Act of 1964 tells federal courts to defer to state agencies to enforce antidiscrimination provisions of parallel state statutes with remedies similar to those of the federal law. Moreover, many states have gone beyond federal law in banning certain forms of discrimination. Thus well before enactment of the Americans with Disabilities Act, more than forty states prohibited such discrimination in private employment.

More than a dozen states ban employment discrimination based on marital status, a category not covered by federal law. Two states have laws that protect those that may be considered "overweight." Two states and more than seventy counties or municipalities ban employment discrimination on the basis of sexual orientation; most large companies have offices or plants in at least one of these jurisdictions.

Employment discrimination is discussed in more detail later in this textbook.

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B. Workers Compensation

The employer owes the employee—any employee, not just agents—certain statutorily imposed tort and workers' compensation duties.

Background to Workers' Compensation

Andy, who works in a dynamite factory, negligently stores dynamite in the wrong shed. Andy warns his fellow employee Bill that he has done so. Bill lights up a cigarette near the shed anyway, a spark lands on the ground, the dynamite explodes, and Bill is injured. May Bill sue his employer to recover damages? At common law, the answer would be no—three times no. First, the "fellow-servant" rule would bar recovery because the employer was held not to be responsible for torts committed by one employee against another. Second, Bill's failure to heed Andy's warning and his decision to smoke near the dynamite amounted to contributory negligence. Hence even if the dynamite had been negligently stored by the employer rather than by a fellow employee, the claim would have been dismissed. Third, the courts might have held that Bill "assumed the risk": since he was aware of the dangers, it would not be fair to saddle the employer with the burden of Bill's actions.

The three common-law rules just mentioned ignited intense public fury by the turn of the twentieth century. In large numbers of cases, workers who were mutilated or killed on the job found themselves and their families without recompense. Union pressure and grass roots lobbying led to workers' compensation acts—statutory enactments that dramatically overhauled the law of torts as it affected employees.

The System in General

Workers' compensation is a no-fault system. The employee gives up the right to sue the employer (and, in some states, other employees) and receives in exchange predetermined compensation for a job-related injury, regardless of who caused it. This trade-off was felt to be equitable to employer and employee: the employee loses the right to seek damages for pain and suffering—which can be a sizable portion of any jury award—but in return he can avoid the time-consuming and uncertain judicial process and assure himself that his medical costs and a portion of his salary will be paid—and paid promptly. The employer must pay for all injuries, even those for which he is blameless, but in return he avoids the risk of losing a big lawsuit, can calculate his costs actuarially, and can spread the risks through insurance.

Most workers' compensation acts provide 100 percent of the cost of a worker's hospitalization and medical care necessary to cure the injury and relieve him from its effects. They also provide for payment of lost wages and death benefits. Even an employee who is able to work may be eligible to receive compensation for specific injuries.

MARYLAND WORKERS' COMPENSATION COMMISSION
MAXIMUM RATE OF BENEFITS FOR CALENDAR YEAR 2018
Effective January 1, 2018

http://www.wcc.state.md.us/Adjud_Claims/Comp_Rates.html

Section 9-603 of the Labor and Employment Article states that the maximum compensation paid shall be determined as of January 1st of each calendar year. The Department of Labor, Licensing and Regulation of the State of Maryland has advised this Commission that the Average Weekly Wage of workers covered by Maryland Unemployment for the fiscal year ending June 30, 2017 is $1,094.00.

In accordance with Section 9-604 of the Labor and Employment Article, which authorizes the computation of Awards to the next highest dollar when the standard computation formula results in an uneven amount, the following are maximum benefits for death and disability for injuries occurring on and after January 1, 2018.

TEMPORARY TOTAL DISABILITY:
Two-thirds of the employee's Average Weekly Wage not to exceed 100% of the State Average Weekly Wage or $1,094.00.

PERMANENT TOTAL DISABILITY:
Two-thirds of the employee's Average Weekly Wage not to exceed 100% of the State Average Weekly Wage or $1,094.00.

PERMANENT PARTIAL DISABILITY:

- For awards for a period less than 75 weeks for events occurring on or after January 1, 2000 but before January 1, 2009, compensation is to be paid at the rate of thirty-three and one-third per centum of the employee's Average Weekly Wage, not to exceed $114.00. The minor disability category does not apply to certain public safety employees. See LE 9-628(a).
- For awards for a period less than 75 weeks for events occurring on or after January 1, 2009 but before January 1, 2010, compensation is to be paid at the rate of thirty-three and one-third per centum of the employee's Average Weekly Wage, not to exceed 14.3% of the State Average Weekly Wage or $130.00. The minor disability category does not apply to certain public safety employees. See LE 9-628(a).
- For awards for a period of less than 75 weeks for events occurring on or after January 1, 2010 but before January 1, 2011, compensation is to be paid at the rate of thirty-three and one-third per centum of the employee's Average Weekly Wage, not to exceed 15.4% of the State Average Weekly Wage or $142.00. The minor disability category does not apply to certain public safety employees. See LE 9-628(a).
- For awards for a period of less than 75 weeks for events occurring on or after January 1, 2011 but before January 1, 2012, compensation is to be paid at the rate of thirty-three and one-third per centum of the employee's Average Weekly Wage, not to exceed 16.7% of the State Average Weekly Wage or $157.00. The minor disability category does not apply to certain public safety employees. See LE 9-628(a).
- For awards for a period of less than 75 weeks for events occurring on or after January 1, 2012 but before January 1, 2013, compensation is to be paid at the rate of thirty-three and one-third per centum of the employee's Average Weekly Wage, not to exceed 16.7% of the State Average Weekly Wage or $162.00. The minor disability category does not apply to certain public safety employees. See LE 9-628(a).
- For awards for a period of less than 75 weeks for events occurring on or after January 1, 2013 but before January 1, 2014, compensation is to be paid at the rate of thirty-three and one-third per centum of the employee's Average Weekly Wage, not to exceed 16.7% of the State Average Weekly Wage or $166.00. The minor disability category does not apply to certain public safety employees. See LE 9-628(a).
- For awards for a period of less than 75 weeks for events occurring on or after January 1, 2014 but before January 1, 2015, compensation is to be paid at the rate of thirty-three and one-third per centum of the employee's Average Weekly Wage, not to exceed 16.7% of the State Average Weekly Wage or $167.00. The minor disability category does not apply to certain public safety employees. See LE 9-628(a).
- For awards for a period of less than 75 weeks for events occurring on or after January 1, 2015 but before January 1, 2016, compensation is to be paid at the rate of thirty-three and one-third per centum of the employee's Average Weekly Wage, not to exceed 16.7% of the State Average Weekly Wage or $168.00. The minor disability category does not apply to certain public safety employees. See LE 9-628(a).
- For awards for a period of less than 75 weeks for events occurring on or after January 1, 2016 but before January 1, 2017, compensation is to be paid at the rate of thirty-three and one-third per centum of the employee's Average Weekly Wage, not to exceed 16.7% of the State Average Weekly Wage or $172.00. The minor disability category does not apply to certain public safety employees. See LE 9-628(a).
- For awards for a period of less than 75 weeks for events occurring on or after January 1, 2017 but before January 1, 2018, compensation is to be paid at the rate of thirty-three and one-third per centum of the employee's Average Weekly Wage, not to exceed 16.7% of the State Average Weekly Wage or

$176.00. The minor disability category does not apply to certain public safety employees. See LE 9-628(a).
- For awards for a period of less than 75 weeks for events occurring on or after January 1, 2018 but before January 1, 2019, compensation is to be paid at the rate of thirty-three and one-third per centum of the employee's Average Weekly Wage, not to exceed 16.7% of the State Average Weekly Wage or $183.00. The minor disability category does not apply to certain public safety employees. See LE 9-628(a).
- For awards for a period equal to or greater than 75 weeks, but less than 250 weeks, for events occurring on or after January 1, 2018 but before January 1, 2019, the compensation is to be paid at two-thirds of the employee's Average Weekly Wage not to exceed one-third of the State Average Weekly Wage or $365.00.

TEMPORARY PARTIAL DISABILITY:
Fifty percent (50%) of the difference between the employee's Average Weekly Wage and his wage earning capacity thereafter, but not to exceed 50% of the State Average Weekly Wage or $547.00.

SERIOUS DISABILITY BENEFITS:

Two-thirds of the employee's Average Weekly Wage not to exceed 75% of the State Average Weekly Wage or $821.00.

DEATH BENEFITS:

For deaths occurring prior to October 1, 2011, the following formula applies:
- If wholly dependent, two-thirds of the employee's Average Weekly Wage not to exceed 100% of the State Average Weekly Wage.
- If partly dependent, two-thirds of the employee's Average Weekly Wage not to exceed two-thirds of the State Average Weekly Wage.
- For deaths occurring on or after October 1, 2011* , the following formula applies:

1. Two-thirds of the deceased employee's Average Weekly Wage at the time of the occurrence not to exceed the State Average Weekly Wage.

2. The deceased employee's income shall be divided by the family income to determine the percent of family income earned by the deceased. The percent of family income earned by the deceased is multiplied by the death benefit (as calculated in paragraph 1) to determine the amount payable, collectively, to all dependents.

In accordance with Section 9-683.3(i) of the Labor and Employment Article, all dependents who are neither a dependent spouse nor a dependent child shall be entitled to no more than a total of $65,000, collectively, as their portion of the total death benefits payable. Beginning on January 1, 2012, this benefit limit shall be adjusted annually by the same percent applicable to the adjustment of the State Average Weekly Wage. See annual maximums in table below:

Table 17 Maximum Death Benefits

Date	AWW	Benefit Limit
January 1, 2013	$990.00	$66,684.00
January 1, 2014	$998.00	$67,223.00

January 1, 2015	$1,005.00	$67,695.00
January 1, 2016	$1,027.00	$69,177.00
January 1, 2017	$1,052.00	$70,861.00
January 1, 2018	$1,094.00	$73,690.00

The injured worker is typically entitled to two-thirds his or her average pay, not to exceed some specified maximum, for two hundred weeks. If the loss is partial (like partial loss of sight), the recovery is decreased by the percentage still usable.

Coverage

Although workers' compensation laws are on the books of every state, in two states—New Jersey and Texas—they are not compulsory. In those states the employer may decline to participate, in which event the employee must seek redress in court. But in those states permitting an employer election, the old common-law defenses (fellow-servant rule, contributory negligence, and assumption of risk) have been statutorily eliminated, greatly enhancing an employee's chances of winning a suit. The incentive is therefore strong for employers to elect workers' compensation coverage.

Those frequently excluded are farm and domestic laborers and public employees; public employees, federal workers, and railroad and shipboard workers are covered under different but similar laws. The trend has been to include more and more classes of workers. Approximately half the states now provide coverage for household workers, although the threshold of coverage varies widely from state to state. Some use an earnings test; other states impose an hours threshold. People who fall within the domestic category include maids, baby-sitters, gardeners, and handymen but generally not plumbers, electricians, and other independent contractors.

Paying for Workers' Compensation

There are three general methods by which employers may comply with workers' compensation laws. First, they may purchase employer's liability and workers' compensation policies through private commercial insurance companies. These policies consist of two major provisions: payment by the insurer of all claims filed under workers' compensation and related laws (such as occupational disease benefits) and coverage of the costs of defending any suits filed against the employer, including any judgments awarded. Since workers' compensation statutes cut off the employee's right to sue, how can such a lawsuit be filed? The answer is that there are certain exceptions to the ban: for instance, a worker may sue if the employer deliberately injures an employee.

The second method of compliance with workers' compensation laws is to insure through a state fund established for the purpose. The third method is to self-insure. The laws specify conditions under which companies may resort to self-insurance, and generally only the largest corporations qualify to do so. In short, workers' compensation systems create a tax on employers with which they are required (again, in most states) to buy insurance. The amount the employer has to pay for the insurance depends on the number and seriousness of claims made—how dangerous the work is. For example, Washington State's 2011 proposed hourly rates for employers to purchase insurance include these items: for egg and poultry farms, $1.16 per hour; shake and shingle mills, $18.06 per hour; asphalt paving, $2.87 per hour; lawn care maintenance, $1.22 per hour; plastic products manufacturing, $0.87 per hour; freight handling, $1.81 per hour; supermarkets, $0.76; restaurants, $0.43; entertainers and dancers, $7.06; colleges and universities, $0.31.

Washington State Department of Labor & Industries, Rates for Workers' Compensation, Proposed 2011 Rates, http://www.lni.wa.gov/ClaimsIns/Insurance/RatesRisk/Check/RatesHistory.

Recurring Legal Issues

There are a number of legal issues that recur in workers' compensation cases. The problem is, from the employer's point of view, that the cost of buying insurance is tied to the number of claims made. The employer therefore has reason to assert the injured employee is not eligible for compensation. Recurring legal issues include the following:

Is the injury work related? As a general rule, on-the-job injuries are covered no matter what their relationship to the employee's specific duties. Although injuries resulting from drunkenness or fighting are not generally covered, there are circumstances under which they will be.

Is the injured person an employee? Courts are apt to be liberal in construing statutes to include those who might not seem to be employed. In *Betts v. Ann Arbor Public Schools*, 403 Mich. 507 (1978), a University of Michigan student majoring in physical education was a student teacher in a junior high school. During a four-month period, he taught two physical education courses. On the last day of his student teaching, he walked into the locker room and thirty of his students grabbed him and tossed him into the swimming pool. This was traditional, but he "didn't feel like going in that morning" and put up a struggle that ended with a whistle on an elastic band hitting him in the eye, which he subsequently lost as a result of the injury. He filed a workers' compensation claim. The school board argued that he could not be classified as an employee because he received no pay. Since he was injured by students—not considered agents of the school—he would probably have been unsuccessful in filing a tort suit; hence the workers' compensation claim was his only chance of recompense. The state workers' compensation appeal board ruled against the school on the ground that payment in money was not required: "Plaintiff was paid in the form of training, college credits towards graduation, and meeting of the prerequisites of a state provisional certificate." The state supreme court affirmed the award.

How palpable must the "injury" be? A difficult issue is whether a worker is entitled to compensation for psychological injury, including cumulative trauma. Until the 1970s, insurance companies and compensation boards required physical injury before making an award. Claims that job stresses led to nervous breakdowns or other mental disorders were rejected. But most courts have liberalized the definition of injury and now recognize that psychological trauma can be real and that job stress can bring it on, as shown by the discussion of *Wolfe v. Sibley, Lindsay & Curr Co.,* 36 N.Y.2d 505 (N.Y. 1975).

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C. Employment Discrimination

As we look at federal *employment discrimination* laws, bear in mind that most states also have laws that prohibit various kinds of discriminatory practices in employment. Until the 1960s, Congress intruded but little in the affairs of employers except in union relationships. A company could refuse to hire members of racial minorities, exclude women from promotions, or pay men more than women for the same work. But with the rise of the civil rights movement in the early 1960s, Congress (and many states) began to legislate away the employer's frequently exercised power to discriminate. The most important statutes are Title VII of the Civil Rights Act of 1964, the Equal Pay Act of 1963, the Age Discrimination in Employment Act of 1967, and the Americans with Disabilities Act of 1990.

Title VII of the Civil Rights Act of 1964

The most basic anti-discrimination law in employment is in Title VII of the federal Civil Rights Act of 1964. The key provision prohibited discrimination based on race, but Congress also included sex, religion, national origin, and color as prohibited bases for hiring, promotion, layoff, and discharge decisions. To put the Civil Rights Act in its proper context, a short history of racial discrimination in the United States follows.

The passage of the Civil Rights Act of 1964 was the culmination of a long history that dated back to slavery, the founding of the US legal system, the Civil War, and many historical and political developments over the ninety-nine years from the end of the Civil War to the passage of the act. The years prior to 1964 saw a remarkable rise of civil disobedience, led by many in the civil rights movement but most prominently by Dr. Martin Luther King Jr. Peaceful civil disobedience was sometimes met with violence, and television cameras were there to record most of it.

While the Civil War addressed slavery and the secession of Southern states, the Thirteenth, Fourteenth, and Fifteenth Amendments, ratified just after the war, provided for equal protection under the law, guaranteed citizenship, and protected the right to vote for African Americans. The amendments also allowed Congress to enforce these provisions by enacting appropriate, specific legislation.

During the Reconstruction Era, many of the Southern states resisted the laws that were passed in Washington, DC, to bolster civil rights. To a significant extent, decisions rendered by the US Supreme Court in this era—such as *Plessy v. Ferguson,* 163 U.S. 537 (1896) condoning "separate but equal" facilities for different races—restricted the utility of these new federal laws. The states effectively controlled the public treatment of African Americans, and a period of neglect set in that lasted until after World War II. The state laws essentially mandated segregated facilities (restaurants, hotels, schools, water fountains, public bathrooms) that were usually inferior for blacks.

Along with these Jim Crow laws in the South, the Ku Klux Klan was very strong, and lynchings (hangings without any sort of public due process) by the Klan and others were designed to limit the civil and economic rights of the former slaves. The hatred of blacks from that era by many whites in America has only gradually softened prior to 1964. Even as the civil rights bill was being debated in Congress in 1964, some Young Americans for Freedom in the right wing of the GOP would clandestinely chant "Be a man, join the Klan" and sing "We will hang Earl Warren from a sour apple tree," to the tune of "Battle Hymn of the Republic," in anger over the Chief Justice's presiding over *Brown v. Board of Education*, 347 U.S. 483 (1954) which reversed *Plessy v. Ferguson*.

But just a few years earlier, the public service and heroism of many black military units and individuals in World War II created a perceptual shift in US society; men of many races who served together in the war against the Axis powers (fascism in Europe and the Japanese emperor's rule in the Pacific) began to understand their common humanity. Major migrations of blacks from the South to industrial cities of the North also gave impetus to the civil rights movement.

Bills introduced in Congress regarding employment policy brought the issue of civil rights to the attention of representatives and senators. In 1945, 1947, and 1949, the House of Representatives voted to abolish the poll tax. The poll tax was a method used in many states to confine voting rights to those who could pay a tax, and often, blacks could not. The Senate did not go along, but these bills signaled a growing interest in protecting civil rights through federal action. The executive branch of government, by presidential order, likewise became active by ending discrimination in the nation's military forces and in federal employment and work done under government contract.

The Supreme Court gave impetus to the civil rights movement in its reversal of the "separate but equal" doctrine in the *Brown v. Board of Education* decision. In its 1954 decision, the Court said, "To separate black children from others of similar age and qualifications solely because of their race generates a feeling of inferiority as to their status in the community that may affect their hearts and minds in a way never to be undone.…We conclude that in the field of public education the doctrine of separate but equal has no place. Separate educational facilities are inherently unequal."

This decision meant that white and black children could not be forced to attend separate public schools. By itself, however, this decision did not create immediate gains, either in public school desegregation or in the desegregation of other public facilities. There were memorable standoffs between federal agents and state officials in Little Rock, Arkansas, for example; the Democratic governor of Arkansas personally blocked young black students from entering Little Rock's Central High School, and it was only President Eisenhower's order to have federal marshals accompany the students that forced integration. The year was 1957.

But resistance to public school integration was widespread, and other public facilities were not governed by the Brown ruling. Restaurants, hotels, and other public facilities were still largely segregated. Segregation kept blacks from using public city buses, park facilities, and restrooms on an equal basis with whites. Along with inferior schools, workplace practices throughout the South and also in many Northern cities sharply limited African Americans' ability to advance economically. Civil disobedience began to grow.

The bus protests in Montgomery, Alabama, were particularly effective. Planned by civil rights leaders, Rosa Parks's refusal to give up her seat to a white person and sit at the back of the public bus led to a boycott of the Montgomery bus system by blacks and, later, a boycott of white businesses in Montgomery. There were months of confrontation and some violence; finally, the city agreed to end its long-standing rules on segregated seating on buses.

There were also protests at lunch counters and other protests on public buses, where groups of Northern protesters—Freedom Riders—sometimes met with violence. In 1962, James Meredith's attempt to enroll as the first African American at the University of Mississippi generated extreme hostility; two people were killed and 375 were injured as the state resisted Meredith's admission. The murders of civil rights workers Medgar Evers and William L. Moore added to the inflamed sentiments, and whites in Birmingham, Alabama, killed four young black girls who were attending Sunday school when their church was bombed.

These events were all covered by the nation's news media, whose photos showed beatings of protesters and the use of fire hoses on peaceful protesters. Social tensions were reaching a postwar high by 1964. According to the government, there were nearly one thousand civil rights demonstrations in 209 cities in a three-month period beginning May 1963. Representatives and senators could not ignore the impact of social protest. But the complicated political history of the Civil Rights Act of 1964 also tells us that the legislative result was anything but a foregone conclusion. *See CongressLink, "Major Features of the Civil Rights Act of 1964,"* *at* http://www.4uth.gov.ua/usa/english/society/rights/essay.html

In Title VII of the Civil Rights Act of 1964, Congress for the first time outlawed discrimination in employment based on race, religion, sex, or national origin:. Title VII declares: "It shall be an unlawful employment practice 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." Title VII applies to (1) employers with fifteen or more employees whose business affects interstate commerce, (2) all employment agencies, (3) labor unions with fifteen or more members, (4) state and local governments and their agencies, and (5) most federal government employment.

In 1984, the Supreme Court said that Title VII applies to partnerships as well as corporations when ruling that it is illegal to discriminatorily refuse to promote a female lawyer to partnership status in a law firm. This applies, by implication, to other fields, such as accounting. *Hishon v. King & Spalding*, 467 U.S. 69 (1984).The remedy for unlawful discrimination is back pay and hiring, reinstatement, or promotion.

While not expressly included in the list of protected classes, substantial litigation has arisen under Title VII when an employee was discharged because of their sexual orientation. Over time, some federal circuits including the second and sixth circuits had decided that such a discharge violated Title VII, while others including the eleventh circuit found that sexual orientation, missing from the list of protected classes, was not covered by the statute. In 2020, the Supreme Court heard *Bostock v. Clayton County, Georgia*, 140 S. Ct. 1731 (2020), and decided that sexual orientation discrimination is discrimination based on sex, and therefore violative of Title VII. "The statute's message for our cases is equally simple and momentous: An individual's homosexuality or transgender status is not relevant to employment decisions. That's because it is impossible to discriminate against a person for being homosexual or transgender without discriminating against that individual based on sex."

Title VII established the Equal Employment Opportunity Commission (EEOC) to investigate violations of the act. A victim of discrimination who wishes to file suit must first file a complaint with the EEOC to permit that agency to attempt conciliation of the dispute. The EEOC filed a number of lawsuits to prove statistically that a company has systematically discriminated on one of the forbidden bases. The EEOC received perennial criticism for its extreme slowness in filing suits and for its failure to handle the huge backlog of complaints with which it has had to wrestle.

The courts have come to recognize two major types of Title VII cases:

Cases of Disparate Treatment

In this type of lawsuit, the plaintiff asserts that because of race, sex, religion, or national origin, he or she has been treated less favorably than others within the organization. To prevail in a disparate treatment suit, the plaintiff must show that the company intended to discriminate because of one of the factors the law forbids to be considered. Thus in *McDonnell Douglas Corp. v. Green*, 411 U.S. 792 (1973), the Supreme Court held that the plaintiff had shown that the company intended to discriminate by refusing to rehire him because of his race. In general, there are two types of disparate treatment cases: (1) pattern-and-practice cases, in which the employee asserts that the employer systematically discriminates on the grounds of race, religion, sex, or national origin; and (2) reprisal or retaliation cases, in which the employee must show that the employer discriminated against him or her because that employee asserted his or her Title VII rights.

Cases of Disparate Impact

In this second type of Title VII case, the employee need not show that the employer intended to discriminate but only that the effect, or impact, of the employer's action was discriminatory. Usually, this impact will be upon an entire class of employees. The plaintiff must demonstrate that the reason for the employer's conduct (such as refusal to promote) was not job related. Disparate impact cases often arise out of practices that appear to be neutral or nondiscriminatory on the surface, such as educational requirements and tests administered to help the employer choose the most qualified candidate. In the seminal case of *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971), the Supreme Court held that under Title VII, an employer is not free to use any test it pleases; the test must bear a genuine relationship to job performance. Griggs stands for the proposition that Title VII "prohibits employment practices that have discriminatory effects as well as those that are intended to discriminate."

Discrimination Based on Religion

An employer who systematically refuses to hire Catholics, Jews, Buddhists, or members of any other religious group engages in unlawful disparate treatment under Title VII. But refusal to deal with someone because of his or her religion is not the only type of violation under the law. Title VII defines religion as including religious observances and practices as well as beliefs and requires the employer to "reasonably accommodate an employee's or prospective employee's religious observance or practice" unless the employer can demonstrate that a reasonable accommodation would work an "undue hardship on the conduct of the employer's business." Thus a company that refused even to consider permitting a devout Sikh to wear his religiously prescribed turban on the job would violate Title VII.

But the company need not make an accommodation that would impose more than a minimal cost. For example, an employee in an airline maintenance department, open twenty-four hours a day, wished to avoid working on his Sabbath. The employee belonged to a union, and under the collective bargaining agreement, a rotation system determined by seniority would have put the worker into a work shift that fell on his Sabbath. The Supreme Court held that the employer was not required to pay premium wages to someone whom the seniority system would not require to work on that day and could discharge the employee if he refused the assignment. *Trans World Airlines v. Hardison*, 432 U.S. 63 (1977).

Title VII permits religious organizations to give preference in employment to individuals of the same religion. Obviously, a synagogue looking for a spiritual leader would hire a rabbi and not a priest. Over time, the Supreme Court has held that a "ministerial exception" under the First Amendment applies to religious organizations, exempting them from certain kinds of claims under Title VII. *Our Lady of Guadalupe Sch. v. Morrissey-Berru*, 140 S. Ct. 2049 (2020).

Sex Discrimination

A refusal to hire or promote a woman simply because she is female is a clear violation of Title VII. Under the Pregnancy Act of 1978, Congress declared that discrimination because of pregnancy is a form of sex discrimination. Equal pay for equal or comparable work has also been an issue in sex (or gender) discrimination. *Barbano v. Madison County* , 922 F.2d 139 (2d Cir. 1990) presents a straightforward case of sex discrimination. In that case, notice how the plaintiff has the initial burden of proving discriminatory intent and how the burden then shifts to the defendant to show a plausible, nondiscriminatory reason for its hiring decision.

The late 1970s brought another problem of sex discrimination to the fore: *sexual harassment*. There is much fear and ignorance about sexual harassment among both employers and employees. Many men think they cannot compliment a woman on her appearance without risking at least a warning by the human resources department. Many employers have spent significant time and money trying to train employees about sexual harassment, so as to avoid lawsuits. Put simply, sexual harassment involves unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature.

There are two major categories of sexual harassment: (1) quid pro quo and (2) hostile work environment.

Quid pro quo comes from the Latin phrase “one thing in return for another.” If any part of a job is made conditional on sexual activity, there is quid pro quo sexual harassment. Here, one person’s power over another is essential; a coworker, for example, is not usually in a position to make sexual demands on someone at his same level, unless he has special influence with a supervisor who has power to hire, fire, promote, or change work assignments. A supervisor, on the other hand, typically has those powers or the power to influence those kinds of changes. For example, when the male foreman says to the female line worker, “I can get you off of the night shift if you’ll sleep with me,” there is quid pro quo sexual harassment.

The second form is hostile work environment. *See Harris v. Forklift Systems, Inc., 510 U.S. 17 (1993)* and *Meritor v. Vinson*, 477 U.S. 57 (1986). Hostile work environment claims are more frequent than quid pro quo claims and are more worrisome to management. An employee has a valid claim of hostile work environment harassment if sexual talk, imagery, or behavior becomes so pervasive that it interferes with the employee’s ability to work to her best capacity. Courts even found that offensive jokes, if sufficiently frequent and pervasive in the workplace, can create a hostile work environment. Likewise, comments about body parts or public displays of pornographic pictures can also create a hostile work environment. In short, the plaintiff can be detrimentally offended and hindered in the workplace even if there are no measurable psychological injuries.

In the landmark hostile work environment case of *Meritor v. Vinson*, the Supreme Court held that Title VII’s ban on sexual harassment encompasses more than the trading of sexual favors for employment benefits. Unlawful sexual harassment also includes the creation of a hostile or offensive working environment, subjecting both the offending employee and the company to damage suits even if the victim was in no danger of being fired or of losing a promotion or raise.

In *Harris v. Forklift Systems*, the “reasonable person” standard in hostile work environment cases was declared by the court as follows: “So long as the environment would reasonably be perceived, and is perceived, as hostile or abusive there is no need for it also to be psychologically injurious.” However, in *Duncan v. General Motors Corporation*, 499 F.2d 835 (8th Cir. 1974), *Harris* was used as a precedent to deny relief to a woman who was sexually harassed, because the court believed the conditions were not severe or pervasive enough to unreasonably interfere with her work.

The reader should note that the vicarious liability of an employer for sexual harassment does not rely on whether the harassment is quid pro quo or hostile work environment; either can form the basis for employer liability for the employee’s conduct. *Burlington Industries v. Ellerth*, 524 U.S. 742 (1998). Employers are also well-served to have an anti-harassment policy to fit within the affirmative defense discussed in *Burlington* to claims of vicarious liability.

Sex discrimination in terms of wages and benefits is common enough that a number of sizeable class action lawsuits have been brought. A class action lawsuit is generally initiated by one or more people who believe that they, along with a group of other people, have been wronged in similar ways. Class actions for sexual harassment have been successful in the past. On June 11, 1998, the EEOC reached a $34 million settlement with Mitsubishi over allegations of widespread sexual harassment at the Normal, Illinois, auto plant. The settlement involved about five hundred women who split the $34 million, although only seven received the maximum $300,000 allowed by law. The others received amounts ranging from $8,000 to $225,000.

Class action lawsuits involve specific plaintiffs (called class plaintiffs or class representatives) who are named in the class action lawsuit to assert the claims of the unnamed or absent members of the class; thus all those with a common complaint need not file their own separate lawsuit. From the point of view of plaintiffs who may have lost only a few thousand dollars annually as a result of the discrimination, a class action is advantageous: almost no lawyer would take a complicated civil case that had a potential gain of only a few thousand dollars. But if there are thousands of plaintiffs with very similar claims, the judgment could be well into the millions. Defendants can win the procedural battle by convincing a court that the proposed class of plaintiffs does not present common questions of law or of fact.

In the *Wal-Mart* class action case decided by the Supreme Court in 2011, three named plaintiffs (Dukes, Arana, and Kwapnoski) represented a proposed class of 1.5 million current or former Wal-Mart employees. The plaintiffs' attorneys asked the trial court in 2001 to certify as a class all women employed at any Wal-Mart domestic retail store at any time since December of 1998. As the case progressed through the judicial system, the class grew in size. If the class was certified, and discrimination proven, Wal-Mart could have been liable for over $1 billion in back pay. So Wal-Mart argued that as plaintiffs, the cases of the 1.5 million women did not present common questions of law or of fact—that is, that the claims were different enough that the Court should not allow a single class action lawsuit to present such differing kinds of claims. Initially, a federal judge disagreed, finding the class sufficiently coherent for purposes of federal civil procedure. The US Court of Appeals for the Ninth Circuit upheld the trial judge on two occasions.

But the US Supreme Court agreed with Wal-Mart. In the majority opinion, Justice Scalia discussed the commonality condition for class actions: "Quite obviously, the mere claim by employees of the same company that they have suffered a Title VII injury, or even a disparate impact Title VII injury, gives no cause to believe that all their claims can productively be litigated at once. Their claims must depend upon a common contention—for example, the assertion of discriminatory bias on the part of the same supervisor. That common contention, moreover, must be of such a nature that it is capable of classwide resolution—which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke." *Wal-Mart Stores, Inc. v. Dukes*, 564 U.S. 338 (2011).

Finding that there was no common condition in Wal-Mart, the Supreme Court reversed the lower courts. Many commentators, and four dissenting Justices, believed that the majority opinion has created an unnecessarily high hurdle for class action plaintiffs in Title VII cases.

Exceptions to Title VII

Merit

Employers are allowed to select on merit and promote on merit without offending title VII's requirements. Merit decisions are usually based on work, educational experience, and ability tests. All requirements, however, must be job related. For example, the ability to lift heavy cartons of sixty pounds or more is appropriate for certain warehouse jobs but is not appropriate for all office workers. The ability to do routine maintenance (electrical, plumbing, construction) is an appropriate requirement for maintenance work but not for a teaching position. Requiring someone to have a high school degree, as in *Griggs vs. Duke Power Co.*, 401 U.S. 424 (1971) is not appropriate as a qualification for common labor.

Seniority

Employers may also maintain seniority systems that reward workers who have been with the company for a long time. Higher wages, benefits, and choice of working hours or vacation schedules are examples of rewards that provide employees with an incentive to stay with the company. If they are not the result of intentional discrimination, they are lawful. Where an employer is dealing with a union, it is typical to see seniority systems in place.

Bona Fide Occupational Qualification (BFOQ)

For certain kinds of jobs, employers may impose *bona fide occupational qualifications (BFOQs)*. Under the express terms of Title VII, however, a bona fide (good faith) occupational qualification of race or color is never allowed. In the area of religion, as noted earlier, a group of a certain religious faith that is searching for a new spiritual leader can certainly limit its search to those of the same religion. With regard to sex (gender), allowing women to be locker-room attendants only in a women's gym is a valid BFOQ. One important test that the courts employ in evaluating an employer's BFOQ claims is the "essence of the business" test.

In *Diaz v. Pan American World Airways, Inc.*, 442 F.2d 385 (5th Cir. 1971), the airline maintained a policy of exclusively hiring females for its flight attendant positions. The essence of the business test was established with the court's finding that "discrimination based on sex is valid only when the essence of the business operation would be undermined by not hiring members of one sex exclusively." Although the court acknowledged that females might be better suited to fulfill the required duties of the position, this was not enough to fulfill the essence of the business test:

"The primary function of an airline is to transport passengers safely from one point to another. While a pleasant environment, enhanced by the obvious cosmetic effect that female stewardesses provide as well as…their apparent ability to perform the non-mechanical functions of the job in a more effective manner than most men, may all be important, they are tangential to the essence of the business involved. No one has suggested that having male stewards will so seriously affect the operation of an airline as to jeopardize or even minimize its ability to provide safe transportation from one place to another." *Diaz v. Pan American World Airways, Inc.*, 442 F.2d 385 (5th Cir. 1971).

The reason that airlines now use the gender-neutral term flight attendant is a direct result of Title VII. In the 1990s, Hooters had difficulty convincing the EEOC and certain male plaintiffs that only women could be hired as waitstaff in its restaurants. With regard to national origin, directors of movies and theatrical productions would be within their Title VII BFOQ rights to restrict the roles of fictional Asians to those actors whose national origin was Asian, but could also permissibly hire Caucasian actors made up in "yellow face."

Defenses in Sexual Harassment Cases

In the 1977 term, the US Supreme Court issued two decisions that provide an affirmative defense in some sexual harassment cases. In *Faragher v. City of Boca Raton*, 524 U.S. 775 (1998) and in *Burlington Industries v. Ellerth*, 524 U.S. 742 (1988), female employees sued for sexual harassment. In each case, they proved that their supervisors engaged in unconsented to touching as well as verbal sexual harassment. In both cases, the plaintiff quit her job and, after going through the EEOC process, got a right-to-sue letter and in fact sued for sexual harassment. In *Faragher*, the employer never disseminated a policy against sexual harassment to its employees. But in the second case, *Burlington Industries*, the employer had a policy that was made known to employees. Moreover, a complaints' system had been established that was not used by the female employee.

Both opinions rejected the notion of strict or automatic liability for employers when agents (employees) engage in sexual harassment. But the employer can have a valid defense to liability if it can prove (1) that it exercised reasonable care to prevent and correct any sexual harassment behaviors and (2) that the plaintiff employee unreasonably failed to take advantage of any preventive or corrective opportunities provided by the employer or to otherwise avoid harm. As with all affirmative defenses, the employer has the burden of proving this defense.

Affirmative Action

Affirmative action is mentioned in the statutory language of Title VII, as courts have the power to order affirmative action as a remedy for the effects of past discriminatory actions. In addition to court-ordered affirmative action, employers may voluntarily use an affirmative action plan to remedy the effects of past practices or to achieve diversity within the workforce to reflect the diversity in their community. In *Johnson v. Santa Clara County Transportation Agency*, 480 U.S. 616 (1987) the agency had an affirmative action plan. A woman was promoted from within to the position of dispatcher, even though a male candidate had a slightly higher score on a test that was designed to measure aptitude for the job. The man brought a lawsuit alleging sex discrimination. The Court found that voluntary affirmative action was not reverse discrimination in this case, but employers should be careful in hiring and firing and layoff decisions versus promotion decisions. It is in the area of promotions that affirmative action is more likely to be upheld.

In government contracts, President Lyndon Johnson's Executive Order 11246 prohibits private discrimination by federal contractors. This is important, because one-third of all US workers are employed by companies that do business with the federal government. Because of this executive order, many companies that do business with the government have adopted voluntary affirmative action programs. In 1995, the Supreme Court limited the extent to which the government could require contractors to establish affirmative action programs. The Court said that such programs are permissible only if they serve a "compelling national interest" and are "narrowly tailored" so that they minimize the harm to white males. To make a requirement for contractors, the government must show that the programs are needed to remedy past discrimination, that the programs have time limits, and that nondiscriminatory alternatives are not available. *Adarand Constructors, Inc. v. Pena*, 515 U.S. 200 (1995).

The Age Discrimination in Employment Act

The Age Discrimination in Employment Act (ADEA) of 1967 (amended in 1978 and again in 1986) prohibits discrimination based on age, and recourse to this law has been growing at a faster rate than any other federal anti-bias employment law. In particular, the act protects workers over forty years of age and prohibits forced retirement in most jobs because of age. Until 1987, federal law permitted mandatory retirement at age seventy, but the 1986 amendments that took effect January 1, 1987, abolished the age ceiling except for a few jobs, such as firefighters, police officers, tenured university professors, and executives with annual pensions exceeding $44,000. Like Title VII, the law has a BFOQ exception—for example, employers may set reasonable age limitations on certain high-stress jobs requiring peak physical condition.

There are important differences between the ADEA and Title VII, as *Gross v. FBL Financial Services, Inc.,* 557 U.S. 167 (2009), makes clear. It is now more difficult to prove an age discrimination claim than a claim under Title VII. "A plaintiff bringing an ADEA disparate-treatment claim must prove, by a preponderance of the evidence, that age was the "but-for" cause of the challenged adverse employment action. The burden of persuasion does not shift to the employer to show that it would have taken the action regardless of age, even when a plaintiff has produced some evidence that age was one motivating factor in that decision."

Disabilities: Discrimination against the Handicapped

The 1990 Americans with Disabilities Act (ADA) prohibits employers from discriminating on the basis of disability. A disabled person is someone with a physical or mental impairment that substantially limits a major life activity or someone who is regarded as having such an impairment. This definition includes people with mental illness, epilepsy, visual impairment, dyslexia, and AIDS. It also covers anyone who has recovered from alcoholism or drug addiction. It specifically does not cover people with sexual disorders, pyromania, kleptomania, exhibitionism, or compulsive gambling.

Employers cannot disqualify an employee or job applicant because of disability as long as he or she can perform the essential functions of the job, with reasonable accommodation. Reasonable accommodation might include installing ramps for a wheelchair, establishing more flexible working hours, creating or modifying job assignments, and the like.

Reasonable accommodation means that there is no undue hardship for the employer. The law does not offer uniform standards for identifying what may be an undue hardship other than the imposition on the employer of a "significant difficulty or expense." Cases will differ: the resources and situation of each particular employer relative to the cost or difficulty of providing the accommodation will be considered; relative cost, rather than some definite dollar amount, will be the issue.

As with other areas of employment discrimination, job interviewers cannot ask questions about an applicant's disabilities before making a job offer; the interviewer may only ask whether the applicant can perform the work. Requirements for a medical exam are a violation of the ADA unless the exam is job related and required of all applicants for similar jobs. Employers may, however, use drug testing, although public employers are to some extent limited by the Fourth Amendment requirements of reasonableness.

The ADA's definition of disability is very broad. However, the Supreme Court issued several important decisions that narrow the definition of what constitutes a disability under the act.

Two kinds of narrowing decisions stand out: one deals with "correctable conditions," and the other deals with repetitive stress injuries. In 1999, the Supreme Court reviewed a case that raised an issue of whether severe nearsightedness (which can be corrected with lenses) qualifies as a disability under the ADA. *Sutton v. United Airlines, Inc.*, 527 U.S. 471 (1999) (legislatively overturned by Congress by its amendments to the ADA in 2008, Pub. L. No. 110-325). The Supreme Court ruled that disability under the ADA will be measured according to how a person functions with corrective drugs or devices and not how the person functions without them. In *Orr v. Wal-Mart Stores, Inc.*, 297 F.3d 720 (8th Cir. 2002) (legislatively overturned by Congress by its amendments to the ADA in 2008, Pub. L. No. 110-325), a federal appellate court held that a pharmacist who suffered from diabetes did not have a cause of action against Wal-Mart under the ADA as long as the condition could be corrected by insulin.

The other narrowing decision deals with repetitive stress injuries. For example, carpal tunnel syndrome—or any other repetitive stress injury—could constitute a disability under the ADA. By compressing a nerve in the wrist through repetitive use, carpal tunnel syndrome causes pain and weakness in the hand. In 2002, the Supreme Court determined that while an employee with carpal tunnel syndrome could not perform all the manual tasks assigned to her, her condition did not constitute a disability under the ADA because it did not "extensively limit" her major life activities. *Toyota v. Williams,* 534 U.S. 184 (2000) (legislatively overturned by Congress by its amendments to the ADA in 2008, Pub. L. No. 110-325).

Equal Pay Act

The Equal Pay Act of 1963 protects both men and women from pay discrimination based on sex. The act covers all levels of private sector employees, and state and local government employees but not federal workers. The act prohibits disparity in pay for jobs that require equal skill and equal effort. Equal skill means equal experience, and equal effort means comparable mental and/or physical exertion. The act prohibits disparity in pay for jobs that require equal responsibility, such as equal supervision and accountability, or similar working conditions.

In making their determinations, courts will look at the stated requirements of a job as well as the actual requirements of the job. If two jobs are judged to be equal and similar, the employer cannot pay disparate wages to members of different sexes. Along with the EEOC enforcement, employees can also bring private causes of action against an employer for violating this act. There are four criteria that can be used as defenses in justifying differentials in wages: seniority, merit, quantity or quality of product, and any factor other than sex. The employer will bear the burden of proving any of these defenses.

A defense based on merit will require that there is some clearly measurable standard that justifies the differential. In terms of quantity or quality of product, there may be a commission structure, piecework structure, or quality-control-based payment system that will be permitted. Factors "other than sex" do not include so-called market forces. In *Glenn v. General Motors Corp.*, 841 F.2d 1567 (11th Cir.1988), the US Court of Appeals for the Eleventh Circuit rejected General Motor's argument that it was justified in paying three women less than their male counterparts on the basis of "the market force theory" that women will work for less than a man.

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D. Enforcing Title VII / EEOC

Many times in the business world, it pays to be exceptional and different. Standing out from the crowd allows an employee to be noticed for exceptional performance and can lead to faster and greater advancement. In some other respects, however, standing out for being a racial or ethnic minority, or for being a woman, can be incredibly uncomfortable for employees.

The main purpose of Title VII was to integrate African Americans into the mainstream of society, so it's no surprise that charges of race-based discrimination continue to generate the highest number of complaints to the Equal Employment Opportunity Commission (EEOC). In 2009 the EEOC received nearly thirty-four thousand complaints of race-based discrimination in the workplace, representing 36 percent of the total number of complaints filed. *(Charge Statistics 2017).* Intentional discrimination against racial minorities is illegal, but as discussed earlier in this section, proving intentional discrimination is exceedingly difficult. That means the EEOC pays close attention to disparate impact cases in this area.

In NBC's hit sitcom The Office, Michael Scott is the hapless and often clueless manager of a paper company's branch office in Pennsylvania. In a scene from the series, he decides to celebrate Diversity Day by having the employees engage in an exercise. He has written certain ethnicities and nationalities on index cards and taped them to employees' foreheads. The employee does not know what his or her card says and is supposed to figure it out through interactions with other employees. The results are a less-than-stellar breakthrough in an understanding of diversity. Does your school or university celebrate in diversity celebrations? Do you believe these celebrations are helpful or unhelpful in the workplace?

For example, an employer policy to examine the credit background of employees might be suspect. Statistically, African Americans have poorer credit than white Americans do, so this policy will necessarily reduce the number of African Americans who can qualify for the position. While a credit check may be a business necessity for a job requiring a high level of trustworthiness, it is hardly necessary for all positions. Similarly, sickle-cell anemia is a blood disease that primarily affects African Americans. An employer policy that excludes persons with sickle-cell anemia must be job related and a business necessity to be legal. A "no-beard" employment policy may also be problematic for African Americans. Many African American men suffer from a medical skin condition that causes severe and painful bumps if they shave too closely, requiring them to keep a beard. A no-beard policy will therefore have to be justified by business necessity.

For example, a firefighter may be required to be beard-free if a beard interferes with the proper functioning of an oxygen mask, a critical piece of equipment when fighting fires. White persons can be victims of race or color discrimination as well. A tanning salon cannot refuse to hire a very light-skinned person of Irish descent, for example, if its refusal is based on color appearance of the job candidate.

To correct past mistakes in treatment of women and minorities, many companies go beyond being equal opportunity employers by adopting *affirmative action* programs. Companies are not required to undertake affirmative action programs, but many do. In some instances, they do so to qualify as a federal contractor or subcontractor. Under Executive Order 11246, most federal contractors or subcontractors must develop an annual affirmative action plan and take "affirmative steps" to recruit, hire, and train females and minorities in the workforce. Even companies that do not seek to sell to the federal government may voluntarily undertake affirmative action programs, as long as those programs are meant to correct an imbalance in the workforce, are temporary, and do not unnecessarily infringe on the rights of non-beneficiaries.

Affirmative action plans can be tricky to administer because white Americans can also be the victims of race discrimination or so-called *reverse discrimination*. The provisions of Title VII are meant to protect all Americans from race discrimination. One of the earliest cases of reverse discrimination took place in 1981, when a white air traffic controller successfully sued the Federal Aviation Administration (FAA), claiming the FAA had hired women and racial minorities over him. In one recent case, the fire department in the city of New Haven conducted a management test to decide which firefighters to promote. When no black firefighters passed the test, the city decided to invalidate the test. Nineteen firefighters who did pass the test (all white or Hispanic) filed suit, alleging the city's actions violated Title VII. The Supreme Court found in favor of the firefighters, holding that the city's fear of a discrimination lawsuit from minorities if it went forward with the test was not enough justification to discriminate against the white firefighters. *Ricci v. DeStefano*, 557 U.S. 557 (2009).

A related form of discrimination is that based on national origin, which is also prohibited by Title VII. This involves treating workers unfavorably because of where they are from (specific country or region) or ethnicity. It is illegal to discriminate against a worker because of his or her foreign accent unless it seriously interferes with work performance. Workplace "English-only" rules are also illegal unless they are required for the job being performed. While English-only rules might be a business necessity for police officers, they would not be for late-night office cleaners.

Members of one of the world's oldest religions, Sikhism, do not cut their hair and wear their hair in a turban. Since 1984 this has been prohibited by the U.S. Army, which has standards for both hair and facial hair for recruits. In 2010 the army lifted this prohibition, resulting in the first Sikh Army officer, Captain Tejdeep Singh Rattan in more than twenty-five years, as this NPR story explains.

Title VII's prohibition on religious discrimination raised some interesting workplace issues. The law makes it illegal to treat an employee unfavorably because of his or her religious beliefs. Furthermore, employees cannot be required to participate in any religious activity as a condition of employment. It extends protection not just to major religions such as Buddhism, Christianity, Hinduism, Islam, and Judaism but also to anyone with sincerely held religious or moral beliefs.

Additionally, employers must reasonably accommodate an employee's religious beliefs or practices as long as it does not cause an undue hardship on the employer's operation of its business. Typically, this would involve being flexible in schedule changes or leaves. A Muslim worker who asked for a few short breaks a day to pray, for example, might be reasonable for an administrative assistant but not for a police officer or air traffic controller. Issues of dress and appearance are often grounds for charges of religious discrimination. For example, if a Muslim woman wished to wear a hijab, or traditional headscarf, then she should be permitted to do so unless it places an undue hardship on operations. In 2010, UPS agreed to settle a case with the EEOC, paying $46,000 in damages for firing a driver who refused to cut his hair or shave his beard, which the driver believes would violate tenets of his Rastafarian religion. (U.S. Equal Employment Opportunity Commission 2010).

A very interesting recent development of workplace discrimination arises when a worker refuses to carry out his or her job duties because of a sincerely held moral belief that doing so would promote immoral activity. For example, after the Food and Drug Administration approved sale of the so-called morning after pill to prevent unwanted pregnancy, some pharmacists refused to fill prescriptions for the drug, claiming it was against their religious beliefs to do so. Another example arose in Minnesota in 2006 when a bus driver refused to drive a bus carrying an advertisement for a gay-themed newspaper. Courts and legislatures continue to struggle with where to draw the line between respecting employees' religious beliefs and the rights of employers to insist their workers perform essential job functions.

Finally, Title VII prohibits discrimination on the basis of sex. Interestingly, the inclusion of sex as a protected class in Title VII was a legislative maneuver designed to kill the bill while it was being debated in Congress. Howard Smith, a Democrat from Virginia, strongly opposed the 1964 Civil Rights Act and thought that by adding the word "sex" to the list of protected classes, the bill would become so poisonous that it would fail passage. In fact, the bill quickly passed, and it led former Chief Justice Rehnquist to complain that courts were therefore "left with little legislative history to guide us in interpreting the Act's prohibition against discrimination based on sex." *Meritor v. Vinson*, 477 U.S. 57 (1986).

The prohibition on sex discrimination means that employers cannot categorize certain jobs as single-sex only unless a bona fide occupational qualification (BFOQ) applies. Customer preferences or market realities are not the basis for BFOQ. For example, a job that requires heavy lifting cannot be categorized as male-only since a woman may qualify after passing a physical test. As society has changed, much progress has been made in this area of equal employment opportunity. Airlines, for example, used to routinely hire predominantly single young women as flight attendants (Figure 21). Male cabin crew could marry, but women could not. Those distinctions have now been erased, partially because of Title VII, and partially because of societal attitudes.

Figure 23 An Advertisement for PSA Airlines

The prohibition against sex discrimination also includes making stereotypical assumptions about women simply because they might be the primary caregiver to children at home. If there are two job applicants, for example, and both have young children at home, it would be illegal to give preference to the male candidate over the female candidate. Once a female employee has children, it would be illegal to assume that she is less committed to her job, or would like to work fewer hours. It's important to note that these protections extend to men as well. If an employer voluntarily provides time off to new mothers, for example, it must extend identical benefits to new fathers. And the Family Medical Leave Act now provides for paternity leave for fathers for employers who qualify under the act.

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Intellectual Property

Intellectual property is a collection of intangible property rights that we will explore this week, including patents, trademarks, copyrights, and trade secrets.

Since its introduction in 2007, the iPhone has redefined the “smart phone” segment of the wireless phone industry and left its competitors scrambling to catch up. Its sleek lines, gorgeous full-color display, built-in GPS navigation and camera, visual voice mail, and Web surfing capability (either over Wi-Fi or 3G phone networks) made it an instant hit, with thousands of consumers lining up for hours to have their chance to buy one. Its revolutionary business model, where thousands of software programmers could write small programs called “apps” and sell them on the App Store through Apple’s iTunes software, created a win-win-win business model for everyone who touched the iPhone. For software programmers, it was a win because small, untested, and first-time programmers could “strike it rich” by selling thousands of their apps directly to consumers without having to find a software publisher first. For Apple, it was a win because thousands of talented programmers, not on Apple’s payroll, were developing content for their product and enhancing its appeal. Apple also wins because it collects a percentage fee from every app sold on its iTunes store. And finally, consumers win because they have access to all sorts of creative programs to help them do more on their iPhones than simply make a phone call. The business has been a tremendous success for both Apple and AT&T, the exclusive service provider of iPhones in the United States.

There are quite a few companies in the industry that aren’t doing as well, from Nokia to Motorola to Sony Ericsson. If they wanted to see how Apple makes the iPhone, all they’d have to do is buy one and then take it apart to see its components (a process known as reverse engineering). Or they could look at the reverse engineering conducted by iSuppli, an independent market intelligence firm.

iSuppli found out that the bill of material (BOM), or the breakdown of each component Apple purchased to assemble into an iPhone, is roughly $187.51. The most expensive components are a $27 16GB flash memory module from Samsung, a $28.50 display module that includes the iPhone’s glossy 3.5-inch screen, and a $10 touch screen assembly that includes the touch-sensitive glass on top of the screen.

Apple makes a lot of money selling iPhones. Although the $199 retail price of the 16GB iPhone 4 suggests that Apple makes only about $12 profit per phone, in reality the “cost” of the iPhone is much higher than $199, since each phone is sold with a two-year contract with AT&T service. (the current iPhone X sells for between $999 and $1,149.) Industry analysts estimate that AT&T pays Apple approximately $300 for each iPhone sold with an AT&T plan, in return for Apple agreeing not sell the iPhone through any other phone network (Siegler). The result for Apple is staggering profitability, with a $1.21 billion profit reported in the first three months of 2009, much of which driven by iPhone sales (Dalrymple). In 2016, Apple had a global revenue of $215.64 billion. https://www.statista.com/statistics/265125/total-net-sales-of-apple-since-2004.

This chart shows, to scale, how outsized Apple’s profits are compared to those of the rest of the industry.

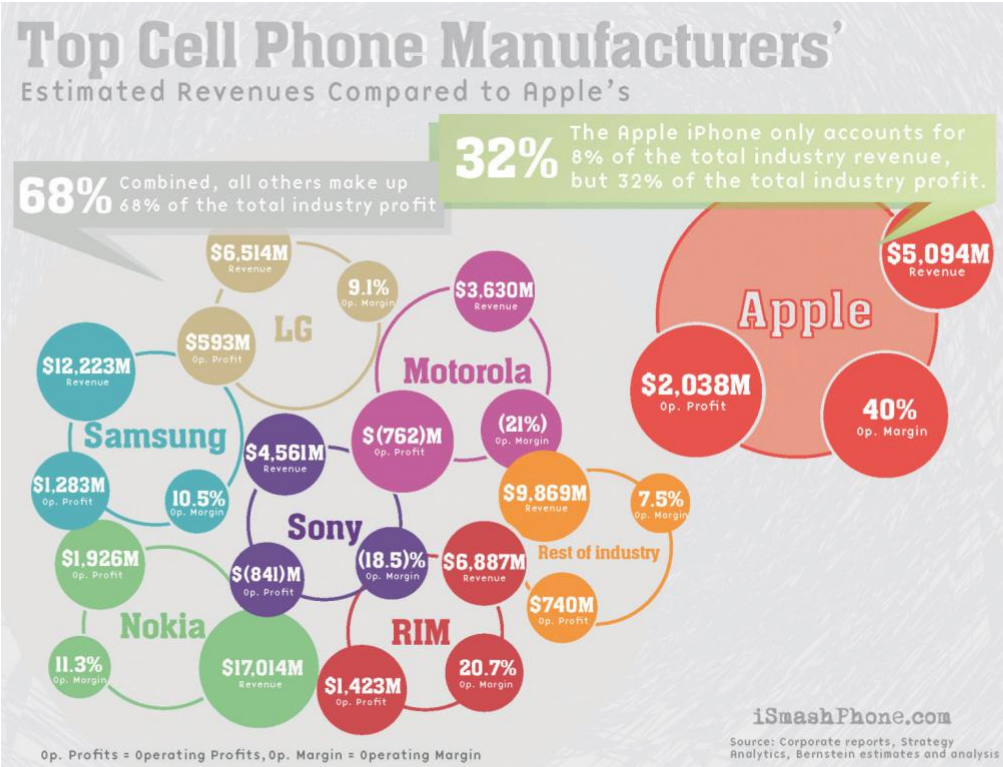

Figure 24 Top Cell Phone Manufacturers Revenue Comparison

Apple's profit margin, at an estimated 40 percent, is nearly double that of its nearest competitor, Research in Motion, maker of the BlackBerry ("A Visualized Look").

If you were a competitor in the cell phone industry, you'd be sorely tempted to try to duplicate Apple's success. After all, if it only costs $187.51 to make an iPhone, and you could sell it for a $320 profit, why not just make something that looks a lot like an iPhone? Behold the Air Phone No. 4:

Figure 25 The "Air Phone No. 4"

Released in 2010, the Air Phone is made by a little-known Chinese manufacturer and looks virtually identical to the iPhone 4. It lacks many of the features of the iPhone 4 and does not run on the iPhone's software platform, but at approximately $150 in online stores, it is proving to be a popular alternative to the iPhone.

The reason that companies like Motorola and Nokia don't simply use the bill of material generated by iSuppli to make their own iPhones, of course, is it's ILLEGAL. The BOM only lists the component costs to Apple; it does not capture the amount of money Apple spent in developing the product through the R&D process. The years of software and hardware development that Apple undertook to create the iPhone involve labor, just as building a skyscraper involves labor. In Apple's case, the product of its labor is not a skyscraper or other tangible property—it is intangible property known broadly as intellectual property, or IP. The law protects Apple's IP just as it protects tangible things from being stolen, so any attempt by a competitor to make an iPhone clone would fail even if the technical ability to do so exists. To be legally sold in the United States, the Air Phone must be different enough from the iPhone that it doesn't actually infringe, or step on, any of Apple's intellectual property rights in the iPhone.

In this section, we'll discuss how the law protects IP. We'll then discuss the four major types of IP protected by the law: patents, trade secrets, trademarks, and copyright. By the end of this section, you'll understand the value that IP plays in a modern economy and the devastating impact that IP infringement (including the downloading of music and movies by college students) has on copyright content holders. You'll also be able to distinguish among the various types of IP protection and how they are similar to, and differ from, each other.

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A. Patents

Source of Authority and Duration

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

Patentability

What May Be Patented

The patent law says that "any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof" may be patented. 35 U. S. C. Section 101. A process is a "process, art or method, and includes a new use of a known process, machine, manufacture, composition of matter, or material." 35 U. S. C. Section 101. A process for making rolled steel, for example, qualifies as a patentable process under the statute.

A machine is a particular apparatus for achieving a certain result or carrying out a distinct process—lathes, printing presses, motors, sewing machine and the cotton gin are all examples of the hundreds of thousands of machines that have received US patents since the first Patent Act in 1790. A manufacture is an article or a product, such as a television, an automobile, a telephone, or a lightbulb. A composition of matter is a new arrangement of elements so that the resulting compound, such as a metal alloy, is not found in nature. In *Commissioner of Patents v. Chakrabarty*, 444 U.S. 1028 (1980), the Supreme Court said that even living organisms—in particular, a new "genetically engineered" bacterium that could "eat" oil spills—could be patented. The *Chakrabarty* decision has spawned innovation: a variety of small biotechnology firms have attracted venture capitalists and other investors, looking into environmental technology.

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

What May Not Be Patented

Many things can be patented, but not (1) the laws of nature, (2) natural phenomena, and (3) abstract ideas, including algorithms (step-by-step formulas for accomplishing a specific task).
One frequently asked question is whether patents can be issued for computer software. The PTO was reluctant to do so at first, based on the notion that computer programs were not "novel"—the software program either incorporated automation of manual processes or used mathematical equations (which were not patentable). But in 1998, the Supreme Court held in *Diamond v. Diehr*, 450 U.S. 175 (1981) that patents could be obtained for a process that incorporated a computer program if the process itself was patentable.

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

Note, however, that the Federal Circuit more recently re-examined its holding in *State Street* in light of interpretation of patentability under section 101 of the Patent Act by the Supreme Court. In the *Bilski* case, the Federal Circuit held that the "useful, concrete and tangible result" test for patentability is not good law, and instead courts must apply the Supreme Court's "machine-or-transformation" test. *In re Bilski*, 545 F.3d 943

(Fed. Cir. 2008). "The machine-or-transformation test is a two-branched inquiry; an applicant may show that a process claim satisfies § 101 either by showing that his claim is tied to a particular machine, or by showing that his claim transforms an article." *Id.* at 961.

Tests for Patentability

Just because an invention falls within one of the categories of patentable subjects, it is not necessarily patentable. The Patent Act and judicial interpretations established certain tests that must first be met. To approve a patent application, the PTO (as part of the Department of Commerce) will require that the invention, discovery, or process be novel, useful, and nonobvious in light of current technology. Perhaps the most significant test of patentability is that of obviousness. The Act says that no invention may be patented "if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains." This provision of the law produced innumerable court cases, especially over improvement patents, when those who wish to use an invention on which a patent has been issued have refused to pay royalties on the grounds that the invention was obvious to anyone who looked.

Procedures for Obtaining a Patent

Previously, the United States (unlike many other countries) granted a patent right to the first person to invent a product or process. In 2011, Congress passed the America Invents Act (AIA), signed into law by President Obama, changed the US patent system to a first to file system (like many European countries). So its is now the first person to file the patent application that is protected. https://www.stoutadvisory.com/insights/article/us-patent-reform-overview-america-invents-act.

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

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

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

Patent Ownership

The patent holder is entitled to make and market the invention and to exclude others from doing so. Because the patent is a species of property, it may be transferred. The inventor may assign part or all of his interest in the patent or keep the property interest and license others to manufacture or use the invention in return for payments known as royalties. The license may be exclusive with one licensee, or the inventor may license many to exploit the invention. One important limitation on the inventor's right to the patent interest is the so-called shop right. This is a right created by state courts on equitable grounds giving employers a nonexclusive royalty-free license to use any invention made by an employee on company time and with company materials. The shop right comes into play only when a company has no express or implied understanding with its employees. Most corporate laboratories have contractual agreements with employees about who owns the invention and what royalties will be paid.

Infringement and Invalidity Suits

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

In a federal patent infringement lawsuit, the court may grant the winning party reimbursement for attorneys' fees and costs. If the infringement is adjudged to be intentional, the court can triple the amount of damages awarded (known as treble damages). Prior to 2006, courts were typically granting permanent injunctions to prevent future infringement. Citing *eBay, Inc. v. Merc Exchange, LLC*, 547 U.S. 388 (2006) the Supreme Court ruled that patent holders are not automatically entitled to a permanent injunction against infringement during the life of the patent. Courts have the discretion to determine whether justice requires a permanent injunction, and they may conclude that the public interest and equitable principles may be better satisfied with compensatory damages only.

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

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

Patent Misuse

Although a patent is a monopoly granted to the inventor or his assignee or licensee, the monopoly power is legally limited. An owner who misuses the patent may find that he will lose an infringement suit. One common form of misuse is to tie the patented good to some unpatented one—for example, a patented movie projector that will not be sold unless the buyer agrees to rent films supplied only by the manufacturer of the movie projector, or a copier manufacturer that requires buyers to purchase plain paper from it. Another form of patent misuse is a provision in the licensing agreement prohibiting the manufacturer from also making competing products. Although the courts have held against several other types of misuse, the general principle is that the owner may not use his patent to restrain trade in unpatented goods.

B. Trademarks

Figure 26 McDonald's Trademark

Source: http://commons.wikimedia.org/wiki/File:RiemArcaden.McD.JPG.

Look at the image above. It's obviously a McDonald's restaurant, but can you tell where this restaurant is? Is it in a mall or airport? Is it in Trenton, Toronto, or Tokyo (or, as it turns out, Messestadt Riem in Germany)? Without additional information, it may be impossible to tell. And yet, no matter where you are in the world, if you enter this McDonald's restaurant, there are certain standards that you expect. You would expect to find a Big Mac on the menu, perhaps Chicken McNuggets and french fries too. You would expect those menu items to taste the same as they do in your local McDonald's. Perhaps you'd expect a certain level of service from the employees, a certain value proposition for your money, a certain look from the uniform and fixtures, or perhaps a clean restroom. If you walked into this McDonald's restaurant and found out that it was in fact not McDonald's, you might be confused. The ultimate goal of trademark law is to prevent this consumer confusion. To prevent any other restaurant from using the name McDonald's, or from using a logo that looks like a stylized "M," McDonald's can trademark both its name and logo (and a lot of other elements of its brand as well). In this section, we'll examine how trademark law accomplishes this goal.

What Is A Trademark?

A trademark is any kind of name, logo, motto, device, sound, color, or look that identifies the origin of a particular good or service. *US Patent & Trademark Office v. Booking.com*, 140 S. Ct. 2298, 2302 (2020). Something begins to look like a trademark when a consumer identifies it with a particular origin. For example, someone buying a Diet Coke knows that he or she is getting a carbonated beverage from the Coca-Cola Company. If he or she bought a Diet Cola, on the other hand, there's no association in the mind with any particular company, so it could be from Coca-Cola, Pepsi, or any number of other companies. The key is consumer identification with a specific origin. If a consumer thinks of a class of goods rather than one specific origin, then it's not a trademark. So, for example, when a consumer hears "aspirin," he or she thinks of a class of goods with no particular origin because the word "aspirin" became generic almost a century ago. *Bayer Co. v. United Drug Co.*, 272 F. 505, 510 (S.D.N.Y. 1921). But if a consumer hears "Bayer," he or she thinks of a specific aspirin from a specific source, making "Bayer" a trademark.

A federal law, the Lanham Act, 15 U.S.C. Sections 1051 et. seq., protects trademarks. Unlike copyrights and patents, trademarks can last forever and are not subject to the Constitution's "limited time" restriction. Since the objective of trademark law is to prevent consumer confusion, the public good is best served by allowing companies to maintain their trademarks as long as consumers associate a trademark with a specific origin. The moment they no longer make that association, however, the trademark ceases to exist.

If you are considering marketing as a career, you will become intimately familiar with the concepts related to branding and the value of branding. At its core, marketing involves the science of relating to consumers, telling them an authentic story about your product and service, and satisfying their wants and needs. Having a brand is essential to carrying out this objective, and it can lead to startling profits. The Apple and iPhone brands, for example, are very strong and yield billions of dollars in profits for Apple. Luxury brands are particularly aware of this phenomenon, as often their brand alone can justify pricing far above a similar good.

Gucci stores trades on the value of its brand to command premium prices (and margins) in the marketplace. Brands such as Rolex, Hermes, Rolls-Royce, and Bentley have similar business models. These brands are all trademarks—indeed, all brands are either registered trademarks or are trademark-able because they share the common feature of consumer identification. Be careful, though. "Trademark" and "brand" are not interchangeable terms because not all trademarks are brands.

What Can Be Registered as a Trademark?

So what can be a trademark? Obviously, words can be trademarked. When it comes to trademarks, distinctiveness is good. Therefore, an invented word is the best type of trademark. In 1997, for example, when Stanford grad students Larry Page and Sergey Brin were brainstorming names for their new Internet search engine, they settled on the word "Google," a play on "googol," which means 1 followed by 100 zeroes. They felt the name reflected their goal to organize the staggering amount of information available on the Internet. On the other hand, regular words can also become trademarks, as long as consumers identify them with a particular source. Amazon, for example, is the name of the world's longest river, but it's also the name of an online retailer. Since consumers now identify Amazon.com as an online retailer, the name can be trademarked. Another example is the phrase "You're Fired" when used in a television program. The phrase was made popular by billionaire, now President, Donald Trump and has such lasting recognition now that it's unlikely any other television show could use that phrase as a central part of its theme.

Can sounds be trademarked? Yes! Some sounds are instantly recognizable, such as AOL's "You've Got Mail" and Twentieth Century Fox's movie opening scene. Click the link to explore other trademarked sounds.

https://www.uspto.gov/trademark/soundmarks/trademark-sound-mark-examples

Figure 27 describes the degree of protection that is afforded to trademarks when evaluating whether a junior mark infringes on the senior mark. Marks that are generic or merely descriptive enjoy little to no protection under trademark law (absent evidence of secondary meaning for descriptive marks), whereas marks that are suggestive or arbitrary enjoy more protection under trademark law. *Booking.com*, 140 S. Ct. at 2302. Variation in protection levels serves an important purpose by balancing the interests of trademark owners in being able to distinguish their goods from others with the rights of the public in being able to freely use descriptive words in regular expression.

Marks that are arbitrary – that is, are a made-up word like “Xanax” or are a normal word that in no way describes or suggests any characteristic of the product like “Camel” brand cigarettes – enjoy more protection because these are “inherently distinctive.” *Id.* “Suggestive” marks are ones that allude to some aspect of the product – such as the “Tide” mark associated with laundry detergent and similar laundry products – but do not literally describe the product or service. “Merely descriptive” marks, however, literally describe the product. For example, “Park’N Fly” is a descriptive mark of the parking lot service near a local airport where you, literally, “park” your car “’N” then “fly” on the airplane. Merely descriptive marks are not registerable on the principal register at the Trademark Office. 15 U.S.C. § 1052(e).

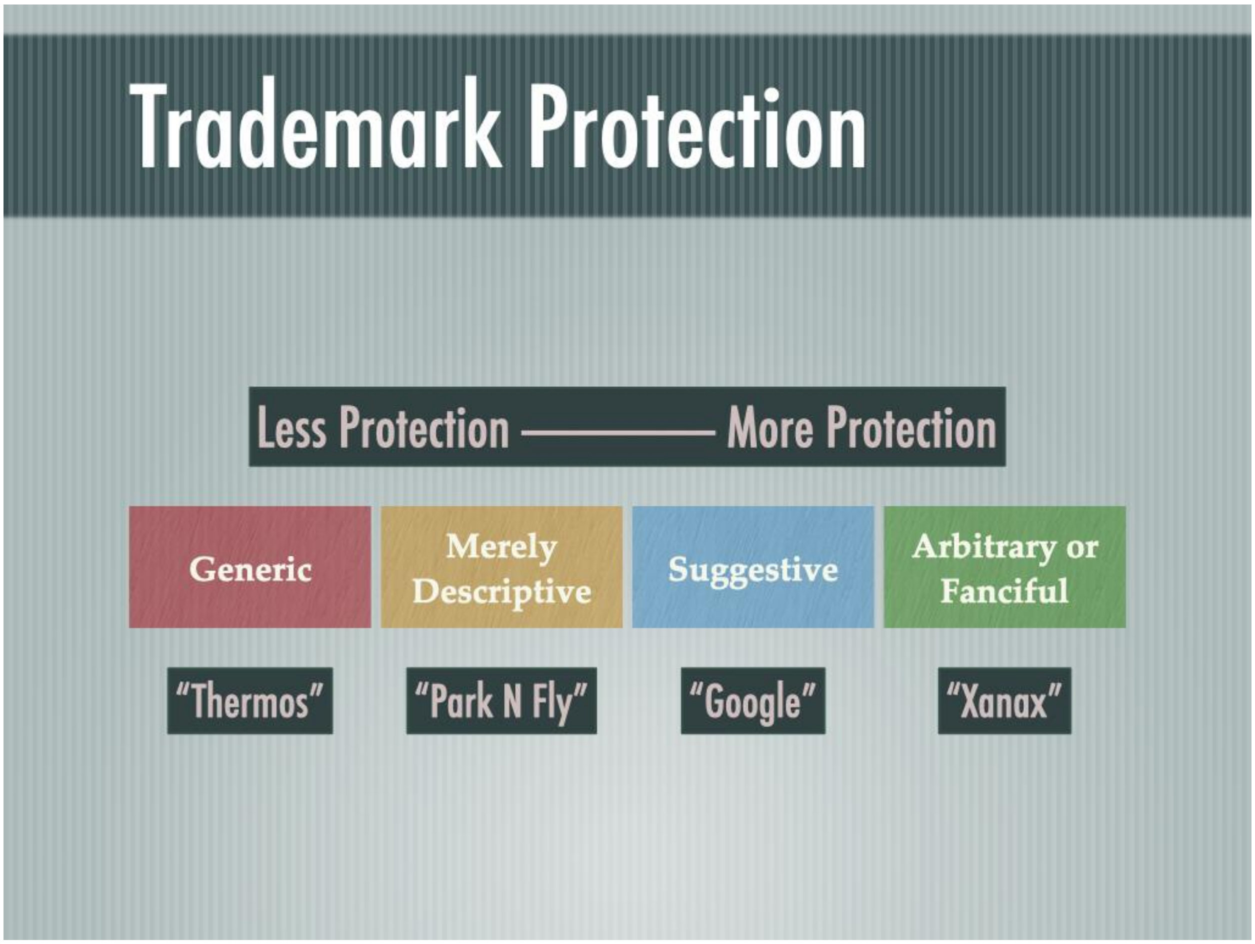

Figure 27 Categories of Trademark Protection

Trade Dress

Trademarks include words or phrases, and also graphical logos (for example, think of Apple’s stylized “apple” logo with a bite taken out of the apple) that uniquely identify the source of goods. Both such types of trademarks can be registered on the principal register when the mark is used in interstate commerce to identify the source of the goods. 37 C.F.R. § 2.52(b) (special form drawing for registration of a two or three dimensional design).

Trade dress, however, is a separate concept in trademark law. Trade dress is a “symbol” or “device” under the Lanham Act, and as such, may also be registered on the principal register if the trade dress operates to uniquely identify the source of goods or services with which such device or symbol is associated. 15 USC § 1052; *Walmart Stores, Inc. v. Samara Brothers*, 529 U.S. 205 (2000). Trade dress has been expanded in recent cases to include the "total image and overall appearance" of a product, or the totality of the elements, and "may include features such as size, shape, color or color combinations, texture, graphics." *Two Pesos, Inc. v. Taco Cabana, Inc.*, 505 U.S. 763, 764 (1992). The *Two Pesos* case involved two competing restaurants that had similar restaurant interior designs. The Supreme Court found that such an interior restaurant design constituted trade dress and could lead to consumer confusion as to the source of the goods sold by each restaurant. *Id.* In *Qualitex*, the Supreme Court held that color alone could constitute protectable trade dress when the color's use otherwise meets the ordinary legal trademark requirements. *Qualitex Co. v. Jacobson Products Co.*, 514 U.S. 159 (1995) (use of a special shade of green-gold color on pads used in the dry cleaning press of dry cleaning firms protectable under Lanham Act).

Figure 28 Taco Cabana Restaurant Sign, courtesy of Andreas Praefcke (CC Attrib 3.0)

There are two important barriers to trade dress protection: whether the trade dress is functional, and whether the trade dress is sufficiently distinctive to operate as a trademark. Aspects of most trade dress serves a functional purpose. For example, the package of a product often has a functional purpose to protect the product during shipping or delivery to the end user, and as a result, such packaging could not be protected under the laws of trade dress. The *Qualitex* court held that trade dress is functional when a feature of that trade dress is "essential to the use or purpose of the article, or if it affects the cost or quality of the article." *Qualitex*, 514 U.S. at 159. The amended Lanham Act also prohibits registration of functional trade dress in 15 U.S.C. § 1052(e)(5).

Whether the trade dress is inherently distinctive can also be a barrier to the trade dress' protection under the Lanham Act. For product packaging, several factors may be considered by a court in evaluating if the packaging is distinctive: whether the proposed mark is (a) a common or basic shape; (b) unique or unusual in a particular field; (c) a mere refinement of a commonly adopted and well-known form of ornamentation for a particular class of goods viewed by the public as a dress or ornamentation for the goods; or (d) capable of creating a commercial impression distinct from the accompanying words. *Seabrook Foods, Inc. v. Bar-Well Foods, Ltd.*, 568 F.2d 1342, 1344 (C.C.P.A. 1977) (finding that the background blue and green oval on frozen vegetables was not sufficiently distinctive to receive trade dress protection).

Figure 29 Seabrook packaging, courtesy of kiliweb (CC Attrib-Share Alike 3.0)

As discussed further below, trade dress that is not inherently distinctive may still enjoy trademark protection if the trade dress has acquired "secondary meaning," where "in the minds of the public, the primary significance of a product feature or term is to identify the source of the product rather than the product itself." *Inwood Laboratories, Inc. v. Ives Laboratories, Inc.*, 456 U.S. 844, 851 (1982). The Supreme Court held in the *Two Pesos* case, however, that trade dress that is inherently distinctive need not also be shown to have acquired secondary meaning to receive protection under the Lanham Act from an infringer. *Two Pesos*, 505 U.S. at 769.

"Secondary Meaning"

However, registration of a trademark is not required for a person to use that trademark in commerce or for that mark to potentially be protected from infringement through a lawsuit (though the Lanham Act provides certain benefits for registrants including the designation of "incontestability" under section 1065). *Two Pesos, Inc. v. Taco Cabana, Inc.*, 505 U.S. 763, 768 (1992).

Consider the following: plenty of businesses have started out using the owner's name as the business' trademark. Generally, surnames are treated as merely descriptive words for purposes of trademark analysis. *Howe Scale Co. v. Wychoff*, 198 U.S. 118 (1905). As a result, such surnames are not initially registerable. For example, if your name is Sam Smith and you called your business Sam Smith, the mark "Sam Smith" cannot be registered under the Lanham Act. However, if your business started growing so that eventually, over time, consumers began to identify "Sam Smith" as your business, then your name has acquired secondary meaning and can be trademarked. Thus, Sam Adams is a trademark for a beer, Ben & Jerry's is a trademark for ice cream, and Ford is a trademark for a motor vehicle. The Lanham Act specifically recognizes the idea of registering marks that have attained secondary meaning – even marks that otherwise are not protectable as they are merely descriptive ones. *Park'N Fly, Inc. v. Dollar Park and Fly, Inc.*, 469 U.S. 189 (1985). The *Park'N Fly* Court held that a merely descriptive mark that has been registered for five years may also become "incontestable" under section 1065 of the Lanham Act, even though the mark otherwise might enjoy minimal protection without secondary meaning.

Can a sportscaster trademark the phrase "Are you ready to rumble"? Can Paris Hilton trademark the phrase "That's hot"? As long as the public associates these phrases with a distinctive origin, the answer is yes. Listen to this National Public Radio broadcast for more examples.

http://www.npr.org/templates/story/story.php?storyId=19227066

"Categories of Goods"

Note that when you register a trademark, it's typically granted for a specific category of goods. The same name can sometimes be used for multiple categories of goods. The name Delta, for example, is a trademark for both an airline and a brand of faucets. Since there is little chance that a consumer will be confused by an airline or faucet brand, trademark law allows these dual registrations. On the other hand, some brands are so strong that they would probably stop registration even for a completely different category of goods. McDonald's is a good example of this. The McDonald's trademark is one of the strongest in the world, meaning that it is instantly recognizable. In 1988, for example, hotel chain Quality Inns decided to launch a new line of budget motels called "McSleep." McDonald's sued, claiming trademark infringement. McDonald's claimed that consumers might be confused and believe that McDonald's owned the hotel chain. A federal judge in the U.S. District Court for the District of Maryland agreed and ordered Quality Inns to change the name of the chain, which it did, to Sleep Inns. *Quality Inns International, Inc. v. McDonald's Corporation*, 695 F. Supp. 198 (D. Md. 1988).

As the Court noted in the *Quality Inn* case, a variety of factors are used to evaluate whether the consuming public might be confused by a mark as to the source of its associated goods or services. In the 4th circuit, this list includes: "(1) the strength or distinctiveness of the mark; (2) the similarity of the two marks; (3) the similarity of the goods or services which the marks identify; (4) the similarity of the facilities used by the parties in conducting their businesses; (5) the similarity of advertising used by the parties; (6) the defendant's intent; and (7) actual confusion." *Id.* at 217. The Court also acknowledged the concept of "family of marks" when evaluating McDonald's claims against Quality Inn, in that McDonald's had numerous marks with the prefix "Mc," such as "McChicken" and "McNugget," which add to the likelihood of confusion about the source of services for the mark, "McSleep."

Trademarks go beyond simply a company's name or its logo. A color can be trademarked if it's strong enough to create consumer identification. Pink, for example, is trademarked when used for building insulation by Owens Corning. All other insulation manufacturers must use different colors. As noted above, sounds can be trademarked too, such as MGM Studios' "lion's roar." Even a certain "look" can be trademarked if a consumer identifies it with a certain origin. Thus, the distinctive colors, materials, textures, and signage of a Starbucks or T.G.I. Friday's are considered trade dress and cannot be copied. A bottle shape can be considered trade dress, too, such as the shape of a nail polish bottle.

Figure 30 OPI's Nail Polish Bottle

OPI, a nail polish manufacturer, registered this bottle shape with the U.S. Patent and Trademark Office (USPTO) and is suing other manufacturers that use a similarly designed bottle. Interestingly, courts have been reluctant to grant certain smells trademark protection, even though it can be argued that certain fragrances such as Old Spice or CK One are distinctive. Imagine the chaos that would ensue if one company claimed trademark protection for vanilla or strawberry scents—consumers would ultimately be robbed of choice if that were to happen.

A trademark is not limited to a name or logo used to sell goods. If a company provides a service (as opposed to selling goods), it too can receive trademark protection. In this case it's called a service mark. 15 U.S.C. § 1053. Facebook, for example, is a service mark. A trademark can also be used to demonstrate certification meeting certain standards, such as the Good Housekeeping Seal of Approval.

If you study operations management, you'll learn about the International Organization for Standardization (ISO) and its various standards for quality management (ISO 9000) or environmental quality (ISO 14000). The Forest Stewardship Council (FSC) allows its logo to be used on paper products that come from sustainable forests, while certain foods can be labeled "Organic" or "Fair Trade" if they meet certain standards as established by governmental or nongovernmental organizations. Each of these marks is an example of a certification mark. Finally, a mark can represent membership in an organization, such as the National Football League, Girl Scouts of America, Chartered Financial Analyst, or Realtor. These are known as collective marks. The rules that apply to trademarks apply equally to service marks, collective marks, and certification marks. 15 U.S.C. § 1054.

Figure 31 Realtor Trademark

Source: http://upload.wikimedia.org

If a color or sound can be trademarked, is there anything that cannot be trademarked? The Lanham Act excludes a few categories from trademark registration, mainly for public policy purposes. Obviously, trademarks will not be granted if they are similar or identical to a trademark already granted. If you're starting a new company, it's a good idea to make sure that not only is a domain name available for your company's name, but that the name isn't already trademarked by someone else. Trademarks also cannot contain the U.S. flag, any government symbol (such as the White House or Capitol buildings), or anything immoral. And, trademarks cannot be merely descriptive. 15 U.S.C. § 1052. (Thus every restaurant is allowed to offer a "Kid's Meal," but only McDonald's can offer a "Happy Meal.")

Whether or not a region can be trademarked (a geographic indicator, or GI) is the subject of some controversy, especially with our trading partners. "Maine Lobster," "Napa Valley Wine," or "Florida Orange Juice," for example, may indicate to some consumers the origin of a particular lobster or bottle of wine or orange juice, and thus may be of commercial value to distinguish the product from competitors from other regions. For the time being, these foods must come from Maine, California, or Florida to avoid liability under consumer protection statutes for fraud (lying) about their origin. What happens, though, if consumers lose the association with the region? For years, sparkling wine manufacturers in Champagne, France, have fought to prevent this from happening by requiring that only sparkling wine made in the Champagne region be called "champagne." Now, food producers (especially in the European Union) are seeking similar protection under international trademark law for Feta, Parmesan, Gorgonzola, Asiago, and hundreds of other names.

Genericide

A trademark is valid as long as consumers believe that the mark is associated with a specific producer or origin. If the mark refers to a class of goods instead, then the trademark can no longer exist. This process is called genericide. Many words today once started as trademarks: furnace, aspirin, escalator, thermos, asphalt, zipper, softsoap, cellophane, lite beer, Q-tip, and yo-yo are all examples of trademarks that are now generic and have therefore lost legal protection. *Booking.com*, 140 S. Ct. at 2302. To prevent genericide from occurring, trademark owners must take active steps, often costing millions of dollars, to educate consumers on the importance of using their trademarks properly and to prosecute infringers. For example, when you hear the word "Kleenex," do you think of a brand of tissue owned by Kimberly-Clark, or do you think of tissues generally? Does "Rollerblade" refer to a brand of in-line skates, or to all in-line skates? In Southern states, does "Coke" refer to a Coca-Cola, or to soft drinks generally? When you run a "Xerox" photocopy, is it on a Xerox photocopier or some other machine? These trademarks, all currently active and worth billions of dollars to their owners, are in danger of becoming generic in the United States. If that happens, the companies will lose control of the marks and the public (and competitors) will be free to use those words just as they use "aspirin" and "yo-yo" today. Xerox has taken many steps to educate the public about its trademark, including running print advertisements in business periodicals. In one of these ads, the text says, "When you use 'Xerox' the way you use 'aspirin,' we get a headache."

Trademark Infringement and Dilution

Trademark infringement occurs when someone uses someone else's mark, either completely or to a substantial degree, when marketing goods or services, without the permission of the mark's owner. As noted in the *Quality Inn* case above, courts will use a variety of factors to evaluate if a defendant's use of a particular mark is infringing on the rights of a senior mark. *Quality Inns International*, 695 F. Supp. 198.

Obviously, making your own pair of jeans and slapping a "Levi's" label on it, or making your own handbag and sewing a "Coach" label on it, constitutes trademark infringement. When Apple first released the iPhone, to its embarrassment it found out that "iPhone" was already a registered trademark belonging to Cisco, another company, for a phone used for placing phone calls over the Internet. To avoid trademark infringement liability, Apple paid Cisco an undisclosed sum to purchase the trademark. Ford found itself in a similar situation when it released a supercar called the "Ford GT." Ford made a similar racing car in the 1960s called the "GT 40" but lost control of the trademark after production ceased. Unable to reach agreement with the current trademark owners, Ford settled for releasing the new car as simply the "GT."

The law also permits trademark owners to sue infringers who use their marks to a substantial degree. For example, when Samsung announced its new smart phone, the Black Jack, the makers of the BlackBerry device sued for trademark infringement. When a software company released a product to eliminate unwanted e-mails called "Spam Arrest," it was sued by Hormel, makers of Spam canned luncheon meat. When a small coffee shop in Syracuse, New York, opened as "Federal Espresso," the shipping company FedEx filed a trademark infringement claim. *Fed. Express Corp. v. Fed. Espresso, Inc.*, 201 F.3d 168 (2nd Cir. 2000).

Even if a trademark owner doesn't believe a similar use of its mark would lead to any consumer confusion, it can protect its trademark through a concept called dilution. Such was the case when an adult novelty store in

Kentucky opened as “Victor’s Secret” (the owner’s name was Victor). The trademark owners of “Victoria’s Secret” filed a dilution suit in response. Traditionally, trademarks are intended to prevent consumer confusion. Dilution permits a trademark owner to stop usage of a similar word or phrase even if consumers aren’t confused. Under dilution concepts, the trademark owner only needs to show that its mark will be diluted or tarnished in some way.

Dilution is controversial in trademark law. When Congress passed the first dilution law in 1995, the Federal Trademark Dilution Act, many felt that Congress went too far in protecting trademarks, to the detriment of the public and small businesses. For one thing, the Act only protected “famous” trademarks. It also failed to clearly define “dilution,” and what was required for trademark owners to win a lawsuit. Finally, when the Victor’s Secret case reached the Supreme Court, *Moseley v. Secret Catalogue*, 537 U.S. 418 (2003), the Supreme Court issued some clarification. The Court ruled that to win a dilution case, a trademark owner had to show that it had suffered actual economic damage from the dilution, not merely the “likelihood” of dilution. This is a high standard for trademark owners to meet, because it means that they (1) have to wait for the diluting mark to hit the market and be used in commerce and (2) must be able to prove that they suffered economic damage from the diluting mark. Unhappy with the Court’s decision, corporations lobbied Congress to pass the Trademark Revision Dilution Act of 2006, which overturns the *Moseley* case. Now, trademark owners of famous trademarks only need to show a likelihood of dilution before filing a dilution lawsuit.

Defenses to Infringement

Companies or persons accused of trademark infringement have several defenses to rely on. The most obvious is arguing that no infringement occurred because the two marks are sufficiently different that consumers won’t be misled. For example, in 2002 Jeep sued General Motors for infringing on what Jeep called its trademark grill. GM’s Hummer division released the H2 that year, with a similar seven-bar grill. A district court held that there was no trademark infringement because the grills were too dissimilar to cause consumer confusion. Look at the Hummer H2 grill (Figure 32) and the Jeep grill (Figure 33). Do you think there is a chance of consumer confusion?

Figure 32 Hummer H2 Grill

Figure 33 Jeep Grill

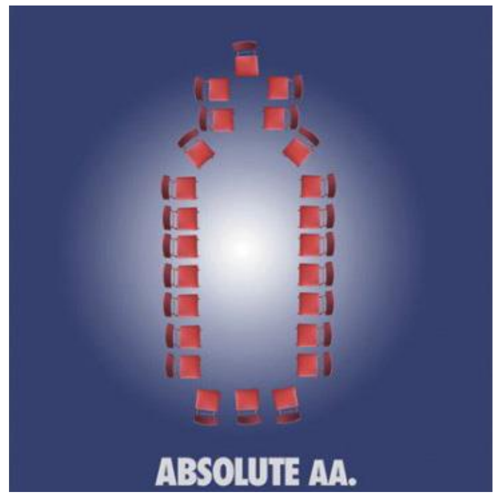

Figure 34 Adbusters Parody of Absolut Vodka Print Ads

Another defense is fair use. The Lanham Act prohibits the use of someone else's trademark when selling goods. It's not uncommon to see various items such as laptop computers, telephones, soda cans, or other foods with their labels covered by stickers or blurred out on television shows and movies because of the trademark law. On the other hand, what if a company wanted to mention a competitor's product to draw a comparison with its own product? This is called comparative advertising, and it's considered fair use. Honda, therefore, is free to claim that its "Honda Accord is better than the Ford Taurus" in its advertising even though Ford and Taurus are both trademarks owned by Ford Motor Company.

The First Amendment also recognizes the use of parody, comedy, or satire as fair use. Comedy skits on television that make fun of, or use, company logos are an example of this fair use. Canadian nonprofit Adbuster organization seeking to advance "a new social activist movement in the info involves making fun of corporations and consumer spending, sponsoring "Buy Nothing Day" as an antidote to the annual holiday spending season. Making fun of corporations also involves spoofing their commercial messages, as the ad illustrates in Figure 34. Although the ad undoubtedly infringes on a trademark, it is considered fair use because of the social commentary and satire behind its message.

Cybersquatting

An interesting aspect of trademark infringement arises through the use of domain names on the Internet. The practice of cybersquatting (or domain name squatting) arises when a company registers a domain name containing a famous trademark in hopes of selling that trademark to its rightful owner for a large profit. The practice arose in the early days of the Internet, when domain name registration took place on a first-come, first-served basis. There is nothing wrong with registering a domain name for a generic word such as "shoes.com," but incorporating a registered trademark into the domain name, for purposes of selling it later, is considered cybersquatting.

Cybersquatting was made illegal in 1999 with the passage of the Anticybersquatting Consumer Protection Act. 15 U.S.C. § 1125(d). The statute creates civil liability when a person has a "bad faith intent to profit from the mark, including a personal name which is protected as a mark" and "registers, traffics in, or uses a domain name" that contains a distinctive mark or contains a famous mark. *Id.* at (1)(A).

Registering a mark in "good faith," however, is not a violation of the statute. Id. at (1)(B)(ii) ("Bad faith …

shall not be found in any case which the court determines that the person believed and had reasonable grounds to believe that the use of the domain name was a fair use or otherwise lawful"). A good example is the domain name registered by Canadian teenager Mike Rowe in 2003. An avid computer user, he registered "mikerowesoft.com" as a domain name. Software giant Microsoft launched legal proceedings against him, claiming violation of the cybersquatting statute and trademark infringement. Rowe's defense was that the Web site merely reflected his name and his interest in computer programming and software and was being used for that purpose. After heavy negative publicity, Rowe and Microsoft settled the case with Microsoft taking control of the domain. Another example surrounds the Nissan.com domain. Uzi Nissan, a computer storeowner, had owned the domain for years before Nissan Motors attempted to gain ownership of the domain. Since the domain was registered in good faith, no cybersquatting occurred. The First Amendment is also a defense to cybersquatting. Web sites run by consumer activists who seek to criticize or parody companies, such as "fordreallysucks.com" or "fordlemon.com" or "peopleofwalmart.com" are not cybersquatting in spite of their use of trademarks.

C. Copyright

The final form of federal intellectual property (IP) protection is *copyright*. Like patents and trademarks, federal law protects copyright. Whereas patents protect processes and inventions, and trademarks protect brands and identity, copyright is designed to protect creativity. It is one of the two types of IP specifically mentioned in the Copyright Clause of the U.S. Constitution. Of course, back then the only works copyrighted would have been songs, art, or works in writing. Today, copyright extends to any form of creative expression, including digital forms.

Copyright Protection & Licensing

If asked to write down four numbers from one to fifty in random sequence, most of us would write four different numbers. The process of picking those numbers requires creativity, so the sequence of the four numbers you write down is copyrighted. Note that the numbers themselves aren't copyrighted, of course. It's just the unique sequence that you choose, the expression of your creativity, that is copyrighted. Since computer software is a compilation of binary code expressed in 1 and 0, all software is copyrighted.

On the other hand, sequential page numbers or listings in a phone directory show no creativity and are therefore not copyrightable. Similarly, if a group of students were given a camera and each was asked to photograph the same subject, each student would come up with a different photograph. Each student would frame the subject differently, and that is an expression of creativity. Finally, consider the notes that you take in class for one of your college classes. A group of students could read the same textbook and listen to the same lecture, and come up with different sets of notes. Each work is unique and demonstrates creativity, so each is copyrighted.

A work must be original (not copied) and fixed in a durable medium to be copyrighted. Therefore, if you sing an original song in the shower in the morning and your roommate hears it and records it, the copyright to the song belongs to your roommate, not you. This requirement exists because it would be impossible to prove, without a durable medium, who is the original author of a work. Ideas, by themselves, cannot be copyrighted. If you had an idea for a novel about a boy wizard who goes to a boarding school with his friends and battles evil monsters while growing up, that would not be copyrighted. If you wrote a novel featuring such a story line, however, you would run the risk of violating the copyrighted Harry Potter works.

A similar dispute arose in 2006 after the blockbuster success of Dan Brown's novel, "The Da Vinci Code." Two authors, Michael Baigent and Richard Leigh, claimed the novel infringed on their copyrighted book, "Holy Blood Holy Grail." In their book, the authors theorized that Jesus survived his crucifixion, married Mary Magdalene, and had children. The British judge hearing the case dismissed the claims, holding that the theory was "too general or too low a level of abstraction to be capable of protection by copyright law." Baigent v. Random House Group, *[2007] All ER (D) 456 (Mar)* http://www.scribd.com/doc/2473519/da-vinci-code-ruling-baigent-v-rhg-0406/ .

A copyrighted work is automatically copyrighted upon its creation. Unlike patents and trademarks, which must go through an expensive and rigorous application and approval process with the government, authors do not need to send their work to the government for approval. Although it's a good idea to write "Copyright" or place a © symbol on the work, such formalities are not required for protection under the Copyright Act. However, registration of one's copyright is strongly encouraged, as the registration is a pre-requisite for bringing an action for statutory damages or attorney's fees resulting from infringement. 17 U.S.C. § 412.

The rights of authors are found in section 106 and 106A of the Copyright Act, and include the exclusive rights of copying, distributing, publicly performing, publicly displaying and preparing derivative works. Congress added section 106A in 1990 to provide for certain "moral rights" of authors of "visual works of art" such as paintings, drawings, and small runs of lithographs and photographs. These "moral rights" included the right of attribution – that is, a requirement that the author's name appear in association with the work – and also a right to prevent mutilation or destruction of a visual work.

Copyright protection lasts for seventy years after the death of the author. If there is more than one author, the copyright expires seventy years after the death of the last surviving author. If a company, such as a publisher, owns copyrighted work, the copyright expires ninety-five years from the date of publication, or one hundred twenty years from the date of creation, whichever comes first. After a copyright expires, the work falls into the public domain. The works of Shakespeare, Bach, and Beethoven, for example, are in the public domain. They may be freely recorded, performed, or modified without permission. If you were to record yourself reciting Shakespeare's "To be or not to be" speech from Hamlet, that recording is copyrighted, as a new creative expression, even though the underlying work (Hamlet) is in the public domain. Classical music recordings are similarly copyrighted under the same concept.

The owner of a copyright may allow members of the public to view or use a copyrighted work, for free or for a fee. This use is contained in a copyright license. A license is essentially permission from the copyright holder to violate the copyright, within the terms of the license. When you purchase a physical book or CD or DVD, for example, the copyright license allows you to view the movie, listen to the music, or read the book, in private. The license does not allow you to show the movie in class to a broad audience, or to record the music into your computer and then modify it, or to run photocopies of the book to give away or sell. These rights of reproduction, exhibition, and sale are not part of the license you received and are reserved by the copyright holder. Of course, you may purchase those rights if you wish, but they will probably cost a lot more than the price of the book or disc. Some organizations advocate the creation of a common license that authors can easily refer to if they wish to distribute their work easily. The *General Public License (GPL)* for software and *Creative Commons* (CC) license for text and media are well-known examples.

One right that you do have, however, in spite of any language in the license, is the right of *first sale*. Essentially this means that as the owner of a physical copy is free to resell that work to others, without any limitation by the author. This right of first sale, codified in section 109 of the Copyright Act, was the subject of litigation involving a student's purchase and resale of textbooks abroad, even though such books purported to limit these sales outside of the geographic area they were purchased. The Supreme Court held that such restrictions were pre-empted by the first sale doctrine in *Kirtsaeng v. John Wiley & Sons. Inc.*, 133 S. Ct. 1351 (2013).

Licenses in the digital arena can be very restrictive if you purchase digital media. Copyright holders may use schemes such as *Digital Rights Management (DRM)* to limit your ownership rights in digital media. DRM limits the number of copies and devices a digital file can be transferred to, and in some cases even permits the copyright holder to delete the purchased work. Amazon.com recently deleted digital George Orwell books from owners who had purchased the works for their Kindle reading device without any prior notification. This would have been impossible if the books were in a physical form. Although Amazon.com was within its rights to do so, the public outcry that followed made Amazon.com promise to not engage in such behavior again in the future.

Copyright Infringement

Copyright infringement occurs when someone uses a copyrighted work without permission or violates the terms of a copyright license. For example, if a classmate takes your class notes without your permission and makes photocopies of them, the classmate infringed on your copyright. It's also copyright infringement if you take someone else's work and simply repackage it as your own. This happened recently to Harry Potter author J. K. Rowling. Her books created a huge fan following, and many fans gather online to discuss the Potter series. One such site is the Harry Potter Lexicon, run by Steve Vander Ark, a former school librarian. The site serves as an encyclopedia to the Harry Potter world, with reference notes on characters, places, spells, and other details. When Vander Ark announced plans to publish the contents of the Lexicon in a book format, J. K. Rowling sued, claiming copyright infringement. The judge agreed and ordered the Lexicon rewritten so that it uses less material from the copyrighted work.

Copyright infringement also occurs when you assist someone in violating a copyright, or create a device that assists in violating a copyright. Thus, Web sites such as the former Napster and Grokster, which existed solely for the purpose of facilitating illegal downloading of music, were held to be infringers even though the Web sites themselves didn't violate any copyrights. Similarly, if you make digital media available for download for others, you are not engaged in illegal downloading but still liable for contributory copyright infringement. The recording industry, which is battling for its very survival in a new file-sharing world, pursues these cases aggressively. In June 2009, a court in Minnesota ordered Jammie Thomas to pay $80,000 per song for making twenty-four songs available for download, for a total fine of $1.92 million. *Capitol Records, Inc. v. Thomas-Rassett*, 799 F.Supp.2d 999 (D. Minn. 2011) (the district court reduced the total damages to $54,000, but on appeal, the 8th Circuit increased the award to $222,000 based on a jury verdict in prior litigation before the trial court on this issue, 692 F.3d 899 (2012)). In September 2009, the industry won a $675,000 verdict against a college student in Massachusetts for file sharing thirty songs, which was upheld on appeal in *Sony BMG v. Tenenbaum*, 719 F.3d 67 (1st cir. 2013). Devices that can be used for purposes other than violating copyrights (such as photocopiers, video/DVD burners, and peer-to-peer networks used for sharing research) are not considered infringing devices.

Fair Use Defense

Copyright law makes a distinction between "fair" use and "infringing" use of a copyrighted work. A fair use includes copying a work for purposes of commentary, criticism, news reporting, teaching, or research. Just because a work is used in a news article or in a classroom, however, does not make its use fair. The law provides four factors that courts must consider in determining whether or not the use is fair. First, the court must consider the purpose and character of the use. Is it for educational purpose, or for making a profit? Second, the court must consider the nature of the copyrighted work. Is the work part of the "core" of the intended protection that copyright provides? Third, the court must consider the amount and substantiality of the portion used. This is an important factor—it's one thing for your professor to copy an excerpt from a journal or book for distribution in class (probably fair) and another to copy the entire journal or book (probably infringing). Finally, the court must consider the effect of the use on the potential market for the copyrighted work. If the use is considered fair, what would it do to the market for the copyrighted work? For example, if copying an entire textbook is fair, it would probably eliminate the market for new textbooks. 17 U.S.C. § 107.

In an attempt to tackle the problem of copyright infringement on the Internet, Congress passed the *Digital Millennium Copyright Act (DMCA)* in 1998. One portion of the law helps Internet service providers by expressly stating that those providers can't be sued for copyright infringement if others use their networks for infringing uses. Another portion of the law helps Web sites by stating that if a Web site user uploads infringing material and the Web site complies with a copyright holder's request to remove the material, the Web site won't be liable for infringement. For example, if you upload a portion of a copyrighted song, movie, or television show to YouTube, you may find that YouTube has removed your clip at the request of the copyright holder.

Finally, the DMCA makes it illegal to attempt to disable a copy protection device. DVD and Blu-ray Discs, for example, are copy protected to prevent them from being copied easily. Anyone who writes software (even if the software is distributed for free) that disables this copy protection device is violating the DMCA. In recent years the DMCA has been used by companies to prevent competitors from making replacement inkjet cartridges, replacement garage door openers, and other replacement parts on the grounds that the replacements circumvent a copy protection device.

D. Trade Secrets

Imagine that you are in an antique store and find a nineteenth-century ledger book for sale, originally from the W. B. Morrison & Co. Old Corner Drug Store in Waco, Texas. Among the recipes for hair restorers and cough syrups, something in particular catches your eye—a recipe entitled D Peppers Pepsin Bitters. What if you also knew that Dr. Pepper was first created and served in that very drugstore? What if you offered to pay $200 for the old ledger book, even though if it did contain the recipe for Dr. Pepper, it would be worth far more? After all, according to the company that manufactures Dr. Pepper, only three people know the recipe to that very closely guarded trade secret. Something very similar to this happened to Bill Waters. He found the ledger book in an antique store, and he paid $200 for it. However, at the time, he did not know that the book might date back to the exact time and place from which the popular soda was created. In fact, he did not even notice the recipe until later, and it took him several more days to recognize the possibility that it might be an early version of Dr. Pepper.

Unlike patents, a trade secret can last forever. That is, it can last forever if the owner of the secret can, well, keep it a secret. If someone uses lawful means to uncover the secret, then the secret is no longer protected by the secret's owners. Does this include reverse engineering? Yes. Reverse engineering is an absolutely legal means of discovering a trade secret. What about ferreting out secrets from an employer's safekeeping, while employed and under a binding confidentiality agreement? No. That is an actionable claim for misappropriation, and the secret's owners can pursue damages.

Trade secrets are unlike patents in another important way. With a patent, the inventor must specifically disclose the details of the invention when applying for a patent. This means that the inventor has not protected the secret of the invention. However, in exchange for this disclosure, a patent owner has a legal monopoly over the property for a specified period of time. So even if others discover the secret of the invention (not a difficult task since patent applications are public record), they are prohibited from making, using, or selling it without the patentee's permission. After the patent expires, then the patentee no longer has a property right to exclude others.

So what is a trade secret? It is, in short, secret information. This information may include a process, formula, pattern, program, device, method, technique, or compilation. For many companies, lists of suppliers, costs, margins, and customers are all trade secrets. Soft drink recipes, KFC's eleven spices, the donut mix sent to Krispy Kreme franchisees, the Big Mac's special sauce, and even the combination of wood that is used in the burning process to make Budweiser beer are all trade secrets. Additionally, the information derives actual or potential economic value from being a secret that is not readily discoverable by others, and the information is the subject of efforts to keep it a secret. While most states have adopted the Uniform Trade Secrets Act (UTSA), not all have: https://www.uniformlaws.org/committees/community-home?CommunityKey=3a2538fb-e030-4e2d-a9e2-90373dc05792 , so the definition of trade secret can vary by jurisdiction. Unlike patents, trademarks, and copyrights, there is no federal law protecting trade secrets.

A claim for misappropriation may be brought when a trade secret has been wrongfully obtained, such as through corporate espionage or bribery. Generally, according to the UTSA, misappropriation occurs if the secret was acquired by improper means, or if the secret was disclosed or used without permission from the secret's owner. Damages may include actual loss and unjust enrichment not captured by actual loss. Additionally, in cases of willful or malicious misappropriation, double damages may be awarded, as well as attorney's fees.

So what if you are never lucky enough to discover a multimillion-dollar secret recipe hidden away in an antique shop? As long as the recipe is not patented, you can try to reverse engineer it. If you succeed, you can use it immediately. However, if you are working for an employer in a creative capacity, working with others to develop the secret, and if you have agreed not to use trade secrets, then the right to the trade secret will belong to your employer, at least in most jurisdictions. Ask Peter Taborsky, an undergraduate student at South Florida University in 1988. According to Taborsky, while working in the university's chemical engineering lab, he began conducting experiments on his own. He discovered a highly effective method for treating sewage. The university demanded that he hand over his notebooks that contained the secrets of this invention. Taborsky refused and filed for a patent for his invention, which he received. However, the university pressed criminal charges for stealing trade secrets. Taborsky lost his case and found himself in a maximum-security facility working on a chain gang.

So does Bill Waters need to worry about Dr. Pepper's owners suing him for misappropriation or pressing criminal charges for stealing trade secrets? No. He lawfully obtained the ledger book by purchasing it in the open market. Additionally, according to a company spokesman, the ingredient list under D Peppers Pepsin Bitters is most likely an old remedy for a stomachache rather than any version of the recipe for Dr. Pepper. But if Mr. Waters had accidentally stumbled on the exact Dr. Pepper recipe, he would have a good argument that the company did not take steps to keep the secret a secret. If it had, he could argue, the company never would have allowed the recipe out of its sight.