LEGAL ENVIRONMENTS OF BUSINESS

Delta Publishing Company

PREFACE

The major purpose of *Legal Environments of Business* is to provide the interested reader with a concise summary of the major legal principles affecting businesspeople and business transactions. It should furnish a quick, yet comprehensive, review of this vital and wide-ranging area of the law. The undergraduate or graduate student should find it invaluable as a vehicle for drawing together and summarizing material s/he is covering currently in courses or for reviewing coursework previously taken. Likewise, it should commend itself to the person preparing for a C.P.A. or C.L.U. examination, to the participant in an executive development program and to the businessperson or ordinary citizen seeking a review or greater knowledge of business law. Readers who require more detailed information on the topics covered are referred to Business Law: Principles and Cases by Lusk, Hewitt, Donnell and Barnes-the source from which this course is drawn.

The subject matter is organized into ten major divisions as follows: (1) introduction of law, including philosophy and history of law, the court system and legal procedures, crimes and torts; (2) contracts; (3) agency; (4) partnerships; (5) corporations; (6) property, including real and personal property; (7) sales of goods; (8) negotiable instruments; (9) credit, including secured transactions and bankruptcy; and (10) economic relations and the law, including competitive torts and the law of ideas, Sherman Act Clayton Act, Robinson-Patman Act, and the Federal Trade Commission Act.

While the reader may, depending on his or her interests and needs, take the chapters in any order or read only those chapters which deal with those interests and needs, the reader who has not had previous experience with business law is probably well advised to read at least Chapter 1 and probably both Chapters 1 and 2 before delving into the remainder of the material. The reader who is in no particular hurry will find that it is best to work through the material somewhat in order since most of the last 17 chapters build to some extent on principles dealt with in the contracts section and, similarly, both partnerships and corporations build to some extent on torts, contracts, and agency law.

The time required to work through each chapter will of course, vary somewhat depending on the length of the chapter, but in most cases it should range from about 30 to 60 minutes per chapter.

TABLE OF CONTENTS

CREDIT

ECONOMIC RELATIONS

Chapter 1

INTRODUCTION TO LAW AND THE LEGAL SYSTEM

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Discuss the nature of law.
2. List and define the functions of law.
3. Articulate and give examples of the legal systems in the United States.
4. Describe and give examples of legal procedures

While the primary purpose of this course is to acquaint the student with the major principles in those areas of the law which affect businessmen, it is also useful to have some elementary understanding of the nature and source of law, legal history, and the legal system and procedure used in this country. This chapter will deal briefly with each of these topics.

Nature of law. No single definition of the word "law" can satisfactorily reflect the many aspects and changing character of the law. Over the centuries, philosophers have discussed the nature of law and the related concept of "Justice." While there are almost as many concepts of the term "law" as there are people who have pondered the question, at least four basic concepts can be identified which may be of assistance to those who seek to understand our legal system.

These basic concepts are:

1. LAW AS WHAT IS RIGHT. Under this concept there is some great and all pervasive code of what is right and wrong. This moral sense of what is right or wrong may be derived either from some divine source or from the nature of man himself.
2. LAW AS CUSTOM. Under this concept law is the accumulated customs and traditions of a society, which reflects that society's interaction with its environment.
3. LAW AS COMMAND. Under this concept law is a body of rules which is issued by the political authority and enforced through various sanctions.
4. LAW AS SOCIAL ENGINEERING. Under this concept law is regarded as a means of social control, which seeks to balance various competing and conflicting interests and values within a society.

Different schools of jurisprudential thought place differing degrees of emphasis on each of these concepts. Those who place primary emphasis on the concept of law as what is right are known as the natural law school. The historical school of thought emphasizes the aspect of custom and tradition, whereas legal positivists stress the concept of law as command. Those

who look at law primarily in terms of its use for social engineering are known as the sociological school of jurisprudence. Another group-known as the legal realists-reject the idea that any theory or group of theories can adequately define law and focus on law as a dynamic, changing process.

The functions of law. Law of some variety has been a part of society since the time of the most primitive societies. Initially the primary purpose of the law was to keep the peace, but as society became more complex and developed, the law took on additional functions. Today, at least eight major functions of law can be identified: (1) to keep the peace, (2) to influence and enforce standards of conduct, (3) to maintain the status quo in certain aspects of society, (4) to facilitate orderly change, (5) to allow for maximum self-assertion by the individual, (6) to facilitate planning and the realization of reasonable expectations, (7) to promote social justice, and (8) to provide a mechanism for compromise solutions between polar principles and positions.

There are limits on the use of the law in certain contexts. For example, the Constitution of the United States and the constitutions of the various states typically place limits on the application of law; the courts themselves have traditionally refused to concern themselves with insignificant or moot matters and hypothetical questions.

Anglo-Saxon legal background. The law and legal system in the United States have been heavily influenced by the Anglo-Saxon legal tradition, which dates back to the year 1066 and William the Conqueror. Certain aspects of our legal procedure such as juries and witnesses sworn under threat of perjury have their roots deep in this tradition. One of the most significant features of the Anglo-Saxon legal tradition, which distinguishes it from the civil code system prevalent on continental Europe, is its heavy reliance on 'common' or judge-made law as opposed to statutory or codified law. Thus the Anglo-Saxon and now the Anglo-American legal tradition is characterized by its reliance on prior judicial decisions or precedents as a guide to the law that should be applied to essentially new but analogous situations arising today.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1. Most legal scholars agree that there is a single definition of the word "law."
____2. The "natural law school" places primary emphasis on the concept of law as what is right.
____3. From its origin until today, the sole purpose of the law is maintaining the peace.
____4. The Anglo-Saxon legal tradition is characterized by its heavy reliance on the "common law."

1. False. No one definition of the term "law" can satisfactorily reflect the varied aspects and changing concepts of the law.
2. True. The "natural law school" is made up of those who place primary emphasis on the concept of law as what is right.
3. False. While the keeping of the peace was originally the primary purpose of the law, today it is but one of its many functions.
4. True. Anglo-Saxon (and now Anglo-American) legal tradition is characterized by its heavy reliance on the "common law."

Sources of law in the United States. The law in this country is a product of a number of different sources. Foremost, of course, is the Constitution of the United States which separates the government into the three coordinate branches, grants certain enumerated powers to each of these branches, reserves certain powers to the states, and sets limits on the power of the federal and state governments to enact certain kinds of legislation or to engage in certain kinds of activities relating to their citizens. Each state has also adopted a constitution which sets out both the form and operation of government in that state and also places certain limits on its power. A third source of law is the enactments of the legislative bodies-that is, acts of Congress, statutes of state legislatures, and ordinances of local governing bodies acting within the powers conferred on them by state legislatures. The common law-that is, the judge made law-is also a very important source of law in this country. In addition, a great deal of law is what is known as private law, where two parties voluntarily assume a set of obligations with reference to each other under such circumstances and conditions that a court will enforce their private agreement.

The "contract" which will be the basis of considerable discussion in this course is a common example of such private lawmaking.

Legal systems in the United States

There are 51 separate court systems in this country-the federal system and the court systems of each of the 50 states. Each of these systems functions independently of the others and each is composed of courts having general jurisdiction and other courts which perform only specialized functions. The courts of this country are unique in that they have the power to declare legislation unconstitutional. This gives the courts a place of special importance in our government. In addition to the court systems, the federal government and virtually every state government contain administrative tribunals which are not formally courts but which do exercise many quasi-judicial powers.

THE FEDERAL COURT SYSTEM. The Constitution of the United States establishes the Supreme Court and vests certain original and appellate jurisdiction in it. The Constitution also empowers Congress to create a system of subordinate courts. In general, these federal courts have jurisdiction over cases directly affecting the federal government, over matters of interstate character, and over cases between citizens of different states or of a state and a foreign country where the amount in controversy exceeds $10,000.

The courts in the federal court system (along with a brief summary of their jurisdiction) are:

Supreme Court. The Supreme Court has original jurisdiction in those cases affecting ambassadors, ministers and consuls and those cases to which a state is a party. The Supreme Court is the appellate court of last resort for cases arising in the lower federal courts and for cases appealed from state courts which involve interpretation of the federal constitution and federal statutes. As a general rule, appeal to the Supreme Court is a matter of privilege and not a matter of right and the Court will decide whether or not it wishes to hear a particular case.

Court of Appeals. Judges of the Court of Appeals generally sit in panels of three and hear appeals taken as a matter of right from the district courts or from various administrative tribunals. The Court of Appeals does not have any original jurisdiction; that is, it does not sit as a trial court to hear any cases.

District Courts. The District Courts are the general courts of original or trial jurisdiction in the federal system. The district courts also hear certain types of suits against the United States where the amount in controversy is less than $10,000. In cases seeking to enjoin the operation of a federal statute on constitutional grounds, a three-judge court is required. The bankruptcy court, master in chancery, and U.S. commissioners are attached to and are a part of the district court and carry out certain specialized functions for the district courts.

Court of Claims. The Court of Claims is a court of original jurisdiction established to hear certain contract claims against the United States. If the amount in controversy is less than $10,000, the suit may be brought in either the Court of Claims or in a district court. Appeals from the Court of Claims are taken directly to the Supreme Court.

Court of Customs and Patent Appeals. The Court of Customs and Patent Appeals is primarily an appellate court which hears appeals from the Customs Court and from various patent administrative boards and commissioners. Appeals are taken directly to the Supreme Court from this court.

Customs Court. The Customs Court is located in the port of New York and has jurisdiction to hear various claims and decisions made concerning import duties.

Tax Court and Court of Military Appeals. The Tax Court and the Court of Military Appeals are actually quasi-judicial agencies with some judicial powers.

Federal administrative agencies. Administrative agencies are outside the regular court system but in most cases they exercise rather broad judicial type powers. Most agencies have investigative, prosecutorial, and adjudicating functions in their statutorily designated areas of operation. Theoretically, administrative agencies have specialized expertise and are capable of dealing rapidly and flexibly with problems in their area of expertise. Among the federal administrative agencies are the Federal Trade Commission, Securities and Exchange Commission, Nuclear Regulatory Commission, Interstate Commerce Commission, National Labor Relations Board and the Federal Communications Commission.

State court systems. While each state has its own court system which is unique in certain details from those of the other states, there are a number of fundamental features which tend to be the same. All of the states have a system of inferior courts-for example, justice of the peace, police, municipal or traffic courts, and small claims courts-which have limited jurisdiction and are not courts of record. There is also a system of courts of general or specialized trial jurisdiction-for example, criminal, circuit, civil, juvenile and probate courts-which are courts of record. All states have some appellate court or courts. The more populous states usually have intermediate appellate courts and all states have an appellate court of last resort. Appeals are more likely to be available as a matter of right than as a matter of privilege.

Indicate whether each of the following statements is true or false by writing “T” or “F” in the space provided.

____1. The foremost source of law in the United States is the Constitution.
____2. U.S. courts have the power to declare legislation unconstitutional.
____3. Appeal to the U.S. Supreme Court is a matter of right.
____4. All state court systems are identical.

1. True. The Constitution of the United States is the foremost source of law in this country today.
2. True. Courts in the United States have the power to declare legislation unconstitutional.
3. False. As a general rule, appeal to the Supreme Court is a matter of privilege; the Court decides whether or not it wishes to hear a particular case.
4. False. Although they are similar in certain respects, the court systems of the states differ to varying degrees.

Legal Procedure

In order to undertake a meaningful study of business law, particularly where that study includes the reading of actual case decisions, it is necessary to have a basic understanding of legal procedure. The Anglo-American legal system operates under what is known as the adversary system. The system is presided over by a theoretically unbiased and essentially passive judge. In a civil law action-as opposed to a criminal action-one party, known as the plaintiff, claims to have been injured by the other party, known as the defendant, and seeks to prove both factual and legal entitlement to relief. At the same time, the defendant seeks to prove that the plaintiff is mistaken as to what happened factually and/or as to the defendant's legal liability. Both parties normally employ lawyers to represent their case to the judge (or to the jury if one is used) and to convince the judge or jury of the soundness of their case and the weakness of the other party's case. Thus, the development of facts and legal issues is essentially within the control of the adversary parties. However, the judge is responsible for guiding the proceeding according to certain procedural rules and for making decisions on questions of law that arise. Moreover, in certain kinds of specialized cases like domestic relations, the judges may take a rather active role in guiding the proceeding.

A civil action is normally initiated by the filing in the court clerk's office of a 'complaint’ which sets out the basis for the court's jurisdiction over the matter, sets forth the essential claims the plaintiff has against the defendant, and demands that the court grant the plaintiff certain specified legal relief. The ‘complaint’ along with a 'summons' is then served by a legal officer upon the defendant named in the lawsuit. The summons notifies the defendant that a lawsuit has been initiated and that there is a certain, specified time in which to defend the suit. Service of the

summons is normally accomplished by personally serving the defendant with the summons, although in certain situations it may be done by mail or by publication in a newspaper.

If the defendant wishes to defend himself or herself, an "answer" to the complaint must be filed within the stated time. In the answer the defendant either admits, denies, or alleges insufficient information to admit or deny each of the allegations in the plaintiff's complaint. The defendant may also raise certain affirmative defenses which are normally legal reasons for denying the plaintiff the desired relief even if the facts are essentially as the plaintiff alleges them to be. The defendant, within certain limits, may present related claims that s/he has against the plaintiff. Under certain circumstances, the plaintiff must then file a responsive pleading known as a "reply" that admits, denies, or claims lack of information as to the facts alleged by the defendant and upon which the plaintiff bases affirmative defenses or counter-claims. If the defendant believes that the complaint does not state facts which would entitle the plaintiff to a judgment even if they are true, the defendant may challenge the sufficiency of the complaint by filing a motion to dismiss or a demurrer. If the judge agrees that the motion to dismiss or demurrer is well taken, the case will be dismissed without ever going to a formal trial.

A recent addition to legal procedure is the pretrial conference. This is a meeting between the opposing counsel and the judge in an effort to narrow the issues for trial or, if possible, to dispose of the case without the necessity of a trial. If a trial is held, the first item of business is to choose and swear in the jury if it is to be a jury trial. This is followed by opening statements by attorneys for both sides in which they outline the claims and contentions they will be making in the course of the trial. The plaintiff's attorney then presents the plaintiff's case through the presentation of documentary evidence and the questioning of witnesses. Then the defendant's attorney presents the defendant's case through the use of documentary evidence and/or witnesses. At several points in the course of the trial each party may make a motion to the court that s/he is entitled to judgment as a matter of law because of weaknesses in the opposing party's case and the judge will rule on the motions. Following the presentation of the defendant's case, both attorneys will sum up the case and make their final arguments. If the trial is before a jury, the judge will then instruct the jury and they will retire to render a decision. If no jury is involved, then the judge will either decide the case immediately or take it under advisement.

Following the court's decision, either or both parties may attempt to appeal the case on the grounds that some material error of law was made in the course of the trial or in the final decision.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1. The Anglo-American legal system operates under the adversary system.

____2. A civil action is usually initiated by the Plaintiff's filing of a summons against the defendant.

____ 3. If a demurrer is granted, a case will not go through a formal procedure.

____4. Either party may appeal the decision of a civil court.

1.True. The adversary system is the basis for the operation of the Anglo-American legal system.

2.False. A civil action is normally initiated by the filing of a 'complaint' with the court. An officer of the court serves the 'complaint' and a 'Summons' upon the defendant.
3.True. If the judge agrees that the demurrer or motion to dismiss is well taken, the case will be dismissed without ever going to formal trial.
4.True. Following the court's decision, either party to the case may attempt an appeal.

Chapter 2

CRIMES, WHITE-COLLAR CRIMES, TORTS, AND CYBERTORTS

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Identify and explain the nature of crimes.
2. Describe and give examples of torts.
3. Explain cyber torts.

Crimes

A crime is an act done by an individual which society considers to be a wrong against it and for the commission of which society prescribes certain penalties or punishment. The conduct which will be considered criminal depends on the attitudes and mores of a society at any given time, although there is commonly some time lag between the time that certain conduct is no longer considered criminal and the time that it is removed from the criminal statutes. The procedure involved in criminal prosecutions differs in several important respects from that involved in civil cases (as was discussed in Chapter 1).

Criminal cases are brought in the name of the state or the federal government, the accused is presumed innocent until proven guilty, the guilt of the accused must be proven beyond a reasonable doubt, and the state cannot appeal a verdict of "not guilty." In civil cases the suit is generally brought by one member of society against another (although governmental units can also be parties). The plaintiff in a civil case must show by the preponderance of the evidence that s/he is entitled to the relief s/he seeks, and either or both parties may appeal. In order to support prosecution for some action that is defined by statute or ordinance to be a crime, there must be both a criminal act and a criminal intent. Determining whether there has been a criminal act is usually relatively simple whereas criminal intent often must be inferred from the circumstances surrounding the commission of the act. Some persons are excused from criminal liability for lack of capacity; thus, under some circumstances infants, insane and intoxicated persons will be so excused. The United States prides itself on the constitutional protections accorded to persons accused of having committed crimes. In recent years the Supreme Court, in a number of landmark decisions, has carefully delineated the protections that must be accorded a person accused of committing a crime.

White-collar crimes

Embezzlement. Embezzlement is the fraudulent conversion of property or money owned by one person but entrusted to another. Embezzlement involves conversion by a person in lawful possession of another's property; larceny involves the taking and carrying away of another's

property, usually without any right to possession. Embezzlement is not robbery because there is no taking by force or intimidation. A special form of embezzlement called misapplication of trust funds occurs when funds are entrusted to a contractor for a specific purpose, and the contractor does not use the money for the purpose.

Use of the mails to defraud. Use of the mails to defraud requires a scheme to defraud and use of the mails to carry it out. It is also a crime to use a telegram, telephone, radio, or television to defraud. Unlike obtaining goods by false pretenses, mail fraud does not require that the scheme succeed.

Bribery. Bribery of public officials is a crime. The bribe can include anything that the official considers valuable. The crime occurs when the bribe is tendered (the official does not have to agree to do anything or accept the bribe). In some states, commercial bribery (kickbacks and payoffs) is a crime. Commercial bribes are typically given to obtain proprietary information, cover up an inferior product, or secure new business. Industrial espionage sometimes involves commercial bribery. Bribing foreign officials to obtain favorable business contracts is also a crime.

Insider trading. Insider trading is using material inside information about a corporation to profit by buying and selling the corporation's securities. Inside information is information not available to the public. Generally, one who possesses inside information has a duty to disclose it to whoever is on the other side of the transaction.

Torts

Under Anglo-American law, a person owes a duty to other persons not only to refrain from doing any intentional act to the damage of that other party's person or property but also to exercise due care in his or her actions so as to avoid doing those things which might unintentionally cause foreseeable injury to such other person or property. If a person fails to observe these duties owed to other persons and someone or something is injured as a result, the wrongdoer will be held liable in damages to the injured person unless the wrongdoer is able to show that his or her actions were privileged in some respect or based on some supervening social interest. A breach of this societal duty is known as a "tort." Torts are usually divided into intentional and nonintentional breaches of duty and intentional torts are further divided into intentional interferences with the person and intentional interferences with property.

Intentional Interferences with the person. The torts of intentional interference with the person include assault, battery, false imprisonment, defamation, invasion of privacy, and intentional infliction of mental distress. An assault occurs when one person intentionally puts another person in apprehension of immediate physical injury. It is not necessary that there be any actual touching nor is it necessary that the person actually be afraid; mere apprehension is all that is needed to constitute an assault. A battery is the intentional touching of another without justification or without that person's consent.

The tort of false imprisonment is, for example, of particular concern to retail business owners who may be mistaken in their belief that particular customers are shoplifters and detain them against their will. False imprisonment occurs when a person is intentionally confined for an appreciable time the duration of which is established by the person causing the confinement;

false imprisonment requires both knowledge of the confinement by the person confined and lack of consent on his part.

False written and oral statements which damage a person's reputation may be actionable as defamation; written defamation is known as libel and oral defamation is known as slander. In order for defamation to be actionable, the false statements holding a person up to hatred, contempt, or ridicule must be published-that is they must be made to a third person or at least under such circumstances that a third person is likely to read or hear them. Usually libel does not require proof of specific damages sustained by the defamed person as a result of the libel, whereas unless oral defamation accuses the person of having committed a crime or of having a loathsome disease, accuses a woman of being unchaste, or damages a person in his or her business or professional reputation, the damages sustained by reason of the slander must be specifically proven. Truth is a defense to a defamation action and in some cases even false statements may be privileged, either absolutely or conditionally. For example, false statements made about public figures such as politicians are not actionable unless the defamed person can show that the defamer was motivated by actual malice in making the false statements.

Interference with a person's right to privacy is a tort of relatively recent development The full extent of the right to privacy has not yet been established, but at the present it includes such things as the right to prevent others from using one's name and picture for advertising purposes and to be free from such things as the tapping of one's telephone or bugging of his dwelling. Another recent development in tort law has been the granting of damages for the intentional infliction of mental distress on another person. However, in order to guard against fictitious claims the courts require not only that the conduct causing the distress be 'outrageous' but also that the resulting injury be of a serious nature.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.Civil and criminal court procedures are identical.
____2.The state may not appeal a "not guilty" verdict in a criminal case.
____3.To support prosecution for a crime, there must be both a criminal act and criminal intent.
____4.The tort of assault always involves physical contact.
____5.Libel and slander are synonymous terms.

1.False. The procedures involved in criminal cases differ in several respects.
2.True.In a criminal case, the state may not appeal a verdict of "not guilty."
3.True.In order to support prosecution for a crime there must be both a criminal act and criminal intent.
4.False.Physical contact is not necessary for the tort of assault; the apprehension of immediate physical injury is all that is required.
5.False. Libel is written defamation, whereas slander is oral defamation.

Intentional Interference with property rights. The torts of intentional interference with property rights include trespass to land, trespass to personal property, conversion, and deceit. Interfering with another's right to the possession of his or her land, such as by entering or

remaining on that land or by allowing some object to remain on the land, without the owner's permission, is a trespass for which damages are recoverable. Even where actual damages cannot be shown, nominal damages may be awarded to compensate for the interference and if it continues, the remedy of an injunction or actual removal may be ordered. Likewise, the intentional interference with someone's right to possession of personal property may also result in a trespass for which damages may be recovered to compensate for any harm caused. The most common intentional tort relating to interference with property rights is that of conversion. Conversion is the unlawful dominion or appropriation of the property belonging to another person. A person who steals another persons property has converted it; likewise, a person who has lawful possession of another's property-such as a bailee-but who wrongfully sells that property has converted it and must answer to the real owner in damages. Damages for conversion are measured by the reasonable value of the converted goods.

The tort of deceit, whereby one person wrongfully obtains an economic advantage over another, is included within what is known by most persons as fraud. There are five essential elements necessary for a recovery of damages based on deceit: (1) the misrepresentation of a material fact, (2) intentionally made or made in reckless regard of the actual truth, (3) which is intended to mislead and induce action, (4) which is justifiably relied on, and (5) which causes injury.

Negligence. Negligence is the failure to use due care to avoid foreseeable injury which might be caused to another person or property as a result of the failure to exercise due care. To recover damages for negligence, a person must establish both that the other person was guilty of negligent conduct and that s/he suffered an injury as the proximate cause of such negligent conduct. What constitutes due care in any given situation is determined by using the standard of that care which a reasonable man would ordinarily exercise under those circumstances. In order to constitute actionable negligence, a person's conduct not only must be unreasonable in relation to the foreseeable risk it creates so that an ordinary and prudent person would not engage in such conduct, but also the conduct must be the proximate cause of the injury for which recovery is sought-that is, the harm must be the natural and probable result of such conduct. While the injured person normally has the burden of proving that the other person was negligent, the doctrine of res ipsa loquitur comes to the aid of the injured person who can show: (1) that the event that caused the injury was one that would not normally happen in the absence of negligence and (2) that the defendant had exclusive control over the instrumentalities which caused the harm. This doctrine then shifts the burden of explanation to the allegedly negligent party who in order to escape liability must show that the duty of due care was met.

The principal defenses to negligence are contributory negligence and assumption of the risk. The defense of contributory negligence is based on the idea that a person should exercise a reasonable amount of care for personal safety and should not be able to recover in negligence from someone else where failure to exercise due care for the person's own safety effectively contributed to the injury, even though the other person was also negligent.

Because a finding of contributory negligence totally bars that person from recovering even though that person's contributory negligence may be slight in comparison to the other person's negligence, some states have adopted the doctrine of comparative negligence. Under the

doctrine of comparative negligence, the person whose own negligence was, for example, 15 percent of the negligence in an accident can only recover 85 percent of the damages sustained in the accident.

Assumption of the risk applies in those situations where the injured party was aware of the risks faced and could be found to have either expressly or impliedly assumed them by proceeding in the face of them. Thus, in some situations, a person who voluntarily proceeds in the face of foreseeable danger will be unable to hold another liable for his negligence.

Strict liability. While negligence is premised on a failure to exercise due care, the courts have developed the doctrine of strict liability where by a person is held liable for the consequences of that person's acts regardless of whether the person exercised all possible due care; thus where strict liability is applied, the person is the virtual insurer of those who may be injured by his or her conduct. Generally strict liability is applied in those situations where the conduct is what might be described as hazardous, yet it involves enough social utility to allow it to be conducted on the condition that the person conducting it will bear liability for the consequences of his conduct. Some examples of activities where strict liability is applied are dynamiting and the keeping of wild animals which may be dangerous if released from their captivity. Strict liability is becoming quite important in the area of product liability, particularly where the product turns out to be defective and thus more dangerous than the ordinary consumer would expect. This aspect of strict liability is discussed in Chapter 18.

Cyber Torts

Cyber torts are torts committed in cyberspace. The issues generally are who should be liable and how to prove, for example, that a defamatory remark was "published."

Defamation Online

Under the Communications Decency Act (CDA) of 1996, Internet service providers (ISPs) are not liable for the defamatory remarks of those who use their services. Sometimes it is viewed as unfair to impose liability on an ISP for the actions of its customers, who may number in the hundreds of thousands, or more. It also sometimes said that imposing such liability would inhibit the development of the Web and the Internet. An analogy might be the imposition of liability on a bookseller for the statements of every author in every book that the seller sold. To so restrict ISPs (or booksellers) would limit access to their products and services to very few customers.

Spam

Spam is junk e-mail. The First Amendment limits what the government can do to restrict it, but its sending may constitute trespass to personal property. The Controlling the Assault of Non-Solicited Pornography and Marketing (CAN-SPAM) Act preempts state anti-spam statutes to permit the use of unsolicited commercial e-mail but prohibit certain spamming activities.

Chapter 3

CONTRACTS, OFFER, AND E-CONTRACTS

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Illustrate the classifications of contracts.
2. Explain and prepare an offer.
3. Describe e-contracts and e-signatures.

Contracts are essentially promises, or groups of promises, to do something in the future. If the promises have certain characteristics defined by law, then the promises give rise to rights which will be protected by society and the breach of the promises will give rise to enforced remedies. The general contract law which will be discussed in this and the following five chapters is based largely on statutes and the common law. The Uniform Commercial Code (U.C.C.), which is now law in all of the 50 states, includes a statutory enactment of the law of contracts for the sale of goods which differs in some respects from the general contract law. The discussion of contracts will on the whole be based on general contract law; where the law of the sale of goods based on the U.C.C. differs from the general principles, those differences will be pointed out.

Classifications of contracts. Contracts are divided into various classes based on their characteristics; these classifications are not all-inclusive or all exclusive and the same contract may fall into various different classifications depending on the characteristics which are determinative of the class in question. Contracts may be unilateral or bilateral. A unilateral contract is one in which only one of the parties makes a promise, whereas in a bilateral contract each of the contracting parties makes a promise. An example of a unilateral contract is where A gives B a radio in return for Bs promise to give A $15 next week. An example of a bilateral contract would be C promising to give D $10 next week in return for D's promise to make a dress for C. Contracts may be valid, unenforceable, voidable, or void. A valid contract is one which meets all of the legal requirements for a contract and which will be enforced by the courts. An unenforceable contract is one which generally meets the basic requirements for valid contracts, but which the courts are forbidden by a statute or rule of law to enforce; for example, under the U.C.C., contracts for the sale of goods with a value of more than $500 must be in writing to be enforceable. A voidable contract is one which binds one of the parties to the transaction but gives the other party the option of either withdrawing from the contract or of insisting on compliance with the contract. A void contract is a contract which is of no legal force or effect and therefore is really not a contract. For example, in some states a contract to pay a wager or gambling debt is null and void and courts will not aid in its enforcement.

A contract is said to be executory until all of the parties have fully performed their responsibilities under the contract; at that point it becomes an executed contract. A contract may be either express or implied. An express contract has its terms, conditions, and promises

specifically set forth in words; whereas an implied contract is one where the essential elements are not set forth in words but must be determined from the circumstances, general language, or conduct of the parties.

Quasi contract. There are some situations where one person confers benefits on another person under such circumstances that it is clear they were not intended to be a gift and where the other person accepts the benefits even though she/he has not promised to pay for the benefits. Such a situation does not fall within the usual concept of a contract where a return promise would normally be made; yet the courts often imply a return promise in order to avoid the injustice that would result from allowing the person to retain the benefits without paying for them. In such a case the recovery allowed for the confer of benefits is the amount of the unjust enrichment that would otherwise occur. There can be no recovery in a quasi contract if there is an express contract actually covering the situation nor can there be recovery if under the circumstances the beneficiary is justified in believing that the benefits are a gift or if the benefits are conferred without the beneficiary's knowledge or consent.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1. The provisions of general contract law and those of the Uniform Commercial Code are identical in every respect.

____2. A contract may be either unilateral or bilateral.

____3. A void contract is one which is of no legal force or effect.

____4. There can be recovery in quasi contract if it is either an express or implied contract.

1.False.The provisions of the Uniform Commercial Code include a statutory enactment of the law of contracts for the sale of goods which differs in some respects from general contract law.

2.True.Contracts may be either unilateral (involving a promise by only one party) or bilateral (involving a promise by each party).

3.True.A void contract is a contract which is of no legal force or effect and therefore is not really a contract.

4.False.If there is an express contract there can be no recovery in quasi contract.

Offer

In order to have a contract there must be a mutual understanding as to what each party will give and receive in return. Prior to the existence of a contract, the parties normally engage in negotiations in an effort to arrive at that mutual understanding. What usually occurs is that A will set forth a proposition-the offer-which, if accepted by B will result in the making of a contract. An offer to contract has two aspects: (1) the offeror indicates what s/he will do or not do, and (2) he indicates what s/he demands in return. The offer must be communicated to the offeree and the communication may be written, oral, by some acts, or by any combination of these means of communication. From all of the circumstances it must appear to the ordinary, reasonable person that the offeror did in fact intend to make an offer. The offeror's actual state

of mind is irrelevant; what is important is whether the offeree is justified in believing that an offer was made. The offeror must state the terms of the offer with reasonable certainty, or at least provide a basis for determining them with such certainty. If the terms are not reasonably certain then the offer will be void and the courts will not make a contract for the parties where they did not make a valid one themselves. The omission of a minor or immaterial term will not affect the validity of the offer or contract but the omission of a material term or an agreement to agree later on a material term will preclude the making of a valid contract. Usage of trade is occasionally used to fill in minor omitted terms or to clarify terms.

The actual making of an offer must be distinguished from what is described as 'preliminary negotiations'-a period during which the parties seek to determine the bargain the other is willing to make but where no definite statement of what is offered and what is demanded in return is made. Advertisements pose a special problem as to whether they constitute an offer. Normally they are considered only invitations to negotiate or to make an offer; however, an advertisement will be held to constitute an offer if it contains a positive promise and a positive statement of what the advertiser demands in return. The offer to pay a reward is an example of an advertisement which is usually held to constitute a binding offer that can be accepted by performing the requested act. Bids normally are considered invitations to make offers unless the bid advertisement states that the job will be let to the lowest bidder without reservation, in which case it is an offer to let the job to the lowest bidder. Likewise auctions, unless they are stated to be without reserve, are merely invitations to make offers which may be either accepted or rejected by the auctioneer.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1. An offer must always be communicated in writing to be effective.
____2. The omission of a minor term invalidates an offer or a contract.
____3. Advertisements are always considered to be offers.
____4. The offering of a reward for a specific act is normally considered to be a valid offer.

1.False.To be effective, an offer may be written, oral by some acts, or by some combination of these means of communication.
2.False.The omission of a minor or immaterial term will not affect the validity of an offer or a contract.
3.False.Normally advertisements are considered to be only invitations to make an offer.
4.True.The offer to pay a reward is usually held to constitute a binding offer.

Terms included in offers. A common problem is determining whether a particular term is included in the offer or in the contract between the parties. As was already indicated, the offer must be communicated to the offeree in order to be valid and is not effective until it has been so communicated. Sometimes the offeror prints certain of the terms of an offer on a tag or ticket attached to merchandise or given to the offeree (for example, when a person receives a ticket when parking a car or checking a coat or is sent a tag in the mail along with some other

material). Have such terms been communicated so as to form part of the offer, particularly if they are in small type or included among many other terms? In such a case, a determination must be made as to whether such terms were likely to be noticed so that it is reasonable to conclude that they were communicated.

Termination of offers. Once made, an offer gives the offeree the power to convert it into a binding contract by accepting it. However, offers are not open-ended and binding for an infinite period of time; they may be terminated in a number of ways: (1) by a provision in the offer itself, (2) by the expiration of a reasonable time, (3) by revocation, (4) by rejection, (5) by death or insanity of the offeror or offeree, (6) by destruction of the subject matter of the proposed contract, or (7) by the performance of the proposed contract becoming illegal.

If the offer specifies that it must be accepted within a certain period of time, then it must be accepted within that time period; a late acceptance does not bind the offeror unless s/he chooses to be bound. If no time is specified, then the offer will remain open for a reasonable time; the determination of what is a reasonable time will depend on all the facts and circumstances of the particular case. Such factors as rapidly changing market prices will result in only a very short time period being considered reasonable.

Normally, the offeror has the right to revoke the offer at any time before it is accepted by the offeree; however, if the offeror contracts to keep it open for a certain specified time (an option), then it is irrevocable for that period. Also, if the offeror knows or has reason to know that the offeree will change his position in reliance on the offer, then the offer may be held to be irrevocable under the doctrine of promissory estoppel (to be discussed in more detail later in the book) if the offeree does indeed change his or her position in reliance on the offer. If the offeror wishes to revoke the offer, s/he must communicate the revocation to the offeree and in most states the revocation is not effective until actually received by the offeree. Offers made to the public-as in the case of rewards or advertisements-may be revoked if done in essentially the same manner as the offer was originally made. If the offer was for a unilateral contract where acceptance would come by doing the requested act, then an attempted revocation would normally not be effective if the offeree had already begun performance at the time of the revocation and completed his performance within a reasonable time thereafter.

If the offeree rejects an offer it is terminated and any later attempt to accept it will not be effective. Both a counteroffer and a conditional acceptance are considered to be rejections since, by implication, both amount to a rejection of the original offer. However, an inquiry regarding the terms is not to be considered a counteroffer and does not terminate the offer. Death or some legal incapacity, such as insanity, of the offeror or offeree automatically terminates an offer as does destruction of the proposed subject matter of the contract without the fault of either party. In addition, if prior to the acceptance of the offer, a statute is enacted which would make performance of the completed contract illegal, the offer is terminated.

Offers under the Uniform Commercial Code. Under the U.C.C. an offer does not fail for lack of definiteness because certain terms have been omitted if the court has a basis for supplying them and granting an appropriate remedy. As will be discussed later in the book in more detail, the U.C.C. contains provisions for determining price, time for performance, and

other similar terms in cases where the parties intended to conclude a contract but left these provisions open. Under the U.C.C., a written promise by the offeror to leave an offer open for a stated period of time is valid and binding for a period of up to three months even though the offeree has not actually purchased an option by giving consideration to the offeror.

Indicate whether each of the following statements is true or false by writing 'T' or 'F' in the space provided.

____1. An offer becomes effective when it has been communicated to the offeree.

____2. When the offeree accepts the offer, a binding contract results.

____3. The revocation of an offer becomes effective when the offeror initiates a communication to the offeree.

____4. A counteroffer is considered to be a rejection of the original offer.

1. True. An offer is effective when communicated to the offeree.
2. True. A binding contract comes into existence when an offeree accepts an offer.
3. False. In most functions, the revocation of an offer does not become effective until it is actually received by the offeree.
4. True. A counteroffer is a rejection of the original offer.

E-Contracts

E-contracts include any contract entered into in e-commerce, whether business to business (B2B) or business to consumer (B2C), including licenses, as well as sales and leases of goods and services. As for online offers, terms should be conspicuous and clearly spelled out. On a Web site, this can be done with a link to a separate page that contains the details. The text lists subjects that might be covered, including remedies, forum selection, payment, taxes, refund and return policies, disclaimers, and privacy policies. An online offer should also include a mechanism by which an offeree can affirmatively indicate assent (such as an "I agree" box to click on). A click-on agreement occurs when a buyer, completing a transaction on a computer, is required to indicate his or her assent to be bound by the terms of an offer by clicking on a button that says, for example, "I agree." The terms may appear on a Web site through which a buyer is obtaining goods or services, or they may appear on a computer screen when software is loaded.

E-Signatures

An *e-signature* is an electronic sound, symbol, or process attached to or logically associated with a record, such as an e-mail message or an online contract form or a contract form sent as an attachment via e-mail, and executed or adopted by a person with the intent to sign the record. Under the Uniform Electronic Transactions Act (UETA), a signature may not be denied legal effect or enforceability solely because it is in electronic form. Also, under the federal Electronic Signatures in Global and National Commerce Act (E-SIGN Act), enacted by Congress in 2000, , an e-signature is as valid as a signature on paper.

Chapter 4

ACCEPTANCE AND REALITY OF CONSENT

LEARNING CONCEPTS:

After studying this chapter you will be able to:

1. Define the conditions of an acceptance.
2. Explain and define reality of consent.

Acceptance

Since contracts rest on the mutual agreement of the parties, it is a prerequisite for a completed contract that the offeree indicate a willingness to be bound on the terms contained in the offer - this is known as acceptance. Under the common law, the acceptance must correspond in all respects with the offer if it is to be effective; a purported acceptance which does not so correspond is nothing more than a counteroffer or conditional acceptance which then requires acceptance by the other party in order for a completed contract to result. Where the offer requests an act in return for a promise, as in the case of a unilateral contract acceptance is not complete until the act, as requested, is completed. Under some circumstances, however, where the offeree begins performance, the offer is irrevocable until s/he has had a reasonable time to complete the performance. Where a promise is requested in return for a promise, as in the case of a bilateral contract, the offer is accepted by making the requested promise. Where the parties reach an agreement and also agree to later reduce it to writing, a contract has been formed and even a later disagreement on the terms of the writing will not affect this fact; however, where only negotiations were conducted and the parties understood there would be no contract until a written contract was agreed to by both parties, then no contract exists until the form of the written contract is agreed to.

A party cannot be bound to a contract without his or her express or implied consent. Thus, silence in response to an offer that provides such silence will be construed as consent, is normally not effective as consent unless (1) there is some evidence that the silence was intended as acceptance, or (2) prior dealings or other circumstances impose on the offeree a duty to reply. Such circumstances might well include a situation where benefits are conferred on the offeree under such conditions that it was clear they were not intended as a gift and the offeree was aware of this when accepting them. It is also necessary to the formation of a valid contract that the offeree intends to accept the offer; for example, in a unilateral contract the requested act must be done with the intent of accepting the offer. Occasionally courts make an exception to this rule in reward cases and allow a person to collect a reward for doing a requested act even though s/he did not know of the reward offer at the time s/he performed the act.

Communication of acceptance. In order to be effective, an acceptance must be communicated to the offeror. If the offer spells out the time, place, or method of

communication, then these terms must be complied with and any attempt to accept at a time, place, or manner other than that specified is a counteroffer. If no such time, place, or manner are specified, then communication may be in any reasonable manner as long as it is received prior to termination of the offer. When the acceptance is made orally to the offeror, the contract comes into existence at that time. However, where the acceptance is by the mail or telegraph, problems sometimes arise because of the delay between dispatch and receipt or the nonreceipt of the acceptance. If the mode of communication used to convey the acceptance was authorized by the offeror, then the carrier is considered to be the agent of the offeror and the acceptance is effective to create a contract when it is put in the hands of that agent; for example, if acceptance by mail was authorized, then it is effective when a letter of acceptance is deposited in a mail box. Where the acceptance is sent by an agency that was not specifically authorized by the offeror or by trade usage, then it is not effective until received and only then if it is received within the time it would have been received if it had been sent by the authorized method of communication.

Indicate whether each of the following statements is true or false by writing 'T' or 'F' in the space provided.

____1. An acceptance must correspond with the offer in all respects in order to have a binding contract under the common law.

____2. A unilateral contract is the exchange of a promise for a promise.

____3 Silence in response to an offer is usually construed to be an acceptance.

____4. If an acceptance by mail was authorized, it becomes effective when it is deposited in the mail.

1.True. Under the common law, the acceptance must correspond in all respects with the offer if it is to be effective.

2.False.This describes a bilateral contract. A unilateral contract contains a promise by only one party (usually in return for an act already performed or to be performed immediately).

3.False.Silence is not normally effective as consent to an offer unless it was intended to be an acceptance or there was a duty to reply on the part of an offeree.

4.True. If acceptance by mail was authorized, it becomes effective when deposited in the mails.

Acceptance under the U.C.C. The U.C.C. focuses more on the intentions of the parties and less on the technical requirements of form that prevail under the common law. Thus a contract can be made under the U.C.C. in any manner sufficient to show agreement even though some terms may be left open and even though the moment of the making of the contract is uncertain. Acceptance may be by any reasonable means, and where orders for immediate shipment are made acceptance may be by either promptly shipping the goods or by giving notice of acceptance. If nonconforming goods are shipped and no notice is given that they are being shipped only for the buyer's convenience, then there is a breach of contract at the same time there is acceptance. Under the U.C.C., contracts can be made through the exchange of printed forms even though those forms contain conflicting terms. So long as the parties act as if they have a contract, then a contract exists with its terms consisting of those terms on which they agree, or which were added by one party's form without objection by the other party. Conflicting terms or those on which they disagree are disregarded. Supplementary terms supplied by the U.C.C. or by trade usage are used to fill in terms discarded as conflicting. Where no means of

communication of the acceptance is specified, then acceptance may be by any reasonable means. If additional or different terms must be agreed to under the terms of the acceptance or offer, then such agreement must exist or the purported acceptance is a rejection or a counteroffer.

Reality of consent

Misrepresentation. In order for a contract to be enforceable it must have been entered into voluntarily, fairly and honestly; an offer or acceptance that was induced by innocent misrepresentations or by fraud is not binding on the person so induced to make the offer or acceptance. Misrepresentation is the creation of an impression in the mind of another person which is not in accord with the actual facts of the situation. Misrepresentation of a material fact which is justifiably relied on by the person to whom the misrepresentation is made is grounds for avoiding a contractual promise. Whether or not the person making the misrepresentation knew it was false does not affect the voidability of the contract. The misrepresentation must be of a material fact, that is, the fact must have been a relevant or contributing factor in the decision to contract, and the circumstances must be such that it can be assumed that the contract would not have been made if the person had known the true facts. The misrepresentation must be of an existing or past fact; a prediction as to a future fact does not fall within the misrepresentation rule. In addition, in order to be entitled to a remedy for misrepresentation, the party seeking the remedy must have been justified in relying on the misrepresentations. S/he must neither know they were false nor be in a position that in view of his or her knowledge and experience and in view of facts and circumstances s/he should have discovered the falsity. The remedy open to the person to whom the misrepresentation is made is recision-that is, s/he may return what s/he has received and recover what s/he has given, or its value. In order to be entitled to this remedy, s/he must act to rescind within a reasonable time after learning of the misrepresentation.

Fraud. Fraud is an intentional misrepresentation of a material fact made with the intent to induce another to rely on it and to surrender a legal right or piece of property; thus fraud essentially is an intentional misrepresentation. Where actual fraud is shown, the injured party who justifiably relied on the fraudulent statement has a choice of remedies. S/he may rescind the contract as s/he can in the case of a misrepresentation, or may affirm the contract and bring a tort action for deceit, which would allow him or her to recover damages for the injury sustained. Again, a person who has been defrauded must act within a reasonable time after discovery of the fraud so as to preserve his or her rights.

Duress and undue influence. Contracts made under duress or undue influence are voidable. Duress is the exercise of some unlawful constraint on a person whereby one is forced to do an act that one would not otherwise have done. In contract law, duress means the use of threats of bodily or other harm which are used to overcome a person's free will and induce the person to enter a contract through fear or force. As presently interpreted, duress includes threats of physical harm, threats to bring a criminal action which are used to gain an advantage to which the maker of the threat is not legally entitled, and the unjustified withholding of a person's goods for the purpose of forcing that person to pay an unreasonable charge. A threat to initiate a civil suit is not considered to be duress unless it amounts to an abuse of civil process or unless it is based on an unfounded claim and the maker of the threat knows that because of the financial position of the other person the suit would likely bring financial ruin to that person.

Undue influence is the use of a confidential relationship, in which one person owes another a duty to look out for the latter person's interests, and where the duty-bound person uses this position for personal benefit at the expense of the person to whom the duty is owed. By allowing such contracts to be voided, the courts protect against unfair contracts which are shocking to the conscience and are obtained through breach of a confidential position.

Mistake. Under some circumstances, a party will be relieved of his or her contractual obligations on the grounds of mistake. Mistake in this context does not mean ignorance, inability, or bad judgment; nor is a party entitled to relief merely on the grounds that s/he made a bad bargain. The types of situations where relief may be available are where the mistake results from an ambiguity in the negotiation of the contract or where there was a mistake as to a material fact which induced the making of the contract.

If in negotiating a contract, the parties used language which is susceptible to more than one interpretation, and one party honestly draws one interpretation while the other party draws another, then the courts will usually hold that no contract resulted since there was no meeting of the minds or mutual agreement. Where a mistake is made as to the existence or nonexistence of a present or past material fact, a court may or may not grant relief from contractual obligations, depending on the facts of the particular situation. If both parties were under a misunderstanding as to the existence or nonexistence of the material fact, this is known as a mutual mistake and it is grounds for recision of the contract. Where the mistake is unilateral in that it is made by only one of the parties, the contract may or may not be enforced. If one of the parties realizes that the other person is operating under a mistaken belief and seeks to take advantage of the error, relief will be granted. While negligence on the part of the party making the mistake usually will not justify the granting of relief, it will be granted where the negligence was slight, where enforcement would impose an unwarranted hardship on the person who made the mistake, and where relief would not impose a material loss on the other party. Relief will also be granted to reform a written document which contains a mistake and which does not correctly set out the actual agreement of the parties. A mistake as to one's legal rights under a contract is usually not sufficient grounds for granting relief, as ignorance of the law is not considered to be excusable.

Indicate whether each of the following statements is true or false by writing 'T' or 'F' in the space provided.

____1. Under the U.C.C., contracts can be made as long as the parties concerned act as if they have a contract.

____2. An offer or acceptance that was induced by innocent misrepresentations is usually binding.

____3. Fraud may be intentional or unintentional.

____4. Contracts made under duress are void.

____5. Mutual mistake is grounds for recision of a contract.

1.True. If the parties act as if they have made a contract, a contract exists under the U.C.C.
2.False. An offer or acceptance induced by innocent misrepresentations or by fraud is not binding.

3.False. Fraud is an intentional misrepresentation of a material fact.
4.False. Contracts made under duress are voidable, not void.
5.True. If both parties misunderstand a material fact, this is known as mutual mistake and is grounds for the recision of the contract.

Chapter 5

CONSIDERATION

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Define consideration.
2. Clarify the term preexisting obligations.
3. Explain debt compromise and composition.
4. Interpret the process of forbearance to sue.

With a few exceptions, a promise is not enforceable by way of court action unless it is supported by consideration. Consideration is usually defined as either a detriment to the promisee or a benefit to the promisor, which was bargained for and given in exchange for the promise. The detriment must be a special kind of a legal detriment-which means the surrendering of a legal right or the assuming of a legal burden. It does not have to have any economic value. Such a detriment to the promisee usually produces a benefit for the promisor, although a detriment without any corresponding benefit is considered to constitute consideration. However, mere benefit to the promisor without corresponding detriment to the promisee does not constitute consideration.

Preexisting obligations. A promise to do something that one is already obligated to do or a promise to refrain from doing something that one is already bound not to do is known as a preexisting obligation. A promise to perform such a preexisting obligation does not constitute consideration. There are four main types of situations in which preexisting obligations may exist: (1) criminal or tortious acts, (2) acts which the holder of an office is obligated to perform, (3) acts which the promisee is under a contractual duty to the promisor to perform, and (4) acts which the promisee has already obligated himself by contract to perform but which through some unforeseen factors are more burdensome than either of the contracting parties contemplated when they entered into the contract.

Since individuals in society owe an obligation to the rest of society not to engage in criminal or tortious activity, a promise to refrain or to actually refrain from such activity does not constitute sufficient consideration to support a contract. Likewise, a promise to engage in such activity is against public policy and void. A person who holds an office, particularly a public office, is obligated to perform those acts which are incidental to that office. If an officeholder promises to perform what s/he is already obligated to do that promise will not constitute sufficient consideration to support a contract. If this were not true, such officeholders would have an incentive to withhold the performance of their duties until they received additional compensation. At the same time, a distinction must be made between (1) those acts which are part of the official duties and (2) acts which are similar to those performed as an official but are

actually performed outside of the official duty; a promise to perform the latter will constitute legal consideration.

If a person owes a contractual duty to perform a certain act, a promise made by the person to whom the duty is owed to pay additional compensation for that same act is usually not enforceable because there was no legal detriment to the person already obligated to perform. An exception to this rule is sometimes made in cases where unforeseen difficulties arise which make performance more expensive or difficult than was anticipated by the parties when they entered into the contract. In this case, a new promise to pay additional compensation will generally be enforced. Where the parties to a contract desire to leave the obligations of one party the same but to increase the obligations of the other party, they should clearly and convincingly terminate the old contract by mutual agreement and enter into a new one. The courts will enforce the new arrangement only if it is clear that it was entered into in good faith and free from any fraud, duress, or undue influence.

Debt, compromise, and composition. If a person promises to discharge a liquidated debt on payment of part of the debt at the place where the debt is payable and at or after the time the debt is due, such a promise does not constitute legal consideration and a contract based on such a promise will not be enforceable in the courts. However, for this rule to be applicable the debt must be liquidated--that is, the parties must be in complete agreement as to the amount--payment must be made at or after the due date, payment must be made at the place called for, and payment must be made in the same medium of exchange called for. A creditor may make a gift of a balance following a partial payment or the debtor may offer some additional consideration in the form of something s/he was not obligated to do and then the contract will be enforced.

An accord and satisfaction is the compromise of a disputed claim that exists between two parties; if there was an honest dispute as to the amount or existence of a claim, such a compromise will be held to constitute consideration and will be enforceable. A composition is an agreement between a debtor and two or more of his or her creditors whereby the debtor agrees to pay each creditor a pro rata share of his or her claim and each creditor agrees to accept that amount in full satisfaction of his or her claim. Such agreements are considered to be exceptions to the usual rule requiring consideration in order to be enforceable and are generally enforced, as long as they are free from misrepresentation, fraud, duress, or undue influence, on the grounds that sound business practice requires enforcement.

Forbearance to sue. Because a person has a right to seek court enforcement of claims s/he may have against others, a promise not to bring suit on a claim, which a person reasonably believes s/he has, is consideration and will support a simple contract. The promisor need not be the party threatened with suit, and a promise made by a third person may be supported by the promisee's forbearance to sue.

Indicate whether each of the following statements is true or false by writing ‘T’ or ‘F’ in the space provided.

____1. Consideration may take the form of the surrendering of a legal right or the assuming of a legal burden.

____2. The performance of a preexisting obligation constitutes consideration.
____3. A composition is the compromise of a disputed claim.
____4. A promise not to bring suit may be valid consideration.

1.True.This is known as legal detriment.
2.False. The performance of a preexisting obligation does not constitute consideration.
3.False.This describes an accord and satisfaction. A composition is an agreement between a debtor and his or her creditors to satisfy a debt on a pro rata basis.
4.True. A promise not to bring suit on a valid claim is legal consideration.

Bargain and exchange. In order to constitute consideration, the detriment to the promisee or benefit to the promisor must be bargained for and given in exchange for the promise. If it was intended as a gratuity it will not constitute legal consideration. Normally, the courts will not look into the sufficiency of the consideration as long as some legal consideration has been given. However, if the exchange is marked by gross inequality of considerations and there is evidence of unfair dealing such as fraud, duress, misrepresentation, or undue influence, the courts may refuse to enforce the contract. If a sufficient or nominal consideration is stated in the contract to have been given, but in fact has not been given, then the contract or promise will not be enforced.

Past consideration. Consideration in the form of a benefit conferred in the past-known as past consideration-is not sufficient consideration to support a contract because at the time the promise is made, the promisee is under no obligation to the promisor and suffers no legal detriment in exchange for the promise. At the same time, past consideration should not be confused with situations where a promise is made to discharge an existing, but unliquidated debt.

Consideration in bilateral contracts. If a bilateral contract is to be valid, both of the contracting parties must make legally binding promises. If one of the promises is illusory-that is, worded so that fulfillment of the promise is left to the option or election of the promisor, then neither party is bound by the contract. Similarly, if either or both of the parties reserve the right to cancel the contract at will, it is not a binding contract. However, if the contract provides that it will be in force for a stated period after the cancellation or if the cancellation can come only at the occurrence of a stated event not within the control of one of the parties, then the contract is supported by consideration and is enforceable.

Situations not requiring consideration. In order to avoid injustices, certain promises are enforceable even though they are not supported by consideration. The most common situation not requiring consideration is where a person makes a promise which s/he reasonably can expect will induce the promisee to rely on the promise and to take some definite and substantial action or forbear from some substantial course of action which is detrimental to the promisor. In such a situation the promise will be enforced on the grounds of promissory estoppel-since the promise led the promisee to justifiably rely on the promise and to change the position to his or her detriment, the promisor is estopped from setting up the lack of consideration as a defense to enforcement of the promise. A common example of a situation where promissory estoppel may be applied is the charitable subscription-the promise to make a gift to some religious, educational

or charitable organization. If the organization changes its position in reliance on the promised gift, then, the promise to make a gift will be enforced.

In general a promise to pay a debt which is barred by the statute of limitations will be enforceable although in some states it must be in writing. Likewise, a promise to pay a debt that was discharged in bankruptcy will usually be enforced. However, a promise to pay a debt discharged in a composition agreement will not be enforceable unless supported by a new consideration.

Consideration under the U.C.C. Under the Uniform Commercial Code, a promise in writing to hold open an offer made between merchants is enforceable for up to 90 days even though it is not supported by consideration. Also, under the U.C.C., an agreement modifying a contract for the sale of goods needs no consideration in order to be binding.

Indicate whether each of the following statements is true or false by writing 'T' or 'F' in the space provided.

____1. A gratuity is not legal consideration.
____2. An illusory promise is one that is worded so that its fulfillment is left to the option of the promisor.
____3. A promise to make a gift to a charitable organization normally cannot be enforced.
____4. Promises to pay debts discharged in bankruptcy or in composition agreements are enforceable.

1.True.A gratuity is not regarded as legal consideration.
2.True. If a promise is worded so that its fulfillment is left to the option or election of the promisor, it is said to be illusory.
3.False. Promissory estoppel may be applied to enforce the promise to make a gift to a charitable organization.
4.False. A promise to pay a debt discharged in a composition is not enforceable unless supported by new consideration.

Chapter 6

CAPACITY OF PARTIES AND ILLEGALITY

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Determine and explain the capacity of parties
2. Define and illustrate illegality.

Capacity of parties

Capacity. Capacity is the ability to perform legally valid acts; that is, the ability to incur legal liability or to acquire legal rights. To have a legally binding contract there must be two parties to the contract - a promisor and a promisee. The same person cannot act in both capacities. Of course, there can be more than one promisor and more than one promisee as there is no legal limit to the number of persons who can be parties to a contract. Everyone is presumed to have the capacity to contract, and if a person wishes to defend an action based on an alleged contract on the grounds that s/he did not have the capacity to contract, s/he must affirmatively set out the defense in the answer to the complaint.

Minors' contracts. The law accords special protection to minors who are generally defined by statute as persons under 21 years of age in some states and under 18 years of age in others. This protection is given by allowing the minor to disaffirm his or her contract. A minor's contract binds both the minor and the adult unless the minor exercises his or her right to disaffirm the contract; thus the minor's contracts are not void but rather only voidable at his option. If the minor chooses to be bound by the contract, then the relation between the parties is the same as it is between two parties who both have the same capacity to contract. In general, minors may disaffirm their business contracts even though the business is operated as a means of self-support. The common-law rules relating to minors' contracts have to some extent been altered by statute and there are some differences between the states in the coverage and terms of these statutes.

Minors may become members of partnerships and they may subsequently disaffirm the partnership agreement without incurring liability to the other partners for breach of the agreement. A minor partner may disaffirm his or her personal liability to creditors of the partnership, but s/he may not withdraw his or her partnership capital to the injury of such creditors.

Minors are liable for the reasonable value of necessaries furnished to them; this liability is based on quasi contract and not on any express promise to pay. Necessaries are those things which are essential to the minor's continued existence and general welfare and generally include food, clothing, shelter, medical care, a basic education or vocational training, and the tools of the

trade. The class of society that the minor was born into affects what will be considered to be necessities for the minor. The minor is liable only for the reasonable value of necessities actually furnished to him or her, and is not liable even for necessaries if s/he is already adequately supplied with them by a parent or guardian.

A minor has the absolute right to disaffirm his or her executed contracts-except contracts affecting title to real estate. This right may be exercised at any time from the time the contract is entered into until a reasonable time after the minor reaches majority age; contracts affecting the title to real estate cannot be disaffirmed during minority but only during a reasonable time after reaching majority age. The minor is bound until s/he does disaffirm, and failure to do so within a reasonable time after reaching majority amounts to a waiver of the right to disaffirm. The right to disaffirm is not conditioned upon the minor's ability to return any consideration received, but the minor normally must return any consideration still in his or her possession so as to prevent the right of disaffirmance from being used as a device to defraud adults. The minor will be entitled to recover any consideration given to the adult after disaffirming a contract. If the minor misrepresented his or her age to the adult, this does not prevent the minor from disaffirming in most states; however, on disaffirmance of the contract the minor must return the consideration received and account for its use and depreciation in value.

A minor may not ratify his or her contract until s/he reaches majority age. Ratification consists of words or acts which signify an intent to be bound by the contract. In the case of an executed contract, failure to act within a reasonable time after reaching majority age amounts to ratification regardless of whether the minor realizes s/he has the right to disaffirm. Some courts do not hold mere inaction sufficient to ratify an executory contract. Ratification makes the contract valid from its inception and once accomplished, it cannot be undone.

Insane and drunken persons. The contract of an insane person is voidable if it was made while s/he was under that incapacity; however, if the person had been declared insane by the court, then most states hold contracts made by the insane person to be void and of no effect. The usual test of insanity is whether or not the contracting person at the time the contract was entered into had sufficient capacity to comprehend the nature of the business being transacted. Like minors, insane persons are liable for the reasonable value of necessaries furnished to them. If the contract is fair and the other person had no reason to know of the insanity, then upon disaffirmance the insane person must return the other party to the status quo. Alternatively, if the other party had reason to know of the insanity, then upon disaffirmance the insane person need only return any consideration or proceeds of the consideration still remaining in his or her possession. An insane person may ratify the contract once the disability is removed or it may be ratified by his or her legal guardian. Any person who at the time of contracting is too intoxicated to comprehend the business being transacted is generally treated in the same manner as if s/he were insane.

Indicate whether each of the following statements is true or false by writing 'T' or 'F' in the space provided.

____1. There is no legal limit to the number of persons who can be parties to a single contract.
____2. Contracts entered into by a minor are void.
____3. A minor may ratify a contract at any time before s/he reaches majority age.

____4.The contract of an insane person may be ratified by his or her legal guardian.

1.True. There is no legal limit to the number of persons who can be parties to a contract.
2.False. A minor's contracts are voidable at his or her option but not void.
3.False. A minor may not ratify a contract until after reaching majority age.
4.True. The legal guardian of an insane party may ratify his or her ward's contracts.

Aliens, corporations, fiduciaries and government entities. In general, there are no restrictions on the right of an alien corporation in the United States to make contracts. Corporations are allowed to enter into such contracts as are permitted by their charter of incorporation. Trustees, receivers, administrators, guardians, and executors may enter into such contracts in their official capacity within the scope of their authority as set out in the statute, agreement, or order from which they draw their authority. Governments and government units generally have the capacity to contract and may sue on their contracts. However, governments and governmental units may not be sued without their consent; such consent is set out in a statute where it is given.

Illegality

A contract is illegal if either its formation or its performance is contrary to the public interest and to public policy. In general, illegal contracts are void. While there is a wide variety of situations which may produce illegal contracts, the discussion in this book will focus on three broad categories of such contracts: (1) contracts in violation of positive law, (2) contracts expressly made void by statute, and (3) contracts contrary to public policy.

Contracts in violation of positive law. A contract which provides for the commission of a crime or whose nature tends to induce the commission of a crime is illegal. Similarly, a contract which cannot be performed without the commission of a tort is illegal; however, the fact that a tort is committed during the performance of a contract does not in itself make the contract illegal.

Indicate whether each of the following statements is true or false by writing 'T' or 'F' in the space provided.
____1. A corporation may enter into a contract on its own behalf.
____2. Illegal contracts are generally void.
____3. If a tort is committed during the performance of a contract, the contract is, by definition, illegal.

1.True. A corporation has the right to enter into contracts on its own behalf.
2.True. Illegal contracts are generally void.
3.False. The commission of a tort during the performance of a contract does not necessarily make the contract illegal.

Contracts made illegal by statutes. Statutes which expressly deal with the legality of certain types of contracts may be divided into three groups: (1) criminal statutes, (2) statutes expressly declaring contracts void, and (3) regulatory statutes. States commonly have statutes which either

prohibit or regulate wagering. Generally, wagering contracts are illegal and will not be enforced. Wagering contracts should be distinguished from contracts to shift a risk. In a wagering contract, a risk is created for the purpose of bearing it-such as a bet on a football game. A risk-shifting contract-such as an insurance contract-is legal so long as the person purporting to shift the risk actually had the risk. Stock and commodity market transactions entered into in good faith are speculative contracts and not illegal as wagers.

Some common examples of statutes declaring certain types of contracts illegal are usury laws and Sunday closing or blue laws. These statutes often make the contracts void and may subject the parties involved to various penalties and forfeitures.

In order to protect the public, states have enacted a wide variety of statutes regulating the conduct of various types of businesses and professions. The most common type of regulation provides for the obtaining of a license before a person, partnership, or corporation engages in a regulated activity such as the practice of law or medicine or the carrying on of a trade such as barbering or plumbing. If a person contracts to perform such a service or engages in a regulated business without first having obtained the required license, any contracts s/he makes are illegal. Again, however, a distinction must be made between regulatory statutes which require proof of skill and character before the issuance of a license, and those statutes designed to raise revenue and which permit the issuance of a license to anyone who pays a certain, often substantial, fee. The failure to obtain a license required by a revenue-raising statute does not affect the legality of a contract made by the unlicensed person.

Public policy. Public policy is a rather nebulous concept which accords courts flexibility to require that contracts be consistent with current mores and concepts of fair dealing and the general welfare. Of course such mores and standards vary over time and also vary between different areas of the country. Public policy is applied on a case-by-case basis and there is no simple standard or rule to guide its application.

A contract is illegal if it purports or tends to induce a public official to deviate from the duty s/he owes to the public or if it purports to grant the official additional or less compensation than s/he is allowed by law. Likewise, a contract which tends to induce a breach of duty on the part of a fiduciary such as a trustee, administrator, or guardian is illegal. A contract which purports to relieve a person of liability for his or her willful negligence or from the consequences of a duty owed to the public is illegal. However, reasonable limitations on damages not attributable to willful negligence may be agreed to legally, and where there is no duty owed to the public and the parties are on an equal bargaining basis, an agreement relieving one of the parties of his or her liability for nonwillful negligence is legal and can be enforced.

A contract that is in direct restraint of trade is illegal; thus an agreement not to compete with someone else in a particular trade or business is illegal. However, contracts which operate only as reasonable restraints on trade and which protect valid interests of the parties are legally permissible. Such a restraint must be ancillary to another contract between the parties such as a contract of employment or a contract of sale of a business, the restraint must be for the purpose of protecting interests created by that contract, and the restraint must be no greater than is reasonably required to protect those interests. Thus, such a restraint is normally limited in space

and may also have to be limited in time. A restraint which is not so limited may not be enforced at all or it may be enforced only to the degree it is reasonable.

There are, of course, a great many other diverse types of contracts which may be considered illegal as in contravention of public policy. For example, a contract which tends to interfere with marital relations might be illegal on grounds of public policy. A detailed listing of these situations is not possible here but the reader should be aware that a contract whose terms or effect runs contrary to generally accepted societal norms runs the risk of being declared illegal on the grounds it contravenes public policy.

Effect of illegality. As a general rule, a court will not enforce an illegal contract and will leave the parties in the same position in which it finds them. One party cannot recover damages for breach of an illegal contract and there is normally no recovery in quasi contract for benefits conferred. However, if the interests of the public, as opposed to the interests of one of the parties, are served by allowing a recovery of some sort, the courts will allow such a recovery. A party who is justifiably ignorant of the facts or special regulations which make the bargain illegal may recover the consideration conferred on the other party. And a person protected by a regulatory statute may recover for breach of contract entered into with a person who has not complied with the statute. A contract made for the purpose of aiding the commission of a crime is illegal. However, mere knowledge that the article sold will be used illegally does not make the sale illegal unless the intended use is the commission of a serious crime.

A party may rescind an executory illegal contract before the performance of the illegal act and recover any consideration s/he has given to the other party. If a contract contains a legal portion and an illegal portion and the illegal portion is divisible, then the legal portion may be enforced and the rest disregarded unless the illegal parts go to the principal objective of the contract. However, if such a contract cannot be so divided, the entire contract is illegal and void.

Unconscionable contracts under the Uniform Commercial Code. Under the U.C.C., a court may refuse to enforce a contract or a contract clause if it finds the contract or clause to be unconscionable. To be unconscionable, it must be commercially unreasonable and unfair at the time the contract was made. This provision is commonly used to refuse enforcement of contracts where one of the parties used a position of economic or strategic superiority to drive an unreasonable and unfair bargain.

Indicate whether each of the following statements is true or false by writing 'T' or 'F' in the space provided.

____1.A wagering contract is generally illegal.
____2.Contracts in direct restraint of trade are illegal.
____3.The knowledge that an article sold will be used illegally makes the sale itself illegal.
____4.A contract is said to be unconscionable if it is deemed to be commercially unreasonable and unfair at the time a contract was made.

1.True.Wagering contracts are generally illegal.
2.True.Contracts that are in direct restraint of trade are illegal.

3.False.This would be true only if the intended use is the commission of a serious crime.
4.True. An unconscionable contract is one that is commercially unreasonable and unfair at the time a contract was made.

Chapter 7

WRITING AND RIGHTS OF THIRD PARTIES

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Clarify why contracts must be in writing.
2. Explain the rights of third parties.

Writing

Statute of frauds. Under the statute of frauds, which is in effect in every state, certain types of contracts must be in writing signed by the party to be bound by his or her authorized agent and are not enforceable unless they are evidenced by such a writing. These classes of contracts include: (1) collateral contracts, (2) contracts for the sale of an interest in real property, (3) contracts which are not capable of performance within a year after they are made, (4) contracts for the sale of goods of a value above a certain fixed amount, (5) contracts to pay a commission for the sale of real estate, and (6) contracts agreeing to pay a debt barred by the statute of limitations or discharged in bankruptcy.

Collateral contracts. A collateral contract is one made with an obligee whereby a third person promises to pay the debt, default, or miscarriage of the obligor in the event the obligor fails to perform as obligated. Whether a contract is a collateral contract or is an original contract depends primarily on the intent of the parties. In an original contract the party in question has promised to perform in all events, whereas in the collateral contract the party's performance is required only upon the default of another promisor. Some examples of collateral contracts are the promise of a father to make good a debt owed by his son in the event the son fails to satisfy it, or the promise of an executor or administrator to be answerable from her own estate for a duty of the decedent's estate. A promise to answer for the debt, default, or miscarriage of another must be in writing to be enforceable under the statute of frauds.

Interests in land. Any contract which will affect the ownership rights in real property such as contracts to sell, to mortgage, to remove minerals, or to grant easements must be in writing to be enforceable. While leases fall into this category, they normally are covered separately by statute of frauds and whether or not a writing is required will depend on the length of the lease.

Contracts not to be performed within a year. Only those executory bilateral contracts that will not be performed within a year after the making of the contract fall under the statute of frauds and must be evidenced by a writing. However, the contract must be bilateral as opposed to unilateral and it cannot have yet been fully performed. And no writing is required if the contract can be performed within a year of the time the contract is made. The one-year period is computed from the time the contract comes into existence and not from the time that

performance of it is to begin. When a contract is made extending the time in which to perform an existing contract, the time is computed from the day the contract to extend time is entered into until the time for performance under the extended contract will be completed; if this time period is more than a year, the contract to extend the time for performance must be in writing. Where the time for performance is stated in indefinite terms such as "for life," and under existing conditions it is possible to perform the contract within a year, then no writing is required even though the contract actually takes more than one year to complete.

Indicate whether each of the following statements is true or false by writing or 'T' or 'F' in the space provided.

____1. Certain types of contracts must be in writing in order to be enforceable under the provisions of the statute of frauds.

____2. In a collateral contract all parties promise to perform in all events.

____3. A contract which affects the ownership rights in real property must be in writing to be enforceable.

____4. All executory bilateral contracts must be evidenced by a writing.

1.True.Under the statute of frauds, certain contracts must be evidenced by a writing to be enforceable.

2.False.In a collateral contract, performance is required by certain promisors only upon the default of other promisors.

3.True. Contracts affecting ownership rights in real property must be in writing to be enforceable.

4.False. Only those that will not be performed within a year after the making of the contract fall under the statute of frauds and must be in writing.

Contracts for the sale of goods. Contracts for the sale of goods are subject to the U.C.C., which has its own statute of frauds provisions differing in some slight respects from the general statutes of frauds. The U.C.C. provisions will be discussed later in this chapter.

Other contracts subject to the statute of frauds. In most states, a contract made with a real estate broker or salesperson to pay a commission on the sale of real estate must be evidenced by a writing to be enforceable. And, in some states, a promise to pay a debt that is either barred by the statute of limitations or that was discharged in a bankruptcy proceeding must be evidenced by a writing to be enforceable.

The writing required. Although some states require a written contract, the statute of frauds of most states provides that a "memorandum" is required. The memorandum or contract may be made at any time up until the time when the suit is filed, and in the case of a memorandum may consist of several documents which show that they should be taken together as evidence of a single contract. The memorandum or contract must include the names of the parties to the contract, contain the material terms of the contract, and describe the subject matter of the contract with reasonable certainty. In addition, it must be signed by the party against whom enforcement of the contract is to be sought or by that party's authorized agent. An oral variation

of a contract which is not evidenced by a sufficient writing or memorandum is not enforceable (although the original contract would be enforceable).

Failure to comply with the statute of frauds. An oral contract which comes within the statute of frauds is not made void or voidable; rather, it is unenforceable in that a court will not aid its enforcement. A party who has performed his or her duties under an oral contract cannot recover on the contract; but s/he may recover in quasi contract for the value of the benefits conferred on the other party. Part performance of an oral contract for the sale of land where one party has entered into possession and made extensive improvements to the property takes the contract out of the statute of frauds. And an oral contract, once completed, cannot be rescinded on the grounds that it was not evidenced by a writing.

The statute of frauds and the sale of goods. Under the U.C.C., the statute of frauds does not apply to an oral contract for the sale of goods unless the price of the goods is $500 or more. If the goods are of more than this price, then the contract will not be enforceable unless it is evidenced by a memorandum sufficient to indicate that a contract of sale has been entered into by the parties and has been signed by the party against whom enforcement is sought. It is not insufficient if it omits or incorrectly states a term, but if the quantity of goods is understated the contract is not enforceable beyond the quantity of goods so stated. Under the U.C.C., if an oral contract is made between two merchants, and within a reasonable time thereafter one of the merchants sends the other a written confirmation which would be sufficient as a writing, then the confirmation binds the other party, even though s/he does not sign it, if s/he does not object to it in writing within 10 days after its receipt. Part payment or delivery of goods takes the contract out of the statute of frauds but only with respect to the goods paid for or delivered and accepted. Oral contracts for the sale of specially manufactured goods are enforceable if the goods are not suitable for sale in the ordinary course of the seller's business and if the seller has made a substantial beginning on their manufacture or commitment for their procurement prior to repudiation of the oral contract by the buyer. The statute of frauds in the U.C.C. makes contracts unenforceable, not void or voidable, if the provisions of the statute are not complied with.

Indicate whether each of the following statements is true or false by writing ‘T’ or ‘F’ in the space provided.

____1.A promise to pay a debt that is barred by the statute of limitations falls under the statute of frauds in some states.

____2.Oral variations of a written contract which is required to be in writing are enforceable.

____3.Oral contracts which come under the statute of frauds are void.

____4. Oral contracts for the sale of specially manufactured goods are often enforceable.

1.True. In some states a promise to pay a debt barred by the statute of limitations falls under the statute of frauds and must be in writing to be enforceable.

2.False. An oral variation of a written contract which is required to be in writing is not enforceable (although the original contract would be enforceable).

3.False. These contracts are not made void or voidable; they are unenforceable.

4.True. If the goods are not suitable for ordinary sale and if the seller has made a substantial beginning on their manufacture or commitment for obtaining them, an oral contract is enforceable.

The parol evidence rule. Under the common law parol evidence rule, oral or extrinsic evidence is not admissible in court to add to, alter, or vary the terms of a written contract. Parol evidence is admissible to prove: (1) that a written contract is illegal or void, (2) that at the time it was executed it was agreed that it would not be operative except on the occurrence of a future, uncertain event, (3) that a subsequent contract was later entered into, or (4) to clear up ambiguities in a written contract. Under contracts for the sale of goods under the U.C.C., such parol evidence is admissible to supplement or to explain a written contract but not to contradict it unless the writing states that it is the exclusive agreement in which case parol evidence cannot be used to supplement or explain.

Rights of third parties

Assignment of contracts. Since the promisee on a contract cannot demand performance of the contract in a manner which differs in any material respect from that promised, the promisee may not assign the promisee's interest in a contract if the duties of the promisor would be changed in any material respect by the assignment. Only those contracts the performance of which can be rendered by the promisor to the assignee without materially altering or increasing the burdens of performance may be assigned. Contracts which are personal in nature may not be assigned; thus, for example, any contract calling for personal skill, judgment, or character, or a contract to support another for life, cannot be assigned. On the other hand, a contract calling for the payment of money is a common example of a contract which is assignable. The duties owed under a contract may not be assigned but may be delegated if they are impersonal in nature. Even though a promisor has delegated his or her duties to someone else, s/he remains liable for their performance in the event the delegates fail to perform.

Rights of an assignee. The assignee of a contract can obtain no greater rights in the contract than the assignor had, since an assignment is essentially a sale of the assignor's contract rights. The assignee takes the contract subject to all defenses that the promisor has against the assignor on the contract. An assignee who wishes to protect the rights s/he acquired by assignment should give notice of the assignment to the promisor on the contract. When such notice is given to the promisor, s/he then becomes liable to render performance to the assignee. Where the promisee wrongfully makes two assignments of the same right without the second assignee realizing that a prior assignment of that right had already been made, the courts may follow one of two different rules: under the so-called “American rule," the first assignee has the better right; whereas under the so-called 'English rule,' the assignee who first gives notice of the assignment has the better right. In most states there are statutes regulating efforts to assign future wages.

Assignor's liability to assignee. When an assignor assigns a claim for value to an assignee, s/he makes certain implied warranties: (1) that the claim is valid, (2) that the parties have capacity to contract, (3) that the claim is not void for illegality, (4) that the claim has not been discharged, and (5) that s/he has, and is passing, good title to the claim to the assignee. The

assignor also warrants that any written instrument involved is valid and that s/he will do nothing to impair the value of the assignment; at the same time the assignor does not warrant the solvency of the promisor. If an assignor should make two assignments of the same claim, s/he is liable for any damages sustained by any of the assignees because of such fraud.

Third-party beneficiaries. A contract may expressly provide that performance of the contract is to be rendered to a third person who is not a party to the contract, or a third person may benefit by the performance of a contract even though the third person is not named in it. A person so benefited is known as a third-party beneficiary. Three different categories of third party beneficiaries are recognized by the law: (1) donee beneficiaries, (2) creditor beneficiaries, and (3) incidental beneficiaries. If the primary purpose of the promisee, in requesting that performance of a contract be made to a third person, is to make a gift to that third person, then the third person is a donee beneficiary. As such, the donee (as well as the promisee) may bring suit to enforce the promise in the event the promisor defaults on his or her promise. A common example of a donee beneficiary is the beneficiary of a life insurance policy.

If the performance of a promise made to a promisee will satisfy an actual or supposed legal duty owed by the promisee to the beneficiary, then the beneficiary is a creditor beneficiary. For example, A, who owes B $10, promises C that he will give him a pair of shoes if C pays B $10; in this example B is a third-party creditor beneficiary of the agreement between A and C. A creditor beneficiary may also sue in his or her own name to enforce performance of the promise by the promisor. A person is an incidental beneficiary if s/he benefits from the performance of a contract to which s/he is not a party. An incidental beneficiary has no rights in the contract and cannot sue to enforce it or to recover damages for nonperformance.

Indicate whether each of the following statements is true or false by writing “T” or "F" in the space provided.

____1.Parol evidence may be used to contradict the terms of a written contract.
____2.Contracts which are personal in nature cannot be assigned.
____3.A promisor escapes all liability by delegating his or her contractual duties to another party.
____4.A creditor beneficiary is an example of a third-party beneficiary.

1.False. Parol evidence may not be used to contradict the terms of a written contract.
2.True. Contracts calling for personal skill, judgement, or character may not be assigned.
3.False. The original promisor remains liable for the performance of his or her duties in the event the delegate fails to perform.
4.True. A creditor beneficiary is an example of a third-party beneficiary. Others are donee beneficiaries and incidental beneficiaries.

Chapter 8

PERFORMANCE AND REMEDIES

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Explain the conditions of a performance.
2. List and give examples of remedies.

Conditions. The parties to a contract may make their duties under a contract contingent on the happening of some future, uncertain event; such a contingency is known as a condition precedent. Likewise, the parties may provide that upon the occurrence of a future, uncertain event a party will be relieved of the performance of a duty that s/he otherwise would have to perform; such a condition is known as a condition subsequent. Some contracts provide that the parties are to perform their duties simultaneously; such a provision is a concurrent condition and more often arises by implication rather than by express provision.

Architects' and engineers' certificates. Construction contracts may provide that the production of an architect's or engineer's certificate is a condition precedent to the duty to make final payment on the contract. Failure to produce the certificate will be excused only on the death or incapacitating illness of the person who is to supply the certificate or if there is a fraudulent or unjustified withholding of the certificate.

Performance and breach. The promisor may or may not perform his or her obligations pursuant to the contract. The courts recognize three stages of performance: (1) complete or satisfactory performance, (2) substantial performance, and (3) material breach. Complete or satisfactory performance is achieved when the obligation is performed to the letter or to such a degree that it is all that could reasonably be expected. Substantial performance implies an honest effort to perform but a performance less than that reasonably expected. In such a case, the promisor is entitled to the contract price less any damage sustained by the promisee as a result of the defective performance. If there is a major defect in performance, there has been a material breach, and the promisor cannot recover on the contract but may be entitled to some recovery in quasi contract for benefits conferred.

Time of performance. If time is of the essence in the performance of a contract then failure to perform within the expected time is a material breach of the contract. On the other hand, if time is not of the essence, then as long as the promisor performs within a reasonable time the performance must be accepted although the promisee may be able to recover damages for late performance.

Impossibility of performance. Performance of a contract becomes impossible and is excused on the happening of the following events: (1) death or incapacitating illness of the promisor

where his or her performance is personal in nature, (2) intervening illegality of the contract, and (3) destruction of the subject matter of the contract. Death of the promisor will always terminate a contract calling for personal service. Whether illness will terminate a contract depends on the length of the contract, the type of work involved, and the seriousness and probable length of the illness. Intervening illegality occurs when a government statute or regulation makes performance of the contract illegal; it is not enough that such a statute or regulation merely makes performance more difficult or less profitable. If the subject matter of the contract is destroyed prior to performance, then performance is excused; however, the destruction must be of something essential to the contract and not merely something of utility to its performance.

Under the U.C.C., nonperformance is excused if performance was made commercially impracticable by the occurrence of a contingency, the nonoccurrence of which was a basic assumption on which the contract was made.

Indicate whether each of the following statements is true or false by writing 'T' or 'F' in the space provided.
____1. If the duties under a contract are contingent on the happening of some future, uncertain event such a contingency is known as a condition subsequent.
____2. A promisor who substantially performs the promise is entitled to the full contract price.
____3. If time is of the essence, failure to perform within the expected time is a material breach of contract.
____ 4. Death of the promisor in a contract for personal services terminates the contract and excuses performance.

1.False. Such a condition is known as a condition precedent.
2.False. A promisor who only substantially performs is entitled to the contract price less the damage sustained as a result of the defective performance.
3.True. If time is of the essence the failure to perform within the expected time is a material breach of the contract.
4.True. Death of the promisor renders the performance impossible and excuses performance of the contract.

Discharge. A contract is discharged when all parties to it are released from their obligations; this normally occurs when the contract is completely performed. Parties may be discharged by the occurrence or nonoccurrence of conditions subsequent and precedent as well as by impossibility of performance. If the other party is guilty of a material breach, a party is discharged from any duty to perform his part of the contract.

Since a contract is created by the agreement of the parties, it may also be discharged by agreement unless the rights of third parties will be adversely affected. The discharge of one party from his or her obligations by an agreement of the parties must be supported by consideration; however, mutual promises to rescind are supported by consideration since both parties have surrendered their rights under the contract. A party may specifically or impliedly relinquish a right s/he has under a contract; such a relinquishment is known as a "waiver." To avoid being considered to have waived his rights, the party should give prompt notice whenever

s/he considers the other party's performance under the contract to be defective. So-called "statutes of limitations" commonly provide that a person must bring suit on a contract within a reasonable time after the cause of action arose or be barred from bringing the suit; each state sets a specific time within which suits on contracts must be brought and commonly distinguishes between oral and written contracts as far as the time allowed to bring suit.

Under the U.C.C., reasonable notice of cancellation must be given where a contract for the sale of goods provides for successive performances over an indefinite time. An agreement dispensing with notification of cancellation is not enforceable if its operation would be unconscionable. And the U.C.C. sets up a four year statute of limitations for bringing suit for breach of contracts for the sale of goods.

Indicate whether each of the following statements is true or false by writing 'T' or 'F' in the space provided.

____1. When a contract is completely performed it is said to be discharged, and all parties to it are released from their obligations.

____2. Under the common law, consideration is not necessary for a binding agreement to discharge one of the parties from his or her obligations under a contract.

____3. The specific or implied relinquishing of rights under a contract is known as a 'waiver.'

____4. Suit on a contract can be brought at any time after the cause of action arose.

1.True. Complete performance discharges a contract and releases all parties from their obligations.

2.False. Under the common law, consideration is needed to support a discharge of one of the parties from his or her obligations by agreement.

3.True. The relinquishment of rights under a contract is known as a 'waiver.'

4.False. A person must bring suit on a contract within a reasonable time after the cause of action arose or be barred from bringing the suit by a "statute of limitations."

Remedies

Nature of remedies. When one of the parties to the contract fails to perform his or her obligations under the contract and the other party thereby sustains some injury, the injured party is entitled to be put, as nearly as possible, in the same position as if the contract had been performed. This may mean that s/he is given some measure of money damages such as the value of the thing s/he expected to receive or the profit that would have been made if the contract had been fully performed. If money damages would be insufficient to put the injured party in the same position s/he would have been in had the contract been fully performed, then the party may be granted the equitable remedy of specific performance, or allowed to rescind the contract, or granted some form of injunctive relief. To enforce a judgment for money damages, the creditor may have the sheriff execute the judgment on property owned by the debtor, or the creditor may proceed to garnish the debtor's wages pursuant to the state garnishment statute. Under some circumstances, the creditor may have the sheriff seize property of the defendant to a suit for breach of contract at the time the suit is initiated; this is known as "attachment" and insures that property will be available to satisfy any judgment obtained against the defendant.

The remedies available to aggrieved parties to contracts for the sale of goods are similar to those at common law and have the same objective; that is, putting the aggrieved party in the same position as if the contract had been performed.

Damages. A number of different types of damages may be awarded for breach of a contract: (1) compensatory, (2) consequential, (3) liquidated, and (4) nominal. Compensatory damages are those damages which would usually flow directly from the breach of contract and which are designed to make good or compensate for the wrong or injury sustained. Consequential damages are those damages which do not flow directly from the breach of contract but are due to the special circumstances of the contract; for example, a farmer sustains consequential damages when he is unable to harvest his crops because the combine he ordered did not arrive within the promised time for delivery. The term "liquidated damages" refers to a specific amount designated by the parties at the time of contracting which is to be recovered by the injured party in the event of a breach of contract. Nominal damages are awarded where there has been a technical breach of the contract but no damages or loss have been sustained as a result of the breach.

In order to recover damages, the aggrieved party must prove to a reasonable degree of certainty the amount of loss and that the loss was the direct result of the breach. Lost profits are recoverable only if they can be proved to a reasonable certainty and if they were within the contemplation of the parties at the time the contract was entered into; they are not recoverable if they are speculative in nature or if the person who breached the contract could not reasonably have been expected to realize that such damages would flow from his or her breach of the contract. The injured party owes a duty to make a reasonable effort to mitigate damages-that is, to minimize the damage s/he sustains. Liquidated damages cannot be recovered unless the damages anticipated are uncertain in amount or difficult to prove, the parties intended to liquidate the damages in advance, and the amount agreed on is reasonable and not so large to be considered a penalty.

Equitable remedies. As has been indicated, courts may decree specific performance of a contract when a damage remedy would be inadequate. Specific performance is most likely to be decreed where the sale of unique items such as pieces of land, antiques, or art objects are involved and where it would be difficult to place a value on the item or to acquire a satisfactory substitute for it. Specific performance is not granted where a contract for personal services is involved or where such a decree would require prolonged and detailed supervision by the court, such as where the contract called for the construction of a building. The remedy of an injunction may be available to prevent or protect against hardship, and is commonly used as a court directive to a person threatening to breach a contract to restrain from his threatened course of action.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.The seizure of the property of a defendant to a suit for breach of contract is known as an 'attachment:'

____2.The amount of any 'liquidated damage' for breach of contract is specified at the inception of the contract.

____3.Lost profits are an example of compensatory damages.
____4.A court would decree specific performance of a contract to paint a picture if the aggrieved promisee could not find another artist to paint it for him.

1.True. 'Attachment' is the seizure of the property of a defendant to a suit for breach of contract.
2.True. The term "liquidated damages" refers to a specific amount designated by the parties at the time of contracting.
3.False. Lost profits are an example of consequential damages. Compensatory damages are those which usually flow directly from the breach of a contract.
4.False. A court will not decree specific performance of a contract which calls for the performance of personal services.

Chapter 9

Agency

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Outline the process of creation of relationship and authority.
2. Define and discuss the relationship of the principal to third persons.
3. Characterize the relation of agent to third person.
4. Depict the relation of principal to agent.

Creation of relationship and authority

Nature and classifications of agency. An agency relationship is a consensual arrangement between two persons whereby one agrees to act for the benefit of and under the control of the other person. Once the relationship is established it is governed by a well-developed body of law which has its roots in the relationship of master and slave where the master was liable for certain acts of the slave. There are two major classifications of agency: (1) master and servant or employer and employee, and (2) principal and agent. In addition, a third relationship which is known as the "independent contractor" has many of the characteristics of these two classifications.

The master-servant or employer-employee relationship is typified by the fact that the master or employer has control over the physical conduct of the servant or employee during the time the relationship is in effect. The factory worker performing under the watchful eye of a supervisor is the most common example of this relationship. If an employee is loaned to do work for someone else with the original employer receiving the compensation paid for the employee's services, then whether the rules pertaining to employer-employee or those relating to the "loaned servant" doctrine apply will depend on whether the regular or the special employer has control over his or her activities.

In the principal-agent relationship, the principal also has control over the conduct of the agent. But the control relates to the business activities of the agent which alter the legal relationship between the principal and third persons as opposed to the physical activities of the employee, as is true in the employer-employee relationship. Agents are sometimes professional agents-such as lawyers and brokers-who are in the business of acting as agents for others. Such an agent may serve in that same capacity for a number of persons and is under their control as to the business acts performed for them but not as to his or her physical acts. Agents may be further divided into general and special agents. A general agent is one who has authority to act for the principal over a period of time in a number of transactions; whereas a special agent is one authorized to act

either in a single transaction or in a limited series of transactions, such as the stockbroker is authorized to make a purchase of a certain number of shares of a certain stock.

Whether a person is considered to be an employee or servant, or whether s/he is considered to be an independent contractor, depends on the degree of control retained over the conduct of the person performing the service. If the person is subject to the direction and control of the employer s/he is an employee or servant; if s/he obligates himself or herself to produce a certain result and is free to proceed toward that objective as s/he sees fit, s/he is likely to be considered an independent contractor.

Creation of agency relationship. There are no formal requirements for the creation of an agency relationship and it may be created either by express consent or it may be implied from conduct. It may be created without the parties actually realizing it exists and even though they expressly stated that they did not intend to create it. The fact that an agent is acting gratuitously does not affect his or her power as an agent, but it does give the agent the right to terminate the relationship at will without incurring liability. Under some state statutes, written evidence of the agency relationship is required if it is to be effective for certain types of transactions.

Capacity. Since the agency relationship is consensual, and not contractual, it is necessary only that the principal must have sufficient legal capacity to give the required consent. Thus persons such as minors and insane persons may appoint and act through agents to the same extent that they might act in person but they cannot enlarge their legal capacity by acting through agents. Formal business organizations such as partnerships and corporations which have the capacity to contract also have the capacity to appoint agents, whereas unincorporated associations normally do not have such power unless it has been expressly granted by statute. A person may have the capacity to be an agent even though s/he cannot be a principal; since the agent obtains his or her capacity to act through his or her principal, all s/he needs generally is the ability to carry out the principal's instructions.

Indicate whether each of the following statements is true or false by writing 'T' or 'F' in the space provided.

____1.In an employer-employee relationship, the employer has control over the physical activities of the employee.

____2. A lawyer is an example of a professional agent.

____3. An agency agreement can only be created by a writing.

____4. A minor may not appoint and act through agents.

1.True. The employer has control over the physical activities of the employee in this classification of agency relationship.

2.True. A lawyer is a professional agent.

3.False. There are no formal requirements for the creation of an agency relationship; it may be oral or even implied.

4.False. A minor may appoint and act through agents but may not enlarge his or her legal capacity by so doing.

Authority to bind the principal. The agent obtains authority to act on behalf of his or her principal through some words or conduct of the principal which make it clear that s/he intends the agent to so act. This authorization to act may be either (1) express, (2) implied, or (3) apparent or ostensible. Express authority is authority explicitly conferred on the agent by the principal for example, through the use of oral or written instructions. Implied authority is the authority reasonably necessary to carry out the task or transaction which the agent has been instructed to do unless the principal has expressly limited this authority in some manner. Apparent authority is determined by looking at the relationship between the principal and a third person. The agent has such apparent or ostensible authority as the principal, by his or her conduct, has led the third person (acting as a reasonable person) to believe has been conferred on the agent. Such authority may be shown by the fact that the agent has engaged in similar acts or conducted similar transactions in the past with the knowledge of the principal and without the principal objecting to it.

Ratification. Ratification is the subsequent adoption of an act done by another person which was not authorized at the time it was performed, although that person was purporting to act as an agent. To be valid, there must be an existing and identifiable principal who indicates his intention to be bound by the person's acts done in the name of the principal. The principal must have been in existence at the time the act was performed and the act must be one that the principal could have performed or authorized. Ratification is retroactive in effect and supplies the authority that was missing at the time the act was performed. Unless third parties have acquired rights which would be adversely affected, the effect of ratification is to place the parties in the same position they would have been in had the act been authorized at the time it was performed. A principal who wishes to ratify must ratify the entire transaction and cannot ratify part of it and repudiate the rest.

Relationship of the principal to third persons

Disclosed or partially disclosed principals. A principal is disclosed when both the existence of the agency and the identity of the principal are known to the third person; a principal is partially disclosed when the existence of the agency is known to the third person but the identity of the principal is not known to that third person. Normally, the agent of a disclosed principal (acting within the scope of his or her authority) does not intend to and will not become a party to the transaction, although the agent may do so by express agreement. On the other hand, the agent of the partially disclosed principal is also a party to the transaction (along with the principal) being negotiated unless it is expressly understood that s/he is not to be liable. The agent should draw written instruments in the name of the principal, and sign them in the name of the principal followed by the name of the agent and an indication that the agent is signing only as an agent. Normally, the fact that an agent was acting as an agent for a principal who is not named in the contract can be established by oral evidence unless a negotiable instrument or contract under seal is involved. In these cases, the principal must be named in the contract.

Undisclosed principal. If both the existence of the agency and the identity of the principal are unknown to the third person, then the principal is undisclosed. Where the principal is undisclosed, the transaction must be negotiated in the name of the agent. If the third person

discovers the existence of the agency and the identity of the principal, s/he then has the right either to hold the agent liable on the contract or to recognize the agency and hold the principal liable. However, the third person must choose between the agent and the principal and can make the election either by words or conduct which indicate which one s/he intends to hold liable. The undisclosed principal is liable to the third person for all authorized acts of his or her agent, and is also liable to the third person for those unauthorized acts which were done in furtherance of the principal's business and which are usual or necessary in carrying out the type of transaction entrusted to the agent. Undisclosed principals are not liable on negotiable instruments or sealed instruments because their names do not appear on the instrument; this is necessary for them to be liable on it. The undisclosed principal has essentially the same rights in the contract negotiated by his or her agent as has an assignee of a contract. Thus, in exercising the normal right to take over the transaction, the principal takes it subject to all the rights, claims, and defenses of the third person.

Liability on special transactions. Agency law determines the liability of the principal for the acts of his or her agent during the negotiation of a transaction. As a general rule, the principal is liable for the representations made by his or her agent in the regular course of transacting the principal's business. Some principals try to limit their liability by allowing their sales people to merely solicit offers on preprinted forms which must be accepted by the principal before they are effective and by including a clause in the form which attempts to limit liability to written representations only. However, despite such clauses, if the agent has made misrepresentations upon which the third person justifiably relied in entering the contract, then the third person has the right to rescind the contract even though the misrepresentations were not within the express, implied, or apparent authority of the agent.

The principal is bound by those warranties made by the agent so long as they are of the nature and type generally made in the trade, but the principal is not liable for those warranties which are unusual and which are not customary in the trade. An agent who has negotiated a contract does not have the right to collect as a matter of law unless such authority is the usual and reasonable incident of the business to be transacted or unless express, implied, or apparent authority to collect is present. If negotiable paper is left in the hands of an agent, it is evidence of authority to accept on, or after, the due date but not before that time. An agent does not normally have the authority to pledge his or her principal's credit, and such authority is implied only where there is a clear necessity for it. Authority to sign or endorse the principal's name to negotiable instruments is granted to the agent only under limited circumstances; there must either be express authority or the nature of the business entrusted to the agent must be such that it is absolutely necessary for the agent to sign or endorse negotiable instruments in order to transact the business at hand.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.In order to be subsequently ratified, an agent's act must have been authorized by the principal.

____2.A principal may ratify all or part of a transaction.

____3.Undisclosed principals are not liable on negotiable instruments used by their agents.

____4.The principal is liable for the representations made by his or her agent in the regular course of business.

1.False. Ratification is the subsequent adoption of an act which was not authorized at the time it was performed.
2.False. The principal must ratify the entire transaction. S/he cannot ratify only a part and repudiate the remainder.
3.True. It is necessary for a party's name to appear on a negotiable instrument in order to be liable.
4.True. The principal is liable for the representations made by the agent in the regular course of business.

Notice to or knowledge of agent. Notice of any fact given to or acquired by an agent that relates to business the agent is transacting for the principal is binding on the principal because the agent is under a duty to communicate such information to the principal. However, notice of facts which are not within the scope of the agency are not binding on the principal, unless the agent actually communicates the information to the principal and unless the information comes from a reliable source. Knowledge of the agent at the time of transacting the principal's business is imputed to the principal. These rules do not apply where the agent's interests conflict with those of the principal, or where the agent and the third person are in collusion to injure the principal so that it is unlikely that the knowledge would be communicated to the principal. Because criminal law is based on actual knowledge and not imputed knowledge, a principal will not be held criminally liable for those crimes requiring knowledge if his or her agent, although possessing the requisite knowledge, did not actually communicate it to the principal.

Liability for acts of subagents. The liability of the principal for acts of other agents appointed by an agent or of a subagent depends on whether the agent has either express or apparent authority to appoint such subagents or other agents. If the agent is authorized to appoint such agents or subagents and acts within that authority, then the appointees are under the control of the principal and s/he is liable for their acts.

The appointing agent is not liable for their acts as such, but if s/he fails to exercise reasonable care in selecting them, s/he may be liable for breach of duty. If an agent is authorized to appoint subagents and to delegate to them certain acts required in the performance of his or her duties to the principal, then the subagents are employees of the appointing agent and are subject to the agent's control, and the agent is liable for their acts. In such a case, the original principal is liable for their acts only to the extent that they are performing acts which the original agent is authorized to delegate. An agent cannot delegate the agent's authority to a subagent if his or her selection as an agent by the principal was based in reliance on his or her skill, discretion, judgment or character. However, duties which are ministerial and involve no discretion can normally be delegated.

Liability for torts of agent. An employer is liable for the torts of his or her employees if the tort is committed within the scope of the employment and during the course of that employment. This liability is absolute and does not depend on the authority conferred on the employee or on

any fault of the employer. If the tort is committed by an employee while s/he is engaged in the performance of his or her duties and the act is connected with the duties assigned to him or her by the employer, the act is considered to have been committed within the scope and in the course of the employee's employment. The employer is not liable if the employee abandoned the employer's business and the act was committed during that abandonment, but a mere deviation in the course of the employment does not so relieve the employer of his liability. This, of course, raises the problem in many cases of whether the deviation was minor or whether it was so substantial so as to be considered an abandonment. Since a professional agent is considered to be an independent contractor as to his or her physical acts, a principal is not liable for torts resulting from those physical acts, but is liable for torts arising in the negotiation of the principal's business to the same extent s/he is liable for the torts of regular agents. If a principal participated in acts of deceit committed by his or her agent or can be seen to have ratified those acts, s/he will be liable for the tort of deceit; however, some courts will relieve the principal of liability if s/he properly instructed the agent and the agent willfully violated the instructions in making the fraudulent statements. The liability of a principal or employer for the torts of the agent or employee is joint and several; that is, the principal and agent or employer and employee, may either be joined in the same court action or they may be sued in individual actions. However, the injured party can only be satisfied once for injuries.

Relation of agent to third person

Liability on authorized contracts. An agent who is acting within the scope of his or her authority on behalf of a disclosed principal is not liable to the third person on the contract unless s/he becomes a party to the transaction. However, an agent will be liable on a negotiable instrument or a sealed instrument if the name of the principal does not appear on the instrument. An agent becomes a party to a contract that s/he negotiates for a partially disclosed or undisclosed principal and is normally liable on it. The agent for a partially disclosed principal may escape personal liability if s/he agrees with the third person that s/he is not to be liable and the identity of the principal is indicated in such a manner that s/he can become known. The agent may become a party to a contract by express agreement in which case his or her liabilities will be determined by the terms of the contract.

Indicate whether each of the following statements is true or false by writing ‘T’ or ‘F’ in the space provided.

____1.Notice of any fact given to an agent is always immediately binding on the principal.

____2.An agent can delegate certain duties to subagents.

____3.A principal is not liable for torts resulting from the acts of an independent contractor.

____4.Agents acting within the scope of their authority on behalf of a disclosed principal are also personally liable on the contract.

1.False. Notice of facts which are not within the scope of the agency are not binding on the principal unless the agent actually communicates the information (received from a reliable source) to the principals.

2.True.Duties which are ministerial and involve no discretion can normally be delegated to subagents.
3.True. A principal is not liable for torts which result from the physical acts of an independent contractor.
4.False. If an agent acts within the scope of his or her authority on behalf of a disclosed principal, s/he is not liable on the contract unless s/he becomes a party to the transaction.

Agent's liability on unauthorized contracts. When a person purports to be acting on behalf of a principal and in fact has no such authority, then the purported agent is liable to the third party for breach of his or her implied warranty of authority. If a person intentionally misrepresents the agency or the scope of the agent's authority and the third person justifiably relies on the misrepresentation to detriment in entering a transaction, then the third person may recover damages in deceit from the person doing the misrepresenting. However, if the third person knows or has reason to know about the lack of authority or the misrepresentation, then s/he is not justified in relying on the agency and does not have an action against the purported agent for breach of warranty of authority or deceit. In addition, if the principal would not be bound on a contract even if the agent was authorized, then the agent cannot be held liable on it.

Lack or limitation of capacity of principal. If an agent purports to act on behalf of a nonexistent or wholly incompetent person, the agent will be personally liable on the contract unless the parties agree and understand that the agent is in no event to be held liable. An agent who acts on behalf of a principal who does not have full capacity to contract (such as a minor) will not be liable on the contract unless misrepresenting or concealing the status of the principal's capacity. All defenses which arise out of a transaction and all defenses between the agent and the third person are usually available to the agent if s/he is sued on the contract.

Agent's liability for torts. The fact that an agent is working within the scope of his or her duties and authority so as to make the principal liable for the agent's torts, does not relieve the agent of liability for the agent's own torts. An agent is liable in deceit if s/he knowingly makes false statements even though the agent does not obtain any personal benefit from them. On the other hand, s/he is not so liable for statements s/he makes based on statements made to the agent by the principal and which the agent has no reason to believe are false. An agent is liable for conversion of another's goods even though s/he only follows the instructions of the principal and believes the goods are the property of the principal. Agents are liable for any negligent injury they cause, but are not liable for the negligent acts of the principal or other agents where they themselves have not been negligent. In general, an agent will not be held liable to a third person for injury resulting from the agent's failure to perform a duty owed to the principal. However, in a few cases, professional persons such as accountants have been held liable to third persons where their work was grossly negligent or where it was clear that the work was being prepared for the benefit of a third person and that the third person would be relying on the accountant's performing the job in a nonnegligent manner.

Relation of principal to agent

Agent's duty of loyalty. The agent owes his or her principal a duty of undivided loyalty and must avoid those situations where the agent's personal interests would conflict with the interests of the principal. An agent also owes a duty not to disclose any confidential information imparted by his or her principal or learned in the course of transacting the principal's business. This includes a duty not to reveal any secret formulas, processes, business methods, or customer lists to which s/he is entrusted by the principal. Agents who are authorized to buy and sell for the principal will not be permitted to buy from or sell to themselves unless they disclose all the material facts to the principal and the principal assents to the purchase or sale. As a general rule, an agent may not act in that capacity for both parties to a transaction and will not be entitled to any compensation if so acting without informing both parties of the dual capacity. If one party knows and assents to the dual agency s/he is bound, but the other party may elect to have the transaction rescinded. Both parties may agree that the agent is to act as an intermediary between them, in which case the transaction will be binding on both and the agent or intermediary will be entitled to compensation.

Agent's duty to obey instructions and use reasonable care and skill. An agent owes a duty to his or her principal to follow and obey the principal's instructions so long as the instructions do not call for the commission of an illegal or criminal act. If an emergency arises which precludes consultation with the principal, the agent may disregard previously given instructions if following them would result in injury to the principal. The agent is required to possess and exercise all the reasonable care and skill which is standard in the locality for the type of work s/he is employed to perform. A paid agent owes a higher duty of care and skill than a gratuitous agent. Since a principal will have knowledge of the agent imputed to him or her, the agent owes a duty to communicate to the principal all notices and material facts that come to the agent's attention in the course of the agency. An agent who is authorized to collect money for his or her principal is under a duty not to accept payment in anything other than money unless given specific authority to accept payment in some other form. An agent that is authorized to sell on credit owes his or her principal a duty to investigate the credit standing of the buyer. Where the agent is making loans for the principal and it is customary to obtain security for such loans, s/he must demand such security.

Agent's duty to account. The agent owes a duty to his or her principal to account for any money or property that comes into the agent's possession in the course of transacting the principal's business. The agent is under a duty not to commingle the money or property of the principal with the agent's own money and property, and if s/he does s/he is liable for any resulting loss. If an agent uses his or her principal's property with the intent of depriving the principal of it, the agent will be guilty of criminal embezzlement. Failure to keep property separate will give rise to an action for conversion or specific recovery of the property.

Principal's duties to agent. Since an agency relationship is often created by contract, the contract creating the agency will normally specify the compensation to which the agent is entitled. If there is no express agreement as to the agent's compensation and if it is clear that the agency was not intended to be gratuitous, then the principal must pay the agent a reasonable compensation for the services performed. If the agent's compensation is contingent on the agent’s accomplishing a stipulated result, then the principal must cooperate with the agent in the accomplishment of that result and must pay the agent if and when the result is accomplished.

The compensation of a professional agent may be put on a contingency or fee basis. In many professions, the performance required, as well as the compensation to be paid, have been standardized. If the advancement of money or the incurring of expenses by the agent is expressly or implicitly authorized, then the principal owes the agent a duty of reimbursement for any such moneys advanced or expenses incurred in the performance of the agent's duties.

Termination of agency. The agency relationship is essentially a consensual arrangement and may be terminated by either party. This may be done by their mutual consent or in violation of a contract of employment, which in the latter case may result in liability for damages for breach of contract. Agency may be terminated through the expiration of a specific agreement or the accomplishment of the objective for which the agency was created. It will also terminate on the death of the principal or agent, the illegality of the objective, the loss or destruction of the subject matter of the agency, or the occurrence of events, which would make it clear that the principal would not wish the agency to continue. If notice of termination of the agency is not given to third persons who have been dealing with the agent, and they have no knowledge of the termination, the principal will continue to be bound by the acts of the agent. This rule does not apply, in general, on the death of the principal and the agent can no longer bind the principal.

Indicate whether each of the following statements is true or false by writing 'T' or 'F' in the space provided.

____1.An agent may be held liable in deceit only if s/he obtains personal benefit.
____2.The agent owes his or her principal a duty of undivided loyalty.
____3.An agent may act for both parties of a transaction if s/he secures their permission.
____4.An agent normally may commingle personal money and/or property with that of his or her principal.
____5.The compensation of an agent may be computed on a contingency basis.

1.False.An agent may be liable in deceit even though s/he does not obtain any personal benefit,
2.True.An agent must avoid any situation where a conflict of interests would arise.
3.True.Both parties may agree that a single agent is to act as an intermediary between them.
4.False.The agent should not commingle the money and/or property of his or her principal with the agent's own.
5. True. Agents are often compensated on a contingency basis.

Chapter 10

PARTNERSHIPS

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Differentiate the relation of partners between themselves.
2. Explain the relation of partners to third persons.
3. Describe the process of dissolution and winding up the partnership.

Introduction to partnership. A partnership is an organization created for the purpose of carrying on a business for profit. Unlike the corporation, the partnership is not a separate legal entity in that it does not have legal existence separate and apart from the persons who have associated together to create the partnership. However, for purposes of carrying on the business, the partners treat it as if it were a separate entity. Both partnerships and corporations have different sets of advantages which may make one form of organization, rather than the other, advantageous in a given business situation. Briefly speaking, partnerships are easily and inexpensively organized, and are generally free from special state regulation and taxes. The primary advantages of the corporation are limited liability of the shareholders, continuous life despite changes in the ownership of individual shares of the corporation, centralized management, and the fact it is often easier to attract capital.

The Uniform Partnership Act has been adopted by some 48 states and governs partnerships in those states.

Creation of a partnership. There are no statutory formalities which must be complied with in order to organize a partnership. All that is necessary is agreements and acts of the parties involved which evidence an intent to operate a business as a partnership. This intent cannot be measured by any one simple test; however, the sharing of profits and losses, a community of property, and voice in the management are the primary tests of the existence of a partnership. The sharing of profits and losses is prima facie evidence of the existence of a partnership while both sharing of profits and losses along with a voice in the management is considered to be conclusive evidence of the existence of a partnership.

Capacity to be a partner. If a natural person has the capacity to own property and to contract, s/he has the capacity to become a member of a partnership. A minor may become a member of a partnership, but having the right to disaffirm his or her contracts the minor may withdraw from the partnership at any time by disaffirming the contract of partnership. The courts are divided on whether the minor can then recover the full amount of the partnership share of losses to investment or must bear the share of losses to date up to the amount of his or her investment. Insane persons who have not been formally declared insane are in the same position as minors.

If the articles of incorporation of a corporation permit it, most states allow a corporation to join a partnership.

Carrying on a business. To have the requisite carrying on of a business, there must be a continuity of business transactions conducted for an appreciable period of time for the purpose of making a profit. To have a partnership, there must be co-owners carrying on the business, although to carry on the business they need not own property in common. Those who hold ownership of property in common such as joint tenants or tenants in common are not considered to be partners even though they realize and share income from the property. If the intent of those carrying on the business is not to make a profit, then the business operation does not constitute a partnership.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.
____1.A partnership is a legal entity separate from its owners.
____ 2.Partnerships are generally free from special state regulation and taxes.
____ 3.There is little or no formality required for the organization of a partnership.
____4.Persons holding property as joint tenants or tenants in common are partners.

1.False. Unlike a corporation, the partnership is not a legal entity separate from its owners.
2.True. One of the advantages of the partnership form of organization is that it is generally free from state regulation and taxes.
3.True. There are no statutory formalities which must be observed in forming a partnership.
4.False. Those who hold ownership of property in common are not considered to be partners.

Persons represented to be partners. The Uniform Partnership Act states that persons who are not partners as to each other are not partners as to third persons. However, persons who hold themselves out as partners or permit themselves to be held out as partners will be liable to those who justifiably rely on the holding out and deal with the partnership to their injury. This liability is based on estoppel. Unless persons being held out as partners acquiesce in the holding out, so as to contribute to the appearance that they are partners they cannot be held liable as partners.

Joint ventures. A joint venture is distinguished from a partnership, usually on the grounds that it is limited to a particular venture or transaction and is intended to be dissolved once that transaction or venture is completed. Members of joint ventures have only limited ability to bind the other members.

Limited partnerships. Limited partnerships are partnerships containing both limited and general partners. A limited partner is one whose liability is limited to his or her contribution to the capital of the partnership, as opposed to a general partner who has unlimited liability for the obligations of the partnership. A limited partnership may not be organized unless the statutes of the state so provide. The statutes usually set out certain requirements which must be met for the limited partnership to be effective. The limited partner may not take part in the control of the business, and if s/he does take part in control, s/he becomes liable to the creditors of the partnership to the same extent as if s/he were a general partner.

Relation of partners between themselves

The partnership relations. The partnership relation imposes certain duties on the members of the partnership which are similar to the duties involved in the principal-agent relationship. The partners may (within certain limits) define their relationship to each other in a partnership agreement, but through the use of such an agreement they may not relieve themselves of the fiduciary duty which they owe each other. Although a formal agreement is not required, the partners should draw up a set of partnership articles in which they set out the basic organization of the partnership and define the powers to be held by the partnership. If no such articles are drawn then general partnership law will be applied.

Partnership property. The intention of the partners is controlling as to what is partnership property and what remains their own individual properties. In general, all property originally brought into the partnership, all property later acquired for the account of the partnership, and, unless contrary intention is shown, all property acquired with partnership funds is considered to be partnership property. Whether property is considered to belong to the partnership or to an individual partner is important if the partnership and the partners become insolvent. In such a case, the partnership creditors have first claim on the partnership property, and the individual creditors have first claim on the individual property of the partners. The name and goodwill of the partnership are considered to be partnership property. While at common law, the title to partnership property, could not be held in the name of the partnership but rather had to be held in the names of the individual partners or a partner, the Uniform Partnership Act allows title to property to be acquired and held in the partnership name. Each partner has the right to possess and use the partnership property for partnership purposes. The partners own the partnership property in a type of co-ownership known as tenancy in partnership. The creditor of an individual partner may reach the partner's interest in the partnership but they can acquire no greater rights in it than the partner has. Under the Uniform Partnership Act, a creditor may obtain a "charging" order which allows for the appointment of a receiver of the partnership interest to collect the profits of the partnership and under some circumstances to sell the partnership interest under court order. The remaining partners may pay the judgement against their fellow partners and thereby relieve the partnership of the charging order.

Indicate whether each of the following statements is true or false by writing “T” or “F” in the space provided.

____1.A joint venture differs from a partnership in that it is usually limited to a single venture or transaction.

____2.By definition, a limited partnership is comprised only of limited partners.

____3. In case of insolvency, partnership creditors have first claim on both the partnership property and the property of individual partners.

____4.The Uniform Partnership Act allows title to property to be acquired and held in the name of the partnership.

1.True. A joint venture is usually limited to a single transaction or venture and differs from a partnership in this respect.

2.False. A limited partnership consists of both limited and general partners.
3.False.Partnership creditors have first claim on partnership property, but the individual creditors have first claim on the property of the individual partners.
4.True. The Uniform Partnership Act permits partnerships to acquire and hold property in the partnership name.

Management of partnership business. Unless there is an agreement to the contrary, all of the partners are entitled to an equal voice in the management of the partnership business. The partners may agree that the authority to manage the business is to be vested in one or more of the partners. They may not, however, exclude a partner from having a voice in the management as that is grounds for dissolution of the partnership. Regardless of the partner's contribution to the capital of the partnership, each partner is entitled to one vote on decisions affecting the business and a majority vote is controlling. If the partners cannot agree on the conduct of the partnership affairs, the courts will not settle the dispute. If they cannot agree, their only course of action is to dissolve the partnership and to wind up its business.

Profits and losses. Unless the partnership agreement specifically defines the partner's rights to share in the partnership profits and the partner's responsibility to share in partnership losses, the partners share equally in the profits and incur the losses equally, without regard to what share of the partnership property they contributed. If the agreement sets out the distribution of profits but is silent as to losses, then losses are shared in the same proportions as profits.

Rotation between partners. Just as an agent owes a duty of loyalty to his or her principal, each partner owes a duty of undivided loyalty to the other partners and to the partnership. The partner may deal with the partnership or with other partners so long as it is done in good faith and discloses all material facts which affect the transaction and which are not known by the other partners. If a partner profits in his or her dealings with the partnership because of misrepresentations, then the partner must account to the partnership for the profits made from such dealings.

When the partner is transacting partnership business, s/he owes a duty to exercise reasonable care and skill as well as not to exceed his or her authority under the partnership agreement. A partner is not liable to his or her partners for losses that result from honest errors of judgment but the partner is liable if s/he is negligent or fails to exercise reasonable care and skill in transacting the business. A partner is also liable if s/he engages in unauthorized transactions and they result in a loss. Each partner must have access to and the right to inspect and copy the partnership books. Each partner also owes a duty to disclose to the other partners all information and notices concerning the partnership business which are not disclosed by the partnership records. Unless the partnership agreement provides to the contrary, each partner owes a duty to devote his or her full time and energy to the business of the partnership, but is not entitled to wages apart from the partnership share of the profits unless the agreement provides for such wages. Partners may not sue each other or the partnership; disputes must be adjusted between the parties or the partnership is dissolved (in which case the courts will assist the dissolution, accounting, and winding-up of the partnership).

Relation of partners to third persons

Partner as an agent of the partnership. As a general rule, each partner has the power to bind the partnership by acts which are ordinarily done in the course of carrying on a business such as the partnership is engaged in. This authority, however, may be limited by an agreement between the partners. A third person dealing with partners is bound to ascertain whether the partnership exists and must take notice of any apparent limitations on the partner's authority; however, unless s/he has notice or knowledge of limitations on the authority of the partner, the third person may assume that the partner has the authority of a general agent.

If real property is held in the partnership name, then it may be conveyed by a conveyance executed by a partner in the name of the partnership. If title to real property is held in the name of one or more but not all of the partners, or is held in trust in the name of a third person, then a conveyance by the named partners will pass good title to an innocent purchaser for value. A partner must have specific authorization to do certain acts on behalf of the partnership: namely, to dispose of its goodwill, to do some act which would make it impossible for the partnership to carry on its business in the usual way, to confess judgment against the partnership, or to bind the partnership to arbitration of a claim or liability.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.
____1.If a partner is excluded from the management of a partnership by the other partners, this is grounds for the dissolution of the partnership.
____2.If a partnership agreement specifies the manner in which profits are distributed but is silent as to the distribution of losses, losses are shared equally.
____3.A partnership may not sue another partner or the partnership.
____4.The right of an individual partner to bind the partnership by his or her acts cannot be limited by the partnership agreement.

1.True. Partners may not exclude one of their numbers from having a voice in the management of the partnership, as that is grounds for dissolution.
2.False. In this case, losses would be shared in the same proportions as profits.
3.True. Disputes must be settled by the partnership or the partnership must be dissolved.
4.False. This right may be limited by an agreement among the partners.

Use of partnership credit to borrow. Whether or not a partner may borrow money in the name of the partnership depends on the type of business being carried on by the partnership and whether it is normal practice in that type of business to use borrowed money to carry on the business. Thus, if the partnership was engaged in manufacturing or retailing or a similar line of business, then a partner would have the power to borrow money, whereas a partner in a service partnership (such as law or medicine) would normally not have the authority to borrow money using the firm's credit. As a general rule, the power to borrow money also carries with it the concomitant power to pledge the partnership's assets as security for the repayment of the money borrowed. If the partnership has a commercial banking account, a partner normally will have the power to endorse negotiable instruments payable to the partnership for deposit or discount. A

partner's power to sign negotiable instruments (like his power to borrow money) is usually dependent on the nature of the business. The power to sign checks is usually indicated on the signature card at the bank, but even a partner whose name is not on the signature card may bind the firm as to a third person who has no knowledge of the limitation on authority. If a partner has the power to borrow money on the firm's credit, then the partnership is responsible for repayment of the money even though the partner converted it to personal use. On the other hand, the partnership is not liable for money borrowed by a partner in his or her own name, even though it is converted to the use of the partnership.

Partner's individual liability. Agency law determines the liability of the partnership and the individual partners for the wrongful acts of the partners. If the wrongful act is committed within the scope and course of the transaction of partnership business, then the partnership and the partners are jointly and severally liable. A partnership cannot, of course, commit a crime since it is not a legal entity, and an individual partner is not liable for crimes committed by the other partners unless s/he participates in the crime. Partners are jointly liable on contracts of the partnership although some states also allow partners to be sued severally on contracts, and (as indicated above) partners are jointly and severally liable for torts chargeable to the partnership.

Dissolution and winding up the partnership

Dissolution. Dissolution of a partnership is a change in the relation of the partners caused by any partner ceasing to be associated in the carrying on of the business. Dissolution is to be distinguished from the winding-up and termination of the partnership which effectively put it out of business. Dissolution may be caused by the expiration of the term of the partnership, the accomplishment of its objective or the death or bankruptcy of a partner; it may occur at the will of a partner or by mutual agreement of the partners where no third-party interests are involved. If the partnership is dissolved by the withdrawal of a partner in contravention of the partnership agreement, the withdrawing partner will be liable in damages to the remaining partners for breach of the agreement. In a few special instances, a court will decree the dissolution of a partnership. Such instances include the insanity or incapacity of a partner, a partner persisting in conduct detrimental to the partnership or in material violation of the partnership agreement (where the partnership can be carried on only at a loss), and where a judgment creditor has obtained a charging order and is entitled by law to have the partnership dissolved by the court.

Changes in membership. A change in the membership of the partnership either by a partner ceasing to be a member or the addition of a new partner technically dissolves the old partnership, but the business of the dissolved partnership may be carried on without interruption. If a partner's interest is acquired by the partners continuing in the business, then the new partnership is liable for the obligations of the old partnership. The estate of a deceased or bankrupt partner is not liable for the debts of partners who continue in the business, but a withdrawing partner is liable unless a person extending credit to the continuing business has notice or knowledge of the withdrawal. If a partner sells his or her interest to a third person, the new partnership is liable for the debts of the old, and the withdrawing partner continues to be liable unless there is a novation whereby the creditors agree to release the withdrawing partner of liability and to substitute the new partner who has promised to pay the old debts. Again, the withdrawing partner is liable for the obligations of the new partnership until notice of his or her withdrawal is given. If a new

partner is added to the firm, a new partnership is created with the newly admitted partner being responsible only for obligations incurred after becoming a member, unless s/he by express agreement undertook to be liable for the already existing obligations.

Notice of dissolution. Third persons who deal with a partnership are normally considered to be justified in assuming that a given partnership will continue in existence and until they are given notice or have knowledge that it has been dissolved, they are justified in continuing to deal with it in their usual manner. Thus, in the event of dissolution, partners who want to protect themselves from continuing liability must give notice of the dissolution to persons who have dealt with the partnership or know of its existence. Persons who have extended credit to the partnership are entitled to actual notice of the dissolution, whereas persons who know of its existence but have not extended credit may be given constructive notice through an advertisement placed in a newspaper of general circulation in the area in which the partnership carried on its business.

Winding up partnership business. If the partnership business is to be terminated, then the next step following dissolution is winding up the partnership business. This involves an orderly liquidation of the firm's assets. Until the assets are liquidated, the creditors of the partnership are paid, and the remaining assets of the firm are distributed to the partners, the partnership continues. During this time, the partners continue to owe a fiduciary duty to each other but have only limited authority to bind the partnership through those acts which are necessary to the winding-up. The right to wind up the business is vested in the partners except where they cannot agree, in which case a court-appointed receiver may do it. The partner or partners charged with the winding-up have the power to do all acts reasonably necessary to that end, but do not have the power to engage in new business. If a partnership is terminated by the bankruptcy or death of a partner, the bankrupt or deceased partner's estate has the right either to have the partnership wound up within a reasonable time or to be paid the value of the bankrupt or deceased partner's share (in cash). The surviving partners may also organize a new partnership with the estate of the deceased partner. In many cases, the partnership agreement will provide for the contingency of the death of one of its members, even to the extent of carrying insurance so that the deceased's estate can be paid off in cash without having to wind up the partnership.

Distribution of assets. If the partnership is solvent when it is wound up, then the order of distribution of assets is relatively unimportant. However, if the partnership is insolvent, the order of distribution becomes very important. The order of distribution set out in the Uniform Partnership Act is; (1) amounts owing to creditors other than partners, (2) amounts owing to partners other than for capital and profits, (3) amounts owing to partners in respect of capital, and (4) amounts owing to partners in respect of profits. Where the partnership is insolvent and there are insufficient assets to satisfy the partnership's creditors, then the creditors of the partnership have the first right to the assets of the partnership and the creditors of the partners as individuals have the first claim on the assets of the individual partners.

Indicate whether each of the following statements is true by writing “T” or “F” in the space provided.

____1.A partnership cannot commit a crime.

____2.The death or bankruptcy of a partner causes the dissolution of the partnership.
____3.If a partner sells his or her interest to a third party, then the partnership is not affected.
____4.When the assets of a partnership are distributed in winding up its business, partners receive the amounts due them before any distribution is made to third-party creditors.

1.True.Because it is not a legal entity, a partnership cannot commit a crime.
2.True.The death or bankruptcy of any partner causes the dissolution of the partnership.
3.False.Technically, the addition of the new partner dissolves the old partnership and a new firm is formed.
4.False. Exactly the opposite is true; creditors are paid before partners.

Chapter 11

ORGANIZATION AND INCORPORATION OF CORPORATIONS

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Diagram the incorporation process of an organization.
2. Outline and explain the incorporation of corporations.

Nature of corporations. A corporation is a legal entity which has a legal existence separate from its owners. A corporation can, therefore, own property in its own name, make contracts, sue and be sued, and do those acts necessary to carry on the business in which it is engaged. While corporations are owned by their shareholders, the corporation itself has title to the assets and it, not the shareholders, is liable for its liabilities. Unlike the partnership, the corporation continues in existence despite the death or bankruptcy of a shareholder or the transfer of the shareholder's interest in the corporation to someone else; the corporation may continue either indefinitely, for a stated period of time as prescribed by its charter or the state in which it is incorporated, or until it surrenders or forfeits its charter. The corporation is typified by centralized management selected by the shareholders to manage the corporate business.

The corporation is the only form of business organization which possesses all of these characteristics. As discussed in the previous chapter, partnerships do not have the standing as a legal person, do not have continuous existence, are dissolved by the death, bankruptcy, or withdrawal of one of their constituent members, and do not enjoy limited liability. While limited partnerships do allow some of the partners to enjoy limited liability so long as they do not take an active part in managing the business, they have the other characteristics of partnerships. Business trusts, permissible in only a few states, have centralized management, continuous existence, and limited liability of the owners; but the owners normally have little or no control over the business.

Corporations may be classified into three different categories: (1) corporations for profit, (2) corporations not for profit, and (3) government corporations. Concern in this and the following three chapters will be primarily with the corporation organized for profit.

Corporation as a legal person. The corporation is recognized as having a legal existence separate and apart from the shareholders who own it. It may acquire that status if the persons who own and organize it comply with the state statute governing the organization of a corporation. As an artificial person, the corporation is considered to have its domicile in its state of incorporation. Generally, the shareholders of a corporation do not owe any fiduciary duty to the corporation, and they may deal with the corporation in the same manner as they would any other person; in short, normally shareholders are not considered to be agents or representatives of

the corporation. It is considered a legitimate objective of incorporation to obtain limited liability for the shareholders; however, the separateness of the shareholder from his corporation and the limited liability of the shareholder may be disregarded if the corporate form is used to promote fraud, evade the law, or accomplish purposes detrimental to society. This is most commonly a problem of the small closely held corporation. The corporate form may also be disregarded where a parent corporation uses a fully or partially owned subsidiary as a screen behind which it seeks to operate in a legally suspect manner; in such a case the parent corporation will be liable for the debts and acts of the subsidiary.

Indicate whether each of the following statements is true or false by writing or "T" of "F" in the space provided.
____1.The corporation has a legal existence separate from that of its owners.
____2.The shareholders of a corporation are always ultimately liable for corporate debts.
____3.In general, the corporation is said to be domiciled in the state of its incorporation.
____4.The shareholders of a corporation owe it a fiduciary duty.

1.True. The corporation is a legal entity which has an existence separate from that of its owners.
2.False.One of the advantages of the corporate form of organization is that the corporation itself, not its shareholders, is liable for its debts.
3.True. The corporation is considered to be domiciled in the state of its incorporation.
4.False. In general, the shareholders of a corporation do not owe it a fiduciary duty, and they may deal with it as they would with any other person.

Corporation and state. The right to charter corporations is vested in the individual states, and this right also carries with it the power to impose reasonable regulations on corporations. In the exercise of this power, states may not impair the validity of contracts or do any other thing which would be unconstitutional. The federal government also regulates corporate activity to some degree where the corporation engages in interstate business or is engaged in activities affecting interstate commerce. The regulation of the securities of such businesses by the Securities Exchange Commission is an example of such federal regulation. The existence of a corporation may be terminated: (1) by voluntary dissolution of the corporation, (2) by suit of the corporation's minority shareholders, (3) by the expiration of its corporate charter, (4) by forfeiture of its charter following some serious breach of its corporate privileges, and (5) by merger or consolidation. In the event of such dissolution, the state statutes prescribe the procedure to be followed.

Incorporation. Where the proposed corporation plans on doing primarily intrastate business (within one particular state), then it normally will be advisable to incorporate in that state. However, if the corporation will operate interstate, then the choice in which state to incorporate will be determined more on the basis of which state has the corporate and tax statutes which are most advantageous to the proposed corporation. The state of Delaware has long been favored by promoters because of the freedom it grants to promoters and management; but such freedom is not always in the interest of minority shareholders. More than half of the states, but few of the major industrial states, have adapted the Model Business Corporation Act which does grant rather broad powers to incorporators. This act will be the main focus of this book, not only

because of its wide adoption but also because it has influenced the statutes and decisions in many of the other, non-adopting states.

In general, the steps involved in incorporation are: (1) the drawing of articles of incorporation, (2) the signing or authenticating of the articles by one or more persons or another corporation, (3) the filing of the articles along with a specified fee with the Secretary of State, (4) the issuance of a certificate of incorporation by the Secretary, (5) payment to the corporation by the shareholders of a specified minimum amount of capital ($1,000 under the Model Act), and (6) the holding of an organizational meeting of the board of directors named in the articles for the purpose of adopting bylaws, electing officers, and transacting other corporate business.

The articles of incorporation spell out certain basic details about the management and structure of the proposed corporation such as its name, its proposed duration, its purposes, the number and classes of shares along with their respective rights and the consideration required for each type of share, the amount of consideration to be paid before the commencement of business, the registered office and agent of the corporation, the names and addresses of the initial board of directors, and the names and addresses of the incorporators. Normally the name must include the word "corporation," "incorporated," "limited," or an abbreviation of one of these words, must not be deceptively similar to the name of some other corporation incorporated or authorized to do business in the state, and must not be deceptive as to the type of business carried on. In many states corporations may have perpetual existence if they desire, but a few others put a time limit on the life. Most states allow wide latitude as to the capital structure and rights accorded the owners of various classes of stock. The business and affairs of a corporation are normally vested in its board of directors, and much of the detail covering the structure, election, and powers of the board is set out in the bylaws. A number of states require at least three incorporators, and at the same time allow both publicly held and closely held corporations with as few as one shareholder.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.The regulation of corporate activities is vested exclusively with the states.

____2.The corporation must be incorporated in every state in which it does business.

____3.The purpose of the articles of incorporation is to spell out certain basic details about the management and operations of the proposed corporation.

_____4.The corporation has a perpetual life regardless of the state in which it is incorporated.

1.False.The federal government is also involved in the regulation of corporations engaged in interstate commerce.

2.False.Even a corporation engaged in interstate commerce need only incorporate in a single state.

3.True.This is the purpose of the articles of incorporation.

4.False. In a few states, the life of a corporation may be limited by state law.

De jure and de facto corporations. Occasionally a business will hold itself out as a corporation without having actually completed all of the steps required by statute. In such a case, the courts recognize three different classifications: (1) de jure corporations, (2) de facto corporations, and (3) no corporation at all. A de jure corporation is one which has complied essentially with all of the mandatory provisions of the statute and has met all of the prerequisites for the organization of a corporation; the validity of a de jure corporation is not subject to attack even by the state. A de facto corporation is one where the incorporators made an honest effort to organize and have actually transacted some business under the corporation name, but failed in some material respect to comply with mandatory provisions of the incorporation statute. If a de facto corporation exists, then neither the corporation nor a third person involved in litigation with the corporation may defend the suit on the grounds that the corporation is defective; however, the state may bring a quo warranto proceeding to directly attack the claim of being a corporation. If persons hold themselves out as doing business as a corporation and third persons are induced to do business with them, then the promoters will be estopped from denying their lack of incorporation as a defense against a third person. Under the Model Act, a certificate of incorporation is conclusive evidence of incorporation against the state, thus eliminating any real difference between de jure and de facto corporations. If persons attempt to organize a corporation but fall short of even a de facto corporation, then they are liable as partners and do not have limited liability.

The role and liability of promoters. A promoter is a person who brings about the organization and incorporation of a corporation for the purpose of carrying on a business. The promoter occupies a unique position with both the corporation and those persons interested in the corporation. Because the corporation-to-be does not yet exist, the promoter cannot be its agent, and since the other persons interested in the corporation did not appoint the promoter as their agent and because s/he is not subject to their direction and control, s/he cannot be their agent. However, the promoter does owe a fiduciary duty to the corporation-to-be and to those interested in it. If s/he makes secret profits on property sold to the corporation due to misrepresentations of option or purchase prices, those profits can be recovered, as can such profits made at the expense of persons interested in the corporation by virtue of misrepresentations made to them. The promoter is generally protected from such liability if: (1) s/he makes a full and accurate disclosure of the facts, and (2) those interested in the corporation consent to the exchange of assets at an inflated value for stock in the corporation.

When the corporation comes into existence, it is not bound by contracts made by the promoter since it was not in existence at the time the contracts were made. The corporation may, however, become liable on such contracts if it takes certain kinds of action, including acceptance of benefits of the contract. Among the theories for holding that the corporation has become liable are adoption, ratification, novation, and continuing offer. In order for the corporation to become liable, the contract must be a valid and legal contract within the powers of the corporation, and the corporation must accept it in its entirety. The promoter continues to be liable on contracts s/he made prior to incorporation unless there is a novation whereby the person with whom the contract is made agrees to substitute the liability of the corporation for that of the promoter. Mere adoption or ratification of the contract by the corporation does not relieve the promoter of liability.

Completing corporate organization. After the state has granted the corporation its charter, there is an organizational meeting of the initial board of directors or, in some states, the incorporators. In those states where the Model Act is in effect, the board of directors adopts the initial bylaws and elects officers, whereas in some other states these powers are given to the incorporators or the shareholders. The bylaws normally provide for annual meetings of the shareholders, for meetings of the board of directors, for the duties and powers of the officers, and for the issuance and transfer of stock. Shareholders are bound by all valid bylaws which are not contrary to rights given them by the articles of incorporation or the state statutes; third persons are generally bound only by those provisions of the bylaws of which they have notice or knowledge.

Financing the corporation. The issuance of stock for consideration is the means by which a corporation obtains its capital. The original capital may be contributed in the form of money, property, or services, and it is the true value of these assets which determines whether the corporation has met the amount of initial capital required before it can commence doing business (a minimum of $1,000 under the Model Act). If stock is issued for services, the services must actually have been performed. Stock may be either par or no-par. If a par value is placed on the stock, then the price paid for the par value stock must be at least the par value in most states; if more than that is paid, the additional amount becomes capital surplus. Usually the price of no-par stock may be fixed by the board of directors; the directors may allocate part of the purchase price to capital surplus. Normally stock which is to be sold to the public must comply with state securities laws (blue-sky laws) and must be qualified by the state securities commission. If the stock is to be sold in more than one state or through the mails, then the provisions of the federal securities laws must also be complied with. Corporations normally have the power to borrow money; this is sometimes done through the issuance of corporate bonds, which are often secured by liens on part or all of the corporate assets.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.A de facto corporation is one that has complied essentially with all the requirements for incorporation.

____2.Only the state may attack the validity of a de jure corporation.

____3.A promoter owes a fiduciary duty to the corporation-to-be.

____4.A corporation is always bound by the actions of its promoters.

____5.The original capital of a corporation is usually obtained by the issuance of stock.

1.False.This is the definition of a de jure corporation.
2.False.Not even the state can attack the validity of a de jure corporation.
3.True.A promoter owes a fiduciary duty to the corporation-to-be.
4.False.A corporation is not bound by the actions of its promoters unless it chooses to be.
5.True.A corporation usually obtains its initial capital through the issuance of stock.

Chapter 12

OPERATING THE CORPORATION

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Explain the scope and limits of corporate powers.
2. Depict the operation of a corporation.

Scope of corporate powers. Because corporations derive their powers from the state, their powers cannot exceed those conferred on them by the state constitution and statutes. Traditionally, corporations have an existence separate from their shareholders, can sue and be sued, can acquire, sell and hold property in the corporate name, and make their own bylaws. Both judge-made law and state statutes have tended to give increasingly broad powers to corporations so that they can exercise all powers reasonably necessary to achieve their corporate purpose. The articles of incorporation may specifically limit the corporate powers but, in the absence of such limitations, the corporation will normally have all the powers permitted by statute. It should be noted that certain special types of businesses such as banks, utilities, and insurance companies are usually incorporated pursuant to special statutes which do place restrictions on the scope of their powers.

The ultra vires doctrine makes acts beyond the corporation's legal authority illegal and void. This doctrine provides a defense to an action which can be asserted either by the corporation or by a person who dealt with the corporation. Today there is a tendency not to allow this doctrine to be used as a means for reneging on an agreement; however, shareholders may bring an action to enjoin acts a corporation proposes to undertake which are beyond its powers.

Managing the corporation. Since the shareholders own the corporation, they have the ultimate control over corporate affairs. Normally, the duties and management are vested in the board of directors with the shareholders having the right to approve or disapprove of extraordinary matters. Thus the board of directors usually determines major policy questions and elects the officers for the purpose of carrying on the day-to-day management of the corporation. The rights, duties, and liabilities of the board of directors and the officers will be discussed in this chapter and Chapter 14 will deal with shareholders' rights and liabilities.

Board of directors. Since directors have the general responsibility of managing the corporation, they have the power to make all decisions for the corporation except those reserved to the shareholders by statute or by the articles of incorporation. The board of directors normally establishes the basic objectives and policies of the corporation and approves all major financial transactions. It also establishes the consideration to be paid for shares of stock, declares dividends and the record dates for receiving them, amends or repeals bylaws, elects, removes, and delegates duties to officers, and sells, mortgages, or leases corporate assets

in the normal course of business. Unless the members of the board of directors are also full-time officers of the corporation, they cannot make all of the day-to-day management decisions; these are delegated to the officers and employees of the corporation.

Under the Model Act, a corporation must have at least three directors, and may have more as affixed by the articles of incorporation or bylaws. Directors are elected by the shareholders at their annual meetings, and hold office until the next meeting or until their term expires and their successors are elected and qualified. Unless otherwise provided in a statute, the articles or the bylaws, vacancies in the board can only be filled by persons who are shareholders. Without specific statutory or other authority, directors may not be removed *without cause* in the nature of misconduct or action contrary to the interest of the corporation. At the same time, the shareholders have the inherent right to remove directors *for cause* and have this power even though the articles or bylaws, with shareholder approval, give this power to the directors themselves. Traditionally, the directors were required to meet as a group in person in order to validly transact corporate business so as to maximize the opportunity for full discussion. Today, most states allow action by directors without a formal meeting if all directors consent in writing. Reasonable notice, which includes the stated purpose of the meeting, must be given for special meetings of the board (but not for regular meeting), but attendance at a meeting is generally sufficient to cure defects in the notice. Each director has one vote at the meeting and a quorum must be present in order to transact business. Unless a greater number is specified in the articles or bylaws, the Model Act provides that a majority of the number of directors specified in the articles or bylaws constitutes a quorum.

The bylaws of most large corporations establish an executive committee composed of members of the board of directors who have authority to act on certain kinds of matters when the full board is not in session. The members of the executive committee are commonly directors at or near the corporate headquarters so they can be quickly convened. While directors traditionally served without compensation, most modern corporation statutes allow directors to fix their own compensation, and most do receive some compensation for their services.

Indicate whether each of the following statements is true or false by writing or "T" or "F" in the space provided.

____1.Unless limited by the articles of incorporation, the corporation will normally have all the powers permitted by state statutes.

____2.The *ultra vires* doctrine makes actions which are beyond the corporation's legal authority void and illegal.

____3.The management of a corporation is usually elected directly by its shareholders.

____4.The board of directors may not act except when they meet formally as a group.

1.True.A corporation normally has all the powers permitted under state statutes unless its articles of incorporation have set specific limitations on its activities.

2.True.This is the definition of ultra *vires* acts.

3.False.Usually the shareholders elect the board of directors, which in turn appoints the management of the corporation.

4.False.Today, most states permit action by directors without a formal meeting if all directors consent in writing.

Officers and employees. Under the Model Act, the officers of a corporation are a president, one or more vice presidents, a secretary, and a treasurer. Any two or more of these positions may be held by the same person except for the offices of president and secretary. Many corporations also have an officer known as the chairman of the board. As agents of the corporation, the officers have the express authority given them by the board or by the bylaws and the implied authority which is reasonably necessary for them to carry out the duties which have been delegated to them. They may also bind the corporation on the basis of apparent authority even though acting beyond their actual authority. The law also accords *ex officio* powers to officers. Thus a president, who is also a general manager, has the power to make contracts and do other acts appropriate to the carrying on of the normal business of the corporation. Vice presidents have no authority by virtue of that office unless they are charged with some specific function, in which case they have the power to transact the business normal to that function. Corporate secretaries keep the minutes of the director and shareholder meetings and keep the custody of corporate records; they normally have no power to bind the corporation by virtue of their office, except that there is a presumption that documents to which they have affixed the corporate seal are duly authorized documents. Treasurers are normally responsible for receiving, disbursing and maintaining custody of corporate funds, but do not have the power by virtue of their office to borrow money or to issue negotiable instruments. Nonofficer employees may also be designated to act as agents, with the relationship and liabilities of the principal and agent to be determined by the usual rules of agency law as discussed in Chapter 9.

Liability for torts and crimes. The agency rules discussed in Chapter 9 apply to the officers and employees of a corporation who are acting as its agents. Corporations are liable for the torts of their employees committed during the course and scope of the employment even though the act itself was not authorized. Under present law, corporations may be held guilty of committing crimes even though the crime requires some sort of intent; such intent can be found from the acts of the board members, officers, or agents of the corporation who were acting in the scope and course of their employment or duties.

Fiduciary duties of directors and officers. Although directors are really not agents of the corporation, both they and corporate officers do owe certain fiduciary duties to the corporation. In general these fiduciary duties are: (1) to act within the scope of their authority and the powers accorded the corporation, (2) to use due care and diligence in conducting the affairs of the corporation, and (3) to act with loyalty and good faith for the benefit of the corporation. The current trend is to raise the standard of conduct expected of corporate directors and officers. Directors must act within the authority granted to them by the articles of incorporation and bylaws and within the authority given to the corporation by statute, the articles, and the bylaws. Unless the director acts with an honest and justified belief that s/he is acting within this authority, s/he may be personally liable for any damage sustained by the corporation due to the unauthorized act unless the act is later ratified by the shareholders. Directors and officers are required to discharge their positions in good faith and with that degree of diligence, care, and skill which ordinarily prudent persons would exercise under similar circumstances in those

positions. While directors may place reasonable reliance on others such as officers, accountants, and lawyers, lack of knowledge as to the actual state of corporate affairs affords no defense to a corporate fiduciary if the knowledge could have been obtained through reasonable diligence.

The duty of loyalty and good faith for the benefit of the corporation can be involved in many different kinds of situations. Among the most common situations are: (1) transactions with the corporation, (2) usurpation of a corporate opportunity, (3) dealing in the stock of the corporation, and (4) oppression of minority shareholders. Fiduciaries are not permitted to benefit from any type of self-dealing. The courts are most likely to uphold transactions between the corporation and a director or another company in which s/he has an interest, if the director made a full disclosure and if his or her vote was not necessary for a quorum or to carry the vote on approval of the transaction. Failure to disclose the interest or unfair terms may cause the transaction to be voided at the corporations or shareholders' insistence. If a business opportunity comes to the attention of a corporate fiduciary in the course of his or her duties and if the opportunity is within the normal scope of the corporation's business and it is able to undertake it, then the fiduciary may not take the opportunity for himself or herself. However, if the corporation is unable or unwilling (through a disinterested vote) to accept it, then the corporate fiduciary may personally undertake to exploit the opportunity unless it would result in harm to the corporation.

Since directors and officers often have access to inside corporate information which affects the value of the corporation's stock and which information is not available to other shareholders or potential sellers or purchasers of the corporation's stock, they are normally under a duty to disclose material inside information to the other party to a transaction involving the corporation's stock. Failure to make such disclosures or acting to use the inside position to the detriment of other stockholders may result in having to pay back profits made or other types of liability. The Securities Exchange Act contains very specific guidelines on so-called insider trading, prohibits deceptive practices, and allows corporations to recover short-term profits made by insiders trading in the stock of the corporation. Directors and officers also owe a duty to exercise their judgment for the best interests of the corporation as a whole; while given considerable discretion to do this, bad faith or clear abuse of the normal exercise of business judgment with the effect of oppressing minority shareholders may result in the issuance of an injunction or the recovery of damages on behalf of the minority shareholders.

Certain other statutory responsibilities are placed on directors and officers, particularly by the federal securities laws, and civil and criminal penalties may be levied on those who violate these responsibilities.

Indicate whether each of the following statements is true or false by writing “T” or “F” in the space provided.

____1.The officers of a corporation cannot bind the corporation if they act beyond their actual authority.

____2.A corporation may be held guilty of committing crimes.

____3.Lack of knowledge of corporate affairs is always a valid defense for a corporate fiduciary.

____4.Corporations may recover short-term profits made by insiders trading in the stock of the corporation.

1.False.The corporation may be bound because of the apparent authority of its officers, even though they may have acted beyond the scope of their actual authority.
2.True. Unlike other forms of business organizations, a corporation may be held guilty of committing a crime.
3.False.If this knowledge could have been obtained through reasonable diligence, lack of it affords no defense to a corporate fiduciary.
4.True.The federal securities regulations allow corporations to recover short-term profits made by insiders trading in the corporation's stock.

Chapter 13

CORPORATE SECURITIES AND FOREIGN CORPORATIONS

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Define the types of corporate securities.
2. Identify and give examples of foreign corporations.

Corporate securities

Securities in general. The initial assets of a corporation come from the promoters and investors. Once it is operating, additional assets and funds may be obtained from earnings, loans, and the issuance of additional stock. There are two major types of securities-equity and debt-and each type has numerous variations in form. In essence, equity securities give their holders an interest in the assets, earnings, and control of the corporation. While this interest is usually proportionate, most corporation statutes do permit different classes of equity securities with different preferences, rights, and limitations. Stock certificates are issued to represent the stock interest, but do not themselves constitute the stock. Debt securities give the holder the status of being a creditor of the corporation as opposed to an owner of it.

Kinds of corporate securities. A corporation may have many classes of stock. If it only has one class, then that class will be common stock. Where more than one class of stock exists, then the common shareholders are normally those who bear the major risk of the corporation's operations. Thus, the common shareholders normally are entitled to whatever is left after the preferences of other classes have been satisfied both as to dividends out of earnings and as to assets on liquidation. In return, the common shareholders normally have the dominant voice in the management or control of the corporation. Those classes of stock which have rights or preferences over other classes of stock are known as preferred stock. These preferences are normally as to dividends and/or assets on liquidation or dissolution of the corporation. Preferred stock may be either cumulative or noncumulative and either participating or nonparticipating. Dividends on cumulative preferred, if not paid in one year, are payable in later years if funds become available for the payment of dividends. On the other hand, dividends on noncumulative stock which are not paid in one year are not payable in a later year. Participating shareholders have a priority on a certain stated amount or percentage of dividends, and then after a prescribed dividend is paid to the common shareholders, they also share along with the common shareholders in any additional dividends paid. Preferred stock may be made redeemable-that is, the corporation may reserve the right to buy it back from the shareholder pursuant to certain predetermined terms, and a sinking fund is sometimes established by the corporation to set aside funds for redemption. Warrants and rights are options to buy stock and are commonly traded on the stock exchanges.

The debt securities of the corporation are usually denominated as bonds although short-term indebtedness may be called notes and longer term, unsecured debt may be referred to as debentures. A debenture holder is considered to be only a general creditor of the corporation in the event of bankruptcy, whereas the holder of a bond normally is a secured or priority creditor since bonds are usually backed by a security interest in some or all of the corporation's assets. The interest on bonds may either be a fixed rate or it may be payable only out of profits, depending on the terms of the bond. Bondholders, as well as the holders of other debt securities, generally have preference over any classes of stockholders.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.Equity securities give their holders an interest in the assets, earnings, and control of a corporation.

____2.If a corporation has only a single class of stock, it is regarded as common stock.

____3.Preferred stockholders normally have the dominant voice in the control of a corporation.

____4. Preferred stock is always cumulative and participating.

1.True. As the term implies, equity securities give their holders an interest in the assets, earnings, and control of a corporation.

2.True. If a corporation has only one class of stock. It is common stock.

3.False. The common, not the preferred, shareholders have the dominant voice in the control of the corporation.

4.False. Preferred stock may be either cumulative or noncumulative and participating or nonparticipating.

Stock subscriptions. A stock subscription is an agreement to buy a certain number of shares of stock in a corporation when they are issued. While the courts have held that, in the absence of statutes, a pre-incorporation subscription to buy stock is merely an offer which is open to the corporation to accept and can be revoked by the subscriber before acceptance, the statutes of most states, and the Model Act, provide that pre-incorporation subscriptions are irrevocable for a stated period of time unless the subscription agreement states to the contrary or unless all subscribers agree to a revocation. The stock subscription may provide that payment is to be made on a specified day or in installments or at the call of the corporation. Normally, a minimum amount must be paid into the corporate treasury before the corporation can commence doing business; this amount is $1,000 under the Model Act. Once an offer in the form of a stock subscription is accepted by the corporation, the subscriber becomes a shareholder even though no certificate is delivered until the purchase price is paid. This is known as "issuing stock"; if more than the total number of authorized shares are subscribed to, then stock is normally issued on a pro rata basis.

The Uniform Commercial Code sets out the liability of a corporation on the corporate securities that it issues. The corporation owes a duty not to issue more shares than it is authorized to issue. While the corporation is not liable for securities which are not genuine, it will be liable to a good faith purchaser for value if the forgery or unauthorized signature on a

security is placed on there by an employee or agent of the issuer. Corporate stock and registered bonds may be transferred by endorsement and delivery. If a stock certificate has been endorsed in blank it may thereafter be transferred by delivery. Bearer bonds are transferable by delivery alone. In view of the transferability of securities, any provision which would make the security nontransferable would be null and void as against public policy. At the same time, there are sometimes valid business reasons for restricting transferability somewhat, such as requiring that the security first be offered for sale to the corporation, and such restrictions will be enforceable if reasonable and if noted conspicuously on the certificate.

The rights of the issuing corporation are not affected by the transfer of one of its securities until the security is presented to the corporation or to its duly appointed transfer agent for registration. A corporation owes a duty to register the transfer of any registered security presented to it for registration so long as the security has been properly endorsed and all other formalities of transfer have been complied with. If the corporation wrongfully refuses to transfer a security, it is liable to the transferee.

Corporations may issue preferred stock which is subject to being called or redeemed by the corporation. Such redemption is an involuntary sale by a shareholder to the corporation at a fixed price. Moreover, a corporation may purchase its own stock from a shareholder ready and willing to sell regardless of whether there is specific authorization in its articles of incorporation. Under some corporate statutes the corporation may do so only out of funds which are unrestricted earned surplus or, in some cases, unrestricted capital surplus.

Federal and state securities legislation. The two major pieces of federal legislation which affect securities are the Securities Act of 1933 and the Securities Exchange Act of 1934. The 1933 act requires corporations that are preparing to offer securities to investors either through the mail or through some means of interstate or foreign commerce to register the issue with the Securities Exchange Commission and to provide each purchaser with a so-called prospectus which contains a large amount of prescribed information about the corporation. This same information, and more, concerning the business, management and control, capitalization, and financial condition of the corporation along with information relating to the planned use of the capital obtained from the issue and the expenses in making it must be presented in a registration statement filed with the SEC. Certain types of private sales of securities are exempted from the 1933 Act's operation. The Act also forbids certain types of deceptive and misleading statements concerning securities, provides both criminal and civil penalties for violation of the act, and gives a right of recovery to purchasers of securities who were harmed by false and misleading statements of the issuer or its agents.

While the 1933 Act covers mainly the issuance of securities, the 1934 Act deals with subsequent trading in the securities. It requires periodic reports of financial and other information concerning registered securities, sets out rules for the solicitation of proxies, prohibits manipulative and deceptive devices in both the sale and purchase of securities, provides for periodic reports of officers, directors, and principal shareholders who trade in the corporation's securities, and provides for the corporation to recover "short-swing" profits made by corporate insiders.

State securities laws-known as "blue-sky laws" also seek to protect investors from fraud and other harms which may be perpetrated on them by promoters and security salespeople. These laws vary considerably from state to state as to their specific terms; however, many of them require registration prior to issuance of stock and many are designed to dovetail with SEC rules and regulations.

Indicate whether each of the following statements is true or false by writing "T" or "'F" in the space provided.
____1.Corporate stock and registered bonds may always be transferred by delivery only.
____2.Usually a corporation may reacquire its own stock by purchasing it from its shareholders.
____3.Securities sold through interstate commerce must first be registered with the SEC.
____4. "Blue-sky" laws is a term used to refer to the SEC Acts of 1933 and 1934.

1.False. Corporate stock and registered bonds normally require endorsement and delivery for transfer.
2.True. A corporation normally may purchase its own stock from its shareholders.
3.True. If securities are sold in interstate commerce, they must first be registered with the SEC.
4.False. "Blue-sky" laws refer to state, not federal, securities laws.

Foreign corporations

Rights of foreign corporations. Corporations are "domestic corporations" in the state or country in which they are chartered and "foreign corporations" in all other states or countries. A corporation has no right to do business in any state other than the one in which it is incorporated, but all states allow foreign corporations to become "authorized" to do business within the state if they comply with certain reasonable requirements set out in the state's corporation statute. The right to do business in other states (subject of course to reasonable regulation) is granted by the Commerce Clause of the Constitution. Normally, in order to qualify to do business in another state, a foreign corporation must apply for a certificate of authority by providing information similar to that of a domestic corporation applying for a charter and must maintain a registered office and agent within the state upon whom service of process upon the corporation may be made. The foreign corporation's right to continue to do business within the state is usually conditioned upon the filing of regular reports and on paying various license and franchise fees and state taxes.

"Doing business." There are three different types of "doing business" which are recognized by the courts: (1) that which subjects the foreign corporation to suit in the state courts, (2) that which subjects the foreign corporation to taxation by the state, and (3) that which requires the foreign corporation to qualify with the state statutes in order to become authorized to conduct its business within the state. While a similar type and amount of business may subject the foreign corporation to service of process and taxation, somewhat more is required for it to have to qualify within the state.

Certain minimum contacts with a state are necessary in order to subject a foreign corporation to suit within that state. These contacts might include the making of a contract or the commission of a tortious act within the state. Such contacts, however, are usually sufficient only for purposes of suing on that contract or to recover because of that tortious act. Many states have codified this principle in the form of so-called "long-arm" statutes, which permit citizens of the state to sue foreign corporations in the state courts based on such contracts or torts; these statutes normally provide for service of process to be made on the Secretary of State.

While a state can clearly tax property of a foreign corporation which is located or stored in the state, the taxation of the income of foreign corporations has been a troublesome problem. Under a recent congressional enactment, states cannot subject transactions to tax where the only activity was the solicitation of an order for goods which was to be accepted and shipped from another state.

A foreign corporation does not have to qualify to do business in a state if its only business in that state is of an interstate nature; however, if it carries on certain acts of an intrastate nature it will have to qualify. It is difficult to give any simple rule as to what those acts must be, but they have included such things as maintaining a stock of goods or peddling goods from a truck brought in from another state. Failure to qualify within a state where such qualification is required may result in various types of penalties being imposed on the offending foreign corporation. It may be subject to fine, may have its intrastate contracts declared unenforceable by the corporation, or be denied access to the state's courts to enforce contracts made with residents of the state.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.A corporation may be both a "domestic" and a "foreign" corporation.

____2.A corporation has no inherent right to transact business in any state other than its state of incorporation.

____3.A corporation may be sued only in its state of incorporation.

____4.A corporation must "qualify" to do business in any state in which it enters into business transactions.

1.True. A corporation is a "domestic" corporation in the state in which it was incorporated and a "foreign" corporation in other jurisdictions.

2.True. But every state allows "foreign" corporations to become "authorized" to do business within its jurisdiction after meeting certain requirements.

3.False. In certain instances, "foreign" corporations may also be sued in the states in which they transact business.

4.False. A "foreign" corporation does not have to qualify to do business in a state if its only activities in that state are interstate in nature.

Chapter 14

SHAREHOLDER RIGHTS AND LIABILITIES

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Discuss and illustrate the shareholder's rights.
2. Define and give examples of liabilities.

The relationship between the shareholder and the corporation is essentially a contractual one with the articles, bylaws, state corporation statutes, and the provisions in the stock certificate constituting parts of the contract which establish the shareholder's rights and liabilities regarding the corporation. This chapter is concerned with those rights and liabilities.

Shareholder meetings. The shareholders have relatively few functions to perform, and those few functions are generally exercised by voting at shareholder meetings. The shareholders elect and remove members of the board of directors, vote on extraordinary matters such as merger or consolidation or sale or mortgage of assets not in the ordinary course of business, and vote on changes in the articles of incorporation. Most corporation statutes provide for an annual meeting of the shareholders to be held at a time specified in the bylaws. Special shareholder meetings may also be held where there are corporate matters requiring prompt shareholder action. Prior notice of the meeting is required to be given to those shareholders "of record"-that is, those shareholders listed on the corporation's books as of a certain day and who will therefore be entitled to vote at the meeting. The Model Act allows the corporation to establish in its articles of incorporation the number of shares which must be represented in person or by proxy at the shareholder meeting in order to constitute a quorum, provided that the number is at least one third of the shares entitled to vote at the meeting. The articles or bylaws will normally state who is to preside at a shareholder meeting, and it is usually the chairman of the board of directors or the president of the corporation. The corporate secretary keeps the minutes of the meeting.

Shareholder voting rights. The state corporation statutes, the articles of incorporation, and the bylaws will determine whether a shareholder has the right to vote at shareholder meetings. While the Model Act permits the issuance of so-called nonvoting stock, it also provides that such shareholders are entitled to vote on extraordinary corporate transactions such as a merger. The shareholders who hold voting stock and who are listed on the corporate books on the record date are entitled to vote. The corporation is not entitled to vote stock that it has not yet issued or that it has reacquired (called treasury stock).

While most corporate director elections are conducted with each share of voting stock entitled to one vote for each vacancy on the board, some corporations allow their shareholders the option of cumulating their votes by giving one candidate as many votes as an amount equal

to the number of directors to be elected multiplied by his or her number of shares. The cumulative voting system is designed to give minority shareholders an opportunity to be represented on the board of directors. Some states require that corporations organized in their state allow their shareholders to cumulate their votes, whereas other states merely make this option open to the corporation.

All states allow shareholders to appoint an agent to vote for them at the shareholder meeting; this agent is known as a "proxy." While some states permit proxies to be granted orally, the Model Act requires that it must be in writing. Proxies are generally revocable at any time by the shareholder, and most states place a limit on their duration. As was indicated in Chapter 13, the Securities Exchange Commission has promulgated a number of regulations which must be followed by those persons soliciting proxies from shareholders of companies whose stock is registered with the SEC. Most states allow shareholders to establish voting trusts whereby shareholders pool their voting power in order to concentrate their power. The state statutes limit the duration of such trust agreements (commonly 10 years) and provide other restrictions that must be complied with in order for the trust to be valid and enforceable; among these provisions is the requirement that the trust must have a legitimate purpose for existing.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.Most of the functions of shareholders are generally exercised by voting at shareholder meetings.

____2.Changes in the corporation's articles of incorporation must be approved by its shareholders.

____3.The officers of the corporation are entitled to vote all unissued stock.

____4.The purpose of cumulative voting is to allow the representation of minority shareholders on the board of directors.

1.True.Most shareholder functions are exercised by voting at shareholders meetings.
2.True.The shareholders must approve any changes in the corporation's articles of incorporation.
3.False.Unissued stock is not entitled to voting privileges.
4.True.Cumulative voting gives the minority shareholders an opportunity to be represented on the board of directors.

Dividends. When shareholders invest in a corporation, they normally expect to share in the earnings of the corporation through dividends. Dividends are usually paid in cash, but may be paid in property or in the stock of the corporation. In discussing dividends, a distinction must be drawn between payments to shareholders in partial liquidation of the corporation's assets and dividends which are distributions of the corporation's earnings. The state corporation statutes specify the sources from which dividends may be paid. The purpose of such specifications is to try to prevent payment of dividends which would impair the capital of the corporation. There are three principal tests utilized by different statutes to test the validity of the payment of a dividend. The first is the surplus test, which is based on the balance sheet and allows dividends to be paid so long as there is earned surplus (also called retained earnings) even though there may be no

earnings during the current year. A second test allows dividends to be paid out of current net profits even though the earned surplus account currently has a negative balance. And the third test (used by the Model Act) prohibits dividends which would render the corporation insolvent and unable to meet its debts as they become due; the Model Act also limits dividends to only earned surplus.

The board of directors has the responsibility to declare or not to declare dividends. The courts are very reluctant to interfere with the board's judgment and to dictate the course of corporate action contrary to this judgment at the bequest of a complaining shareholder. The exception to the business judgment rule is that certain preferred stock makes payment of a dividend mandatory under certain circumstances, but such stock is rare. The three major types of preferred stock are cumulative, cumulative-to-the-extent earned, and noncumulative. Most courts have held that unpaid accumulated dividends on preferred stock must be paid on liquidation of the corporation if sufficient assets are available, even though there were insufficient earnings available earlier to pay the dividends when they were due.

Dividends are sometimes paid in the stock of the corporation; such a dividend amounts to the capitalization of surplus, making it a part of the permanent capital of the corporation. The stock split is sometimes confused with the stock dividend. However, in a stock split all that happens is a change in the par or stated value of the shares and there is no transfer to or change in the total amount of capital account. The Model Act distinguishes dividends from distributions, and allows the latter to be paid from capital, as opposed to earned surplus.

After a dividend has been declared by the board, it becomes a debt owing to the shareholder and cannot be rescinded if it is a cash dividend; a stock dividend, however, may be rescinded. The corporation may treat the shareholder of record as the person entitled to receive the dividend; the right to a dividend on stock which has been sold depends on the agreement between the transferor and the transferee of the stock. In the absence of an agreement, the transferor is entitled to the dividend if the sale was made after the record date; if the sale was made on a stock exchange, the transferee gets it unless s/he buys it after it is declared to be "ex dividend" - this is five business days before the record date for the dividend.

Shareholders' right to inspect books and records. Under the common law, shareholders have the right to inspect a corporation's books and records (including the list of shareholders) so long as they have a proper purpose for doing so. Because of the difficulties of proving a proper purpose and due to obstacles often put in the way of a shareholder trying to exercise this right, most state corporation statutes, including the Model Act, grant shareholders the *absolute right* to inspect the voting list and a limited *right* (for shareholders with certain qualifications as to amount or length of ownership) to inspect books and records if they have a proper purpose. The statutes provide for penalties in the form of damages on corporate officers who improperly interfere with these shareholder rights.

Shareholder preemptive rights. If a corporation makes a nonproportionate issuance of additional shares of stock to shareholders, the proportionate interest in dividends, control, and assets of some existing shareholders will be adversely affected. The doctrine of shareholder preemptive rights was developed to allow shareholders to maintain their existing proportionate

control. In essence, it allows shareholders to subscribe to a new allotment of shares in proportion to the number of currently outstanding shares which they hold. This right normally does not apply to treasury shares (shares reacquired and held by the corporation), shares that are issued in connection with a merger, or shares issued for some noncash consideration, and there is a conflict of authority as to shares which were authorized already but have not been issued. Some state statutes allow the corporation to avoid the preemptive right, although the courts will grant relief to aggrieved shareholders where officers or majority shareholders seek to issue new shares to themselves or some other group in order to gain an advantage over other shareholders.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.
____1.Corporate dividends are always paid in cash.
____2.Dividends are declared by the board of directors of the corporation.
____3.The payment of a stock dividend involves the capitalization of earned surplus.
____4.The terms stock dividend and stock split are synonymous.

1.False. Corporate dividends are usually paid in cash, but may also take the form of distributions of property or the corporation's own stock.
2.True. The board of directors of a corporation has the authority to declare dividends.
3.True. The payment of a stock dividend amounts to the capitalization of earned surplus.
4.False. A stock dividend involves the capitalization of earned surplus while a stock split does not.

Extraordinary corporate transactions. State corporation statutes provide that shareholders are entitled to vote on fundamental changes in the structure or purpose of the corporation. Amendments in the articles of incorporation normally require the approval of a certain percentage--often two thirds--of the voting shares. Also, where the proposed amendment would affect the rights of a nonvoting class of stock, they must be given the right to vote. Most states also provide for shareholder votes for such extraordinary transactions as mergers, consolidations, the sale of assets not in the ordinary course of business, and for voluntary liquidation of the corporation. Shareholders who disapprove of a proposed merger, consolidation, or sale of most of the assets other than in the ordinary course of business are entitled to payment of the value of their shares so long as they properly register their dissent within a certain time period (10 days under the Model Act). Usually the corporation must make an offer of a certain price to the dissenting shareholders which they may accept or which they may use as the basis for a suit requesting a court to determine the fair value of the shares. This is known as the right of appraisal.

Suits by shareholders. Normally, shareholders have no right to bring suits in their own names to recover damages for the impairment of their investment resulting from some wrong done to the corporation. In such a case, the person wronged is the corporation and it is the one with the cause of action. Shareholders do have the right to bring an action in their own name where there has been some violation of their contract with the corporation (such as their right to inspect the books, or to recover a dividend declared and not paid, or to enjoin some *ultra vires* act, or to

protect their preemptive rights). Shareholders are also allowed to bring so-called "derivative" suits or class actions which are suits brought for the benefit of the corporation, its shareholders, and creditors, where the officers or directors have breached their fiduciary duty by failing to bring suit and where their failure to do so will result in injury to the corporation. In order to prevent misuse of such suits, persons wishing to initiate a derivative suit must show that they were shareholders at the time the wrong occurred and that they have exhausted their intracorporation remedies by requesting the directors (and where appropriate the shareholders) to take action. While the recovery in a shareholder derivative action accrues for the benefit of the corporation, the shareholder is entitled to be reimbursed for the cost of bringing a successful suit, including a reasonable attorney's fee. Where the officers or directors refuse to defend a suit brought against the corporation and a shareholder can show that the corporation has a good defense and will be injured if it is not defended, the courts may allow the shareholder to defend the suit on behalf of the corporation and for the benefit of the corporation, shareholders, and creditors.

Since the right to control the affairs of the corporation is vested in the holders of a majority of the shares, the courts are reluctant to interfere in the internal affairs of a corporation at the request of minority shareholders. They will, however, do so where the conduct of the majority shareholders amounts to a fraud on the minority. The relief available in an extreme case will include a court-decreed dissolution of the corporation since such discretionary relief is specifically authorized by statute in some states.

Shareholder liability. Shareholders are liable to the corporation on any unpaid portion of their share subscription contract, and this may be enforced by the trustee or receiver of an insolvent corporation for the benefit of creditors. A shareholder may also be liable for so-called "watered stock" which was issued for less than lawful consideration; in such a case the liability is computed on the difference between what was actually paid and what should lawfully have been paid. A shareholder who receives dividends knowing them to be illegal is liable for their return to the corporation; similar liability is imposed, irrespective of knowledge, if the corporation was insolvent at the time the dividend was paid.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.Most states grant shareholders the right to inspect the books and records of the corporation.

_____2.The preemptive right of shareholders normally applies to the reissuance of treasury shares.

____3.A "derivative" suit is a class action brought for the benefit of a corporation, its shareholders, and its creditors.

____4.Shareholders may be held liable for "watered stock."

1.True.Shareholders have the right (although sometimes limited) to inspect the books and records of the corporation under the laws of most states.

2.False.The preemptive right does not apply to the reissuance of treasury shares.

3.True.The corporation, its shareholders, and its creditors are intended to benefit from "derivative" suits.
4.True.Shareholders may be held liable for "watered stock" (stock which was issued for less than lawful consideration).

Chapter 15

PERSONAL PROPERTY

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Explain the acquisition of ownership of personal property.
2. Give examples of discuss bailment.

Nature and classification of property. "Property" or the "ownership of property" is generally defined as a bundle of rights which includes, among others, the exclusive right to possess, use, and dispose of objects or rights having economic value. Thus "property" may refer to an object having a physical existence; it may refer to the legal rights growing out of such an object; or it may refer to rights which have no connection at all with a physical object. A piece of land, a copyright on a book and a patent of an idea are all property and subject to being owned.

Property is commonly divided into "real" and "personal" property. *Real property* consists of the earth's crust and all things firmly attached to it; *personal property* consists of all other objects and rights that are capable of ownership. However, what is personal property today may be converted into real property tomorrow by annexation to real property, and what is real property today may be converted into personal property tomorrow by being severed from the real property. For example, a growing tree is considered to be part of the real property on which it grows; if it is cut down and saved into lumber it would become personal property; and if the lumber is used to build a house, then it would again become part of real property.

Property is sometimes divided into other classes using a different set of qualifications. It may be classified as "tangible" or "intangible." It is tangible property if it has a physical existence, such as a building or a watch; it is intangible property if it has no physical existence, such as a patent right. And property may be classified as "public" or "private" depending on whether it is owned by the government or a political subdivision of the government or whether it is owned by an individual or a business organization.

Acquisition of ownership of personal property

The ownership of personal property may be acquired in a variety of ways. The most common ways are: (1) capture or taking possession; (2) production or purchase; (3) gift; (4) finding; and (5) accession.

Capture or taking possession. Ownership of previously unowned property is obtained by taking possession of the unowned property. The person who captures wildlife, such as fish or

game, becomes the owner of it. And if property is abandoned-that is, the previous owner voluntarily parted with the property with the intent of relinquishing ownership-then the first person to reduce the abandoned property to his or her possession with the intent of claiming ownership is considered to be the owner of it.

Production or purchase. Unless a person has agreed to produce for another person, one owns the product of one's own labors. Thus, the artist or the craftworker becomes the owner of that which s/he produced unless the artist contracted to produce it for someone else, in which case the employer becomes the owner of it. By far the most common way of obtaining ownership in our society today is by purchasing it, and an extensive body of law exists regarding the purchase and sale of personal property.

Gift. A gift is a voluntary transfer of personal property from one person to another person without any consideration being given for the transfer. A valid gift requires: (1) intent on the part of the donor that s/he relinquish ownership, (2) delivery in the form of an unconditional transfer of possession from the donor to the donee, and (3) acceptance of the gift by the donee.

Gifts may be either *inter vivos or causa mortis.* An *inter vivos* gift is a present unconditional gift which, once made, cannot be revoked by the donor. On the other hand, *causa mortis* is a gift made in contemplation of death which is conditional and may be defeated if the donor is delivered from the sickness or peril under fear of which s/he made the gift, or if the donor revokes the gift before death, or if the donee dies before the donor. For example, suppose that Uncle Harry who is about to undergo a very serious operation gives his watch to his nephew with the implied understanding that it be returned if Uncle Harry survives the operation. This is a gift *causa mortis* which can be defeated if any of the three conditions mentioned above occurs.

Finding. When lost property is found, the finder obtains the best right to it as against anyone except the real owner. However, some courts have made a distinction between lost and mislaid property. Thus, if property is found on the counter in a business establishment where it might be assumed that the real owner had intentionally placed it down, then the property is considered to be mislaid property and the owner of the business establishment is given the better right to it than the finder and becomes an involuntary bailee of the property for the purpose of returning it to the real owner. However, if the property is found in a place that suggests it was not intentionally placed, it is lost property and the finder has a better right to it than the owner of the business establishment.

Accession. Usually the owner of property that is improved by the addition of labor or material becomes the owner of the improved property. However, occasionally someone substantially enhances the value of property or substantially changes the form or nature of property which actually belongs to someone else, even though the improver does not realize that it belongs to that other person. In such a case, the improver obtains good title to the improved property by "accession," even though s/he must reimburse the original owner of the property for its fair market value at the time s/he converted it by improving it without the owner's consent.

Indicate whether each of the following statements is true or false by placing "T" or "F" in the space provided.

____1.The term 'property" may refer to rights which have no connection at all with a physical object.
____2.An *inter vivos* gift may be revoked if the donor later decides that s/he did not want to give the property away after all.
____3.Someone who finds "lost" property becomes the absolute owner of it.
____4.If someone improves property which s/he does not own, it is not possible for the improver to obtain title to the property.

1.True. The term "property" may refer to a physical object, to the rights growing out of a physical object, or to rights apart from a physical object such as a patent of an idea.
2.False. A valid *inter vivios* gift, once completed, is unconditional and cannot be revoked.
3.False. The finder of lost property has a better right to it than anyone else other than the real owner, but must surrender it to the real owner.
4.False. If someone substantially enhances the value of property which belongs to someone else, even though the improver does not realize that it belongs to that other person, the improver can obtain good title to the improved property by "accession." The improver must reimburse the original owner of the property for its fair market value at the time the improver converted it.

Bailments

Creation. A bailment exists when possession of property belonging to one person is delivered to another person who intends to assume custody or control over the property and who expressly or implicitly promises to return it to the owner or to dispose of it as directed by the "owner". A bailment is essentially a contractual situation, although that contract may be implied from the facts and circumstances surrounding the transaction as well as an express contract. Thus, a bailment may exist in many situations where the parties do not realize it exists; for example, if you borrow your neighbor's car there has been a bailment of the automobile. In such a situation, the owner of the automobile is the bailor while the person who has temporary possession and custody is the bailee.

Rights and liabilities of the bailor and bailee. The duty of care imposed on the bailee may be determined by an express term of the contract. If there is no such express term, then the duty of care depends on the type of bailment involved. If the bailment is a mutual benefit bailment in that both bailee and bailor receive benefits, as is true in most commercial bailments, then the bailee owes a duty of ordinary care and is liable for loss or damage only if s/he is negligent. If the bailment is for the sole benefit of the bailor, as where you care for your neighbor's dog while the neighbor is on vacation without receiving any compensation, then a duty of slight care is owed and the bailee is liable for loss or damage only if grossly negligent. And if the bailment is for the sole benefit of the bailee, as where you are permitted to use the goods of another free of charge, then a duty of great care is owed and the bailee is liable even for slight negligence. Some courts do not go solely by the type of bailment but require all bailees to use a "reasonable" amount of care. Attempts by a bailee to contract out of his or her liability for negligence are not favored by the courts and enforcement of such provisions is often refused on the grounds that they are in contravention of public policy and void.

The bailee owes a duty to the bailor to return the property on the termination of the bailment or to deliver it to someone else on the bailor's instructions. If the bailee does not or cannot deliver the bailed property pursuant to the duty owed, the bailee must show that the goods were damaged or destroyed despite the fact that the duty of care was met, or the bailee is liable to the bailor for their value or for the loss in value.

The bailor impliedly warrants that there are no defects in the property bailed of which he or she is aware and which would make it unsafe for use. And, if the bailment is one for hire, then the bailor owes a duty to inspect the property and to make sure that it is safe for use for the purpose for which it is bailed. Some bailments are termed "special" bailments and are governed by a slightly different set of rules. Among bailees in this class of bailments are common carriers and innkeepers who are subjected to special rules because they are obliged to serve the public and are held to a higher degree of responsibility than the ordinary bailee.

Indicate whether each of the following statements is true or false by writing "T" or "F" 'in the space provided.

____1.In order for a bailment to exist, the bailee either expressly or impliedly must accept custody and control over the bailed property.

____2.A bailment may exist between parties even though neither party realizes it.

____3.A person who rents a lawn mower from a rent-all store owes a duty of slight care and is only responsible for damage due to his or her gross or willful negligence.

____4.The bailor impliedly warrants that the property bailed is safe for use and is not defective to the best of his or her knowledge.

1.True. The acceptance of custody or control by the bailee is usually the crucial element in deciding whether a bailment exists.

2.True. A bailment can exist without the knowledge of the parties to the bailment. Borrowing of property would be a bailment.

3.False. A rental for hire is a mutual-benefit bailment and the bailee owes a duty of ordinary care and is liable for damage due to negligence.

4.True. In a bailee-bailor relationship, the bailor impliedly warrants that the bailed property is safe for use and is not defective to the best of his or her knowledge.

Chapter 16

Real Property

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Differentiate between estates and interests in real property.
2. Outline the process in the acquisition of real property.
3. Discuss the concept of co-ownership of real property.
4. Distinguish between the law of landlord and tenant.
5. Describe the controls on the use of property.

Fixtures. Fixtures mark the boundary line between personal and real property. A fixture is usually defined as personal property which has been so firmly attached to, or used with, real property that it is considered to be part of the real property. The term *fixture* may also refer to property used in carrying on a business which is attached to the real estate, but which the owner is permitted to remove when leaving the real estate; this is the concept of *trade fixtures.* In determining whether personal property is deemed to have become a fixture, a number of factors are considered: (1) whether there is an agreement between the owners of the real and personal property as to the status of the property, (2) the mode of attachment, if any, to the real property, (3) the appropriateness of the use of the personal property only to that particular piece of real property, and (4) the identity of the owner of the attacher of the personal property-i.e., whether s/he is also the owner of the real property, or a tenant or mortgagor. If the personal property can be deemed to be a trade, domestic, or agricultural fixture, then generally the tenant may remove the property so long as s/he does so before the termination of the lease.

Estates and interests in real property

Fee simple. The fee simple is the basic land ownership unit in the United States. It entitles the owner to the entire property for an unlimited duration of time with the unconditional power to dispose of it during the owner's life or upon his or her death, and which will descend to the heirs if the owner dies without making a will. The owner of the fee simple may grant many subordinate rights to others without changing the nature of the interest.

Life estate. A life estate gives the holder of the estate the unlimited right to use and enjoy the property for a period of time which is limited by the holder's life or the lives of other persons in being.

Leaseholds. A leasehold gives the lessee the right to possess and use a given piece of real property either for a fixed period of time or for a time determinable at will of either of the parties.

Easement. An easement is the nonpossessory right to use or enjoy the land of another person. An easement may be created by an express grant or reservation in a deed, by implication, by estoppel, by necessity, or by prescription (adverse possession). With certain exceptions, an easement must be in writing to be enforceable.

License. A license is the temporary and revocable right to use the land of another person. It usually is created orally and for a limited and specific purpose.

Acquisition of real property

Acquisition by gift. Real property may be acquired by gift if the donor delivers a valid deed to the property either to the donee or to some third person with instructions to hold it for the donee.

Acquisition by adverse possession. A person who holds land by actual, open, hostile, adverse, and continuous possession for the period specified by statute in the state in which the land is located can acquire title to it by the doctrine of adverse possession. In some states, the possessor must also pay the taxes. In essence, the doctrine of adverse possession allows someone who acts for a certain number of years as if s/he is the owner of real property, and who performs acts on the land which should make it obvious to the real owner that someone else has taken over his or her land, to become the actual owner of the property, and to divest the previous owner of ownership.

Acquisition by purchase. All states have statutes which regulate the transfer of land within the borders of the state and which provide certain formalities which must be complied with. In general, there are two types of deeds which are used to transfer ownership to real property from one person to another: (1) the quitclaim deed, and (2) the warranty deed. When the owner-seller of real property conveys property with a warranty deed, s/he makes a covenant that s/he is the true owner of the real property and that it is not subject to any defects or encumbrances other than those of which the buyer has been made aware. Warranty deeds are of two types: (1) special, and (2) general. A general warranty deed warrants against all defects and encumbrances, whereas a special warranty deed warrants only against defects and encumbrances arising since the grantor of the deed acquired the property. A quitclaim deed, on the other hand, contains no warranty of title, and the grantor of the deed specifically conveys only that interest the grantor has in the land, which may be complete ownership or nothing.

In order to protect his or her ownership claim, the buyer of real property should immediately record the deed pursuant to the recording system in effect in the state in which the property is located. This rule also applies to mortgagees and other holders of liens on real property. A buyer should also procure a policy of title insurance whereby s/he is protected against the possibility of defects in the title to the property acquired.

Although traditionally the purchase of a house was subject to the rule of *caveat emptor*, recently, some courts have adopted the rule of *caveat venditor* in the sale of new homes and given the buyer an implied warranty of merchantable fitness or habitability.

Acquisition on death of previous owner. If a person does not make a will then at death the

owner's property will pass to his or her heirs according to the laws of intestacy; the passage of the real property will be determined by the laws of intestacy of the state in which the real property is located, and the passage of his or her personal property will be determined by the laws of the state of the deceased domicile. Of course, the owner of property who wants to be sure who will inherit his or her property at the owner's death can make a will which complies with the law in the state of execution of the will. While the statutory requirements vary from state to state, in general they require that the will be in writing, witnessed by two or three witnesses, signed by the testator in the presence of the witnesses, and declared by the testator to be his or her will at the time it is signed. A will conveys no interest in the testator's property until death, and can be revoked at any time up to the testator's death. And, in most states, a spouse who has been excluded from the deceased spouse's will may take a statutory share of the estate so that his or her rights to a portion of the property cannot be defeated by will. A few states recognize *holographic wills,* which are wills wholly written and signed in the testator's own hand. And many states recognize *nuncupative wills,* which are oral wills, insofar as they purport to dispose of a limited amount of personal property. However, the use of this type of will is often limited to people like soldiers or sailors under battle conditions, and it must be reduced to writing within a specified time by the person to whom the oral will is stated.

Indicate whether each of the following statements is true or false by writing 'T" or "F" in the space provided.

____1.A house built on a plot of land is an example of a fixture

____2.An owner of a fee simple cannot grant subordinate rights to others without changing the nature of his or her interest.

____3.A quitclaim deed contains a warranty that the grantor of the deed is the legal owner of the property conveyed by the deed and that there are no encumbrances on the property.

____4.Generally, wills need only to be written out and signed by the maker of the will in order to be legally effective.

1.True. A fixture is personal property that is so affixed or attached to real property that it is considered to be part of the real property.

2.False. An owner of a fee simple can grant many subordinate rights to others without changing the nature of his or her interests.

3.False. A quitclaim deed only purports to convey whatever interest the grantor has; a warranty deed warrants ownership and absence of encumbrances.

4.False. Generally, wills must also be witnessed by two or more persons and declared to be the maker's last will and testament.

Co-ownership of real property

Tenancy in common. Tenants in common are co-owners of real property, whose undivided ownership of the property passes on their deaths to their heirs or devisees. Tenants in common have the right to possess and use the property, and, if a disagreement arises between them, they may petition a court to partition the property-that is, to give each tenant a proportionate share in absolute ownership.

Joint tenancy. Joint tenancy is undivided ownership of property where the surviving tenant succeeds to the ownership interest of the deceased tenant with the deceased tenant having no opportunity to pass his or her interest to someone else by will. The instrument of transfer must specifically state that the transferees are to hold as joint tenants if they are to so hold.

Tenancy by the entirety. A tenancy by the entirety is essentially a joint tenancy with the right to survivorship in which the tenants must be husband and wife.

Law of landlord and tenant

A lease is both a conveyance of real property and a contract. In most states, a *lease for more than one year* from the date it is made must be in writing to be enforceable; however, in some states leases for up to three years are enforceable even though not evidenced by a signed writing. When the landlord leases the premises, s/he impliedly warrants that the tenant will have the right to the possession of the premises for the lease period and that the possession will not be interfered with; in the absence of a lease provision to the contrary, the landlord has no right to enter the premises during the duration of the lease. The landlord normally does not warrant the condition of the premises, and the tenant should make a visual inspection of the premises before renting them. However, the landlord is under a duty to disclose any hidden defects s/he is aware of, and the landlord is responsible for the upkeep of the public areas of an apartment building. In addition, many cities now have ordinances which require rental property to be habitable and to meet certain standards.

The tenant may use the premises for any legal and appropriate purpose unless the lease provides otherwise. The tenant owes the duty to return the premises to the landlord the same condition they were in when the lease began, except for normal wear and tear. Thus, the tenant must make those repairs necessary to keep the premises in this condition, and must take steps to prevent damage from the elements (such as when a window is broken or the roof leaks), but is not responsible for major upkeep repairs. In some leases the landlord agrees to make all repairs, and under some state and city statutes the landlord of residential property is obligated by law to make these repairs. If the landlord fails to do so, the tenant may in some cases have them done and recover the cost from the landlord, or the tenant may withhold the rent and may hold the landlord liable for injuries or damage sustained by reason of the landlord's failure to repair. If the premises become uninhabitable because of the landlord's acts, then the tenant may move out after giving the landlord a reasonable time to remedy the defect-this is *the doctrine of constructive eviction.*

Unless the lease prohibits an assignment, the tenant has the right to sublease the premises. The lease normally ends by "surrender" of the premises by the tenant and "acceptance" by the landlord. However, it may terminate prior to the normal expiration of the lease under the doctrine of constructive eviction noted above or if the tenant abandons the premises. If the tenant abandons the premises without sufficient legal cause, in some states the landlord must make an effort to rerent if s/he desires to hold the tenant liable for damages; in other states the landlord is under no duty to try to rerent, but if s/he does rerent, s/he loses his or her claim for damages against the prior tenant.

Controls on the use of property

While the owner of real property has the right to possess, use, and enjoy his or her property, society places a number of restraints on this right: (1) the owner cannot use it in such a way as to unreasonably interfere with the rights of others to enjoy their property-that is, the owner cannot create a nuisance on the property; (2) through the use of the "*police power,"* local and state governmental units have the right to make reasonable regulations to control the use of the property-this is commonly done through zoning and subdivision controls; and (3) governmental units have the right, through the exercise of the power of eminent domain, to take title to the property-thus private property may be taken for public purposes upon the payment of just compensation for the property taken.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.Joint tenants are co-owners of real property whose undivided ownership in the property passes on to their heirs or devisees upon the death of the joint tenant.

____2.The landlord who owns a contractual or statutory duty to make repairs and fails to do so may be held liable for injuries suffered by tenants which are attributable to the landlord's failure to repair.

____3.The doctrine of constructive eviction gives a tenant the right to move out of the premises if they become uninhabitable because of defects caused by a landlord's acts.

____4.A nuisance exists when one person makes a use of his or her land that unreasonably interferes with another person's enjoyment of his or her land.

1.False. Joint tenancy is undivided ownership of property, and the solving tenant succeeds to the ownership interest of the deceased tenant

2.True. Landlords who fail to perform their duty to repair may well be held liable for injuries attributable to the failure to repair.

3.True. The doctrine of constructive eviction gives a tenant the right to move out of premises that have become uninhabitable because of the landlord's acts, but the tenant must give the landlord a reasonable time to remedy the defect before moving.

4.True. The law of nuisance focuses on what the effect is on the neighbor's land and on his or her right to use and enjoy it.

Chapter 17

FORMATION, TERMS, TITLE, AND RISK

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Explain and define the conditions required for formation.
2. Define the terms of a contract.
3. Express the process of obtaining a title.
4. Define the factor associated with risk.

Formation. Article 2 of the U.C.C. applies only to contracts for the sale of goods; thus it does not apply to contracts for services, or for the sale of real property or investment securities. The U.C.C. is essentially a codification of current commercial practice as to the sale of goods, and deviates to some extent from the general rules of contract law discussed in Chapters 3-8. Under the U.C.C., an offer or a contract does not fail for indefiniteness of terms even though one or more terms are left open, so long as the parties intend that there be a contract and there is a reasonable basis for determining what those terms are and for giving an appropriate remedy. And an offer in writing by a merchant to buy or sell goods, which by its terms gives assurance that it will be held open, is not revocable for lack of consideration during the time stated or for a reasonable time if no time is stated, with a limit of three months in both cases.

The U.C.C. does not follow the common-law rule that the acceptance of an offer must conform in all respects to the offer. This is an accommodation to the fact of commercial life that sales contracts are often formed by the exchange of printed forms which may well have conflicting terms. Since the parties in such a case usually think and act as if they have a contract, the U.C.C. recognizes the existence of a contract and forms its terms out of those on which the writings of the parties agree, and incorporates supplementary terms under various provisions of the U.C.C.

Terms. If the parties have not agreed on a price or time for performance, a reasonable price or time are read into the contract. The U.C.C. sets out standardized shipping terms which have come to have a specific meaning through commercial practice. The terms F.O.B. (free on board) and F.A.S. (free alongside) are basic delivery terms which require the seller to deliver the goods to a carrier and to make a reasonable contract for their carriage. Unless the contract calls for F.O.B. the buyer's place of business, the buyer must bear the cost of freight. A *C.I.F.* contract means that the price includes the cost of the goods along with the cost of insurance and freight to the named destination, and a *C.F.* contract means that the cost of the goods and freight to the named destination are included in the contract price. In the C.I.F. contract the seller must, in addition to delivering the goods to a carrier and making a contract for their carriage, also procure a contract of insurance to cover the goods during their carriage. Under a “no arrival, no sale” contract, the goods are at the risk of the seller during their carriage and the seller is not liable to the buyer if the goods are lost or destroyed en route without fault of the seller.

In a sale on approval, the goods are delivered to the buyer under an agreement that s/he may test or use the goods in order to determine whether to buy them. Unless otherwise agreed, the title and risk of loss do not pass to the buyer until s/he accepts them, and the buyer may use them in any manner consistent with the purpose of the trial. If delivered goods may be returned by the buyer even though they conform to the contract, it is a "sale or return" if the goods were delivered primarily for resale to customers of the buyer. Under a sale or return, the title and risk to the goods are the buyer's, and the goods are subject to the claims of the buyer's creditors. Goods delivered "on consignment" are considered to be on "sale or return," and are subject to the claims of the buyer's creditors if the buyer operates a place of business under a name other than that of the seller of the goods. For self-protection, a consignment seller must perfect a security interest in the goods or post a notice at the place of business to alert other creditors to the seller's interest in the consignment shipment.

Statute of frauds. A contract for the sale of goods for the price of *$500 or more* is not enforceable unless there is some writing sufficient to indicate that a contract for the sale of goods has been made between the parties, and the writing must be signed by the party against whom enforcement is sought. A writing is not insufficient because it omits or incorrectly states a term agreed upon; however, it is not enforceable beyond the quantity of goods stated in the writing. Between merchants, a written confirmation sent and not objected to within ten days of its receipt operates to bind the person who received it. An oral contract is enforceable to the extent that goods have been accepted and paid for or received and accepted, but not beyond that if the contract involves more than $500. Oral contracts for the sale of goods to be specially manufactured are enforceable if the goods are not suitable for sale in the ordinary course of the seller's business and from the circumstances it is apparent that the goods were for the buyer. An oral contract is also enforceable if the party against whom enforcement is sought admits in court that the contract exists but it is only enforceable to the extent of the quantity of goods admitted.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.The U.C.C. follows the common law rule that the acceptance of an offer must conform in all respects to the offer.

____2.Under an F.O.B. contract, the seller owes the duty of delivering the goods to the carrier and making a reasonable contract for their carriage.

____3.If goods are delivered to a buyer on consignment and the buyer operates under a name other than that of the seller of the goods, the buyer's creditors can attach a claim to the goods.

____4.Under the U.C.C., an oral contract for the sale of goods with a price of $700 is enforceable in its entirety if there has been part performance of the contract.

1.False. The U.C.C. does not follow the common-law rule; instead it follows normal commercial practice and holds that a contract results where both parties think they have a contract and so act.
2.True. This is precisely the duty owed by the seller in an F.O.B. contract.
3.True. A claim can be attached unless the seller perfects a security interest in the goods or posts a notice at the buyer's place of business.

4.False. Under the U.C.C., such an oral contract is enforceable only to the extent that goods have been accepted and paid for or have been received and accepted.

Bulk sales. To prevent fraud on the creditors of sellers who sell in bulk the major part of their materials, supplies, merchandise, or other inventory, the U.C.C. contains an Article on Bulk Transfers which is designed to protect the creditors in such a situation. In general, Article 6 requires that the would-be buyer at a bulk sale must obtain a sworn list of the seller's creditors and must give the creditors notice at least ten days before taking possession of the goods. And, in some states, the buyer must use the purchase price to pay off the creditors before remitting the balance, if any, to the seller. Failure to comply with the provisions of the Bulk Transfers law results in the buyer holding the goods in legal trust for the creditors.

Passage of title. While the passage of title under the U.C.C. is not a very important factor in determining the rights and risks of the parties, the U.C.C. does set out rules as to when title passes. Title cannot pass until goods are identified to the contract, and the fact that the seller purports to retain a security interest in the goods does not affect the passage of title. Unless it is otherwise agreed, title to goods passes when the seller completes his or her performance with reference to the physical delivery of the goods. If the seller is to ship the goods, then title passes when s/he delivers them to the carrier. If the seller is to deliver the goods to the buyer, then title passes on tender of delivery. If the goods have been identified and the goods are to be delivered without moving them, then title passes at the time and place of contracting. In the event the buyer refuses to accept the goods or justifiably revokes acceptance, then title reverts to the seller of the goods.

Rights of third parties. Normally, a buyer of goods can get no better title than the seller has. Thus a person who buys goods from a thief, or from a person who acquired the title through a thief, has only the title of the vendor, which is a void title and no title at all; the buyer must surrender the goods to their owner on the owner's request. However, there are some important exceptions to this rule. If a seller has a voidable title, for example, if s/he obtained title by impersonating another person, or by using a check in payment where the check was later dishonored, or without paying when the sale was an agreed “cash sale,” then the seller may pass on good title to a good faith purchaser for value.

Any person who entrusts his or her goods to a merchant dealing in goods of that kind gives the merchant power to pass on good title to those goods to a buyer in the ordinary course of the merchant's business. Thus, if a person takes his or her television set to an appliance store to have it repaired, the appliance dealer may pass on good title to the set to one of its customers and the entruster's only recourse is against the dealer who converted it by selling it.

Risk of loss. When goods which are the subject of a contract for sale are lost, damaged, or destroyed, a determination must be made as to which of the two parties to the contract must bear the risk of loss. Under the U.C.C., risk of loss does not turn on who has title to the goods. It may be determined by an express agreement between the parties, and in the absence of an express agreement, is determined by rules set out in the U.C.C. If the seller is responsible only

for shipping the goods, then the risk of loss passes to the buyer when the goods are delivered to the carrier who is to carry them to the buyer. On the other hand, if the seller is responsible for delivering the goods to the buyer, then the risk of loss remains on the seller until the tender of delivery of the goods is made to the buyer. If no delivery of the goods is contemplated, then the risk of loss passes to the buyer on the buyer's receipt of the goods if the seller is a merchant. If the seller is not a merchant, then the risk of loss passes to the buyer on tender of delivery. If the seller has tendered delivery of nonconforming goods which would give the buyer the right to reject them, then the risk of loss remains with the seller until the defect is cured or the buyer accepts the goods. In the event that either party has insurance on the goods, the insurance inures to the benefit of the party who must bear the loss.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.Creditors of the seller have little protection under the Bulk Transfer law if a bulk buyer buys goods for cash and fails to comply with the provisions of the Bulk Transfer law.

____2.Normally, buyers of stolen goods get good title to them as long as they buy in good faith and give value for them.

____3.If you take your "bald" automobile tires to a tire recapper to be recapped and s/he recaps them and sells them to another car owner, you can recover your tires from the purchaser.

____4.If a contract calls for the seller to deliver the goods to the buyer, then the risk of loss passes to the buyer when the seller delivers the goods to the carrier.

1.False.Any failure to comply with the provisions of the Bulk Transfer law results in the buyer holding the goods in legal trust for the creditors of the seller.

2.False.Normally the buyers of stolen goods can get no better title than their seller had, which is no title at all in the case of stolen goods.

3.False. Your only recourse is against the recapping company. You have entrusted your goods to a merchant dealing in that type of goods and s/he can pass good title to those goods in the normal course of business.

4.False. The risk of loss shifts to the buyer in such a case when delivery of the goods is tendered by the carrier to the buyer.

Chapter 18

PRODUCT LIABILITY

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Explain and give example of an express warranty.
2. List and illustrate product liability.

Warranties, negligence, and strict liability are the grounds on which sellers and manufacturers of goods are held liable to the buyers of the goods for the quality, suitability, and character of the goods. Warranties are contractual grounds for this liability, whereas negligence and strict liability are usually considered to be tort grounds for it. Warranties may be either express, that is, based on representations of the seller; or implied, that is, imposed on the seller by operation of law. And warranties may pertain to the quality of goods or to title to them.

Express warranties. When any affirmation of fact or promise is made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain, an express warranty is created that the goods will conform to the promise or affirmation of fact. Likewise, any description of the goods or sample or model, which is made part of the basis of the bargain, creates an express warranty that the goods will conform to the description, sample, or model. It is not necessary to the creation of an express warranty that the seller use formal words such as "warrant" or "guarantee" or that s/he intends to make a warranty; however, a mere affirmation of the value of the goods or a statement which purports to be merely the seller's opinion or commendation of the goods does not create an express warranty.

Implied warranty of title. The seller of goods impliedly warrants that: (1) the title being passed is good, (2) the transfer is legal, and (3) the goods are free from any security interest or lien that the buyer does not have knowledge of at the time of contracting. This warranty attaches unless the buyer is aware that the seller is acting in some official capacity (such as a sheriff at a judicial sale) and cannot be excluded except by clear and unequivocal language in the contract which indicates the seller is not warranting a clear and unencumbered title.

Implied warranty of merchantability. There are two implied warranties of the quality of goods, the warranties of *merchantability* and of *fitness for a particular purpose*, which are imposed on the seller of goods by operation of law unless they are excluded or modified by the contract of sale. The implied warranty of merchantability is made by merchants dealing in goods of the kind sold, and means that in order for the goods to be up to the warranted standard they must: (1) pass in the trade under the contract description; (2) be of fair average quality within the contract description if they are fungible goods; (3) be fit for the ordinary purposes for which such goods are sold; (4) be of even kind, quality, and quantity within each unit and among all units involved; (5) be adequately contained, packaged, and labeled; and (6) conform to promises or

affirmations of fact, if any, contained on the label or container. Under the U.C.C., the serving of food and drink to be consumed either on the premises or elsewhere is a sale of goods and subject to the implied warranty of merchantability.

Implied warranty of fitness for a particular purpose. If the seller at the time of contracting knows the purpose for which the goods are required by the buyer and that the buyer is relying on the seller's skill and judgment to pick out suitable goods, the seller makes an implied warranty that the goods will be suitable or fit for the intended purpose. This warranty may apply even to nonmerchant sellers; however in all cases, it is necessary to show that the buyer was relying on the seller and that the seller knew this as well as knowing the desired purpose for which the goods are sought.

Exclusion and modification of warranties. Since warranties are considered to be part of the contract for the sale of goods, the parties are free (within certain restraints of public policy) to exclude or modify them. However, the courts are fairly solicitous of the interests of the buyers and are reluctant to allow them to contract away their rights in the warranty area unless it is clear that the buyers: (1) were aware that they were doing so and freely consented to the exclusion or modification; and (2) were not in a take-it-or-leave-it situation with a seller of considerably larger economic power. To exclude the implied warranty of merchantability, the word "merchantability" must be used, and if the exclusion is in a written contract it must be conspicuous, that is, set out in larger or different colored type so that it is likely to be noticed. To exclude the implied warranty of fitness for a particular purpose, the exclusion must be in writing and must be conspicuous. If the buyer was given an opportunity to inspect the goods and did so or refused to do so, then the implied warranties do not include those defects which should have been apparent from the inspection. Implied warranties can also be excluded or modified by course of dealing, course of performance, or trade usage. And where the contract contains both express and implied warranties, they are to be construed as consistent with each other and cumulative unless such a construction is unreasonable, in which case the intent of the parties controls.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.Warranties are tort grounds on which sellers and manufacturers of goods can be held liable to buyers of goods.

____2.The words "warrant" or "guarantee" are necessary to the creation of an express warranty of quality.

____3.The implied warranty of merchantability means, in essence, that the goods will be fit for the ordinary purposes for which they are used.

____4.The statement "the seller makes no implied warranties" in regular black type in a contract is sufficient to exclude the implied warranty of merchantability.

1.False.Warranties are contractual grounds for liability, not tort grounds.

2.False. These words are not necessary; what is needed is a promise or affirmation of fact as to the good's quality which is relied on by the buyer in the buyer's decision to purchase the good.

3.True.Merchantability has the connotation of being fit for usual purposes.
4.False.In order to exclude merchantability, the disclaimer must mention the word merchantability, and if it is in writing it must be conspicuous.

Beneficiaries of warranties. Since warranties are part of the contractual relationship between buyer and seller, the courts for some time displayed a reluctance for anyone to be able to claim the benefits of the warranty unless this person was in *"privity of contract"* with the actual seller of goods. Today, through statutory and decisional law changes, the rule of privity of contract is no longer adhered to. The demise of the rule of privity of contract is important in two areas: (1) in determining whether someone other than the buyer (e.g., someone in the buyer's family who is injured by a defective product) can sue the seller of the product, and (2) in determining whether the actual buyer of goods who is injured or has sustained other damage because of a defective product can sue not only the immediate seller, but also the manufacturer who put the product into the stream of commerce.

The U.C.C. specifically provides that a seller's warranty runs not only to the buyer of goods but that it also runs to any natural person in the family or household of the buyer, or who is a guest in the buyer's house, if it is reasonable to expect that such a person may use, consume, or be affected by the use of the goods and who is injured in his person by breach of the warranty. And the U.C.C. provides that the seller may not exclude or limit his or her liability for breach of warranty to members of the buyer's family or household or guests.

The U.C.C. does not take a position on whether a buyer may sue the manufacturer directly for breach of warranty even though the buyer did not purchase the goods directly from the manufacturer. However, virtually all courts allow recovery directly from the manufacturer. This is justified on the grounds that the manufacturer has control over the quality of the product and should be held responsible for the quality or lack thereof. In most modern marketing situations, the retailer and wholesaler are mere conduits for the product that is manufactured and advertised by the manufacturer. In those cases where the buyer recovers from the retailer for breach of warranty, the retailer usually has a right back against the manufacturer, so by allowing a direct suit against the manufacturer an unnecessary step in the litigation process is avoided.

Magnuson-Moss Warranty Act. In 1975 the Magnuson-Moss Warranty Act was enacted. This Act, which is enforced by the Federal Trade Commission, is designed (1) to provide minimum warranty protection for consumers; (2) to increase consumer understanding of warranties; (3) to assure warranty performance by providing meaningful remedies; and (4) to promote better product reliability by making it easier for consumers to choose between products on the basis of their likely reliability. Under the Act and the F.T.C.'s regulations, any seller of a consumer product that costs more than $15 who gives a written warranty to the consumer is required to clearly disclose a number of items of information concerning the warranty and to designate it as a "full warranty" or a "limited warranty." Failure to comply with the Act subjects the seller to a lawsuit for damages.

Liability based on negligence. The seller owes a duty to the buyer to use due care in the production, packaging, and sale of his or her goods so that foreseeable harm, which might proximately result from the seller's failure to use due care, will be avoided. Failure to exercise this duty of due care, which results in injury to the buyer, is the basis for a suit in negligence to recover the damages sustained by the breach of duty. Liability for negligence has been found in cases where there was: (1) a failure to adequately inspect the goods prior to sale; (2) misrepresentation as to the character of the goods and their fitness for a particular purpose; (3) failure to disclose known defects or to warn about known dangers; and (4) failure to use due care in designing and preparing the goods for sale. Lack of privity of contract is no defense to an action for negligence because it is based on tort law, not contract law, and courts do not look with favor on efforts of sellers to disclaim liability for their own negligence because it is considered to be against public policy to allow them to do so.

Strict liability. Strict liability is a means of holding a seller liable for the safety of the seller's product even though all reasonable care may have been exercised in producing and selling it-thus making the seller an insurer of the safety of the product. Strict liability arises when a product reaches customers in a defective state that presents an unreasonable danger to them; that is, more danger than they would normally expect from a product of that type. Lack of privity of contract is no defense to an action premised on strict liability, and the seller cannot defend on the grounds that s/he exercised all reasonable care. Strict liability is not accepted by all states with respect to all types of products. At present, it finds its most common acceptance with sales of food and drink, but is gradually being extended to all types of products that can be considered to be unreasonably dangerous if defectively manufactured.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.Under the U.C.C., the rule of privity of contract bars members of the buyer's family from recovering for injuries they sustained because of a breach of warranty.

____2.The U.C.C. does not take a position on whether a buyer may sue the manufacturer directly for breach of warranty when the buyer purchased the goods directly from a retailer.

____3.Lack of privity of contract is not a defense to a negligence action.

____4.Strict liability may be imposed when a defective product is more dangerous than the buyer would normally expect.

1.False. Under the U.C.C., privity of contract is not a bar to recovery by members of the buyer's family if it is reasonable to expect that person might use, consume, or be affected by the goods and is injured as a result of the breach of warranty.

2.True. The U.C.C. does not take a position on direct suits against a manufacturer by a purchaser of goods who purchased from a retailer; however, virtually all courts allow recovery directly from the manufacturer.

3.True. Negligence is a tort action, and lack of privity of contract is a possible defense only in a contract action.

4.True. Strict liability makes the seller the insurer of the safety of his or her goods where they turn out to be unusually dangerous due to a defect.

Chapter 19

PERFORMANCE AND REMEDIES

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Describe the rules of performance.
2. List and give examples of remedies.

Performance

General rules. The U.C.C. picks up many of the basic rules of contract law as they relate to determining the rights and duties of the parties as to performance of the contract for the sale of goods. Usage of trade, previous course of dealing between the parties, and current conduct of the parties are relevant in determining their duties of performance. Under the U.C.C., an agreement to modify or rescind a contract for the sale of goods does not need to be supported by consideration to be valid, as it must under general contract law. The U.C.C. does liberalize the general rules as to assignment of contract rights. Under the U.C.C., an assignment of a contract for the sale of goods includes a delegation of the duties, and if there is a contract provision generally barring assignment, such a prohibition is taken to prohibit only a delegation of duties. An assignor is not relieved of his or her liability for performance of a contract by virtue of having delegated these duties to the assignee.

Delivery. The seller has the obligation to tender delivery of goods which conform to the contract. If the contract calls for the seller to ship the goods, then the seller must deliver conforming goods to the carrier and make a reasonable contract for their carriage. If no place of delivery is specified, then it is at the seller's place of business or, if there is none, the seller's house, unless the goods are known by the parties to be at some other place at the time of contracting, in which case delivery is at that place.

Inspection and payment. Unless the parties agree otherwise, the buyer has the right to inspect the goods before accepting and paying for them. If the shipment is C.O.D., the buyer must pay before inspecting them unless the goods are marked "inspection allowed." And unless there is an agreement for credit, payment must be made after inspection of the goods. Payment may be made by check or any other means current in normal business practice unless the seller demands legal tender.

Acceptance. If after the buyer has inspected the goods or has had a reasonable opportunity to do so, the buyer indicates to the seller that s/he will keep them, or s/he fails to reject them, or does any act inconsistent with the seller's ownership, then the buyer will be deemed to have accepted the goods. Acceptance will normally be a bar to later rejection unless acceptance is

made under the reasonable assumption that the nonconformity will be cured by the seller, but acceptance does not preclude other rights such as a suit for breach of warranty, provided that timely notice of the defect is given to the seller.

Revocation. The buyer may revoke his or her acceptance of nonconforming goods if: (1) the nonconformity substantially impairs the value of the goods and they were accepted on the reasonable assumption that they would be cured and this has not been done; or (2) if the goods were accepted without discovering the nonconformity due to the difficulty of discovery. The right to revoke acceptance must be exercised within a reasonable time after the nonconformity is discovered or should have been discovered, and must be before there has been a substantial change in the goods not due to the defect.

Rejection. If the goods delivered to the buyer do not conform to the contract, then the buyer may reject all of the goods, accept all of the goods, or accept any commercial unit and reject all of the rest. Goods accepted must be paid for at the contract rate. The seller must be given reasonable notice of the rejection, and the buyer is under the duty to follow reasonable instructions as to disposition of the rejected goods. If no instructions are given and the goods are perishable, the buyer owes a duty to make a reasonable effort to sell them. Otherwise, the buyer may store them, resell them, or ship them back to the seller. In any event, the buyer is entitled to reimbursement of his or her expenses in handling the rejected goods.

Excuse from performance. A party to a contract for the sale of goods is excused from performance if, through no fault of his or her own, performance becomes commercially impracticable or impossible. If the impracticality relates to the means of transportation or payment, substitute means must be resorted to if they are available. If the impracticality only causes delay or ability to perform partially, then the seller may allocate performance among the seller's customers and they have the option of accepting the partial performance or canceling the contract.

Indicate whether each of the following statements is true or false by writing or "T" or "F" in the space provided.

____1.Under the U.C.C. an assignor cannot reduce contractual liability for performance through assignment.

____2.Unless the parties agree otherwise, the buyer has the right to inspect the goods before accepting and paying for them.

____3.As long as buyers have not indicated to the seller that they intend to keep a shipment of goods, they have not accepted them.

____4.If the buyers reject perishable goods on the grounds that they do not conform to the contract, all they have to do is to tell the carrier that they will not take them and then send notice to that effect to seller.

1.True. Performance of a contract cannot be relieved through assignment under the U.C.C.
2.True. The buyer normally does have the right to inspection before payment.
3.False. Buyers may be deemed to have accepted the goods if the buyers have not rejected them within a reasonable time or if they do any act inconsistent with the seller's ownership of them.

4.False. In the case of perishable goods, the buyer cannot just abandon them to the carrier; instead the buyer must seek instructions from the seller and if none are forthcoming, the buyer owes a duty to try to resell the goods.

Remedies

Seller's remedies. When the buyer defaults or is in breach of the contract, the aggrieved seller has a number of optional remedies available. In providing these remedies, the object of the U.C.C. is to put the seller in the same position as if the buyer had performed the contract. The seller is entitled to the purchase price of conforming goods which have either been delivered and accepted by the buyer or which have been damaged or destroyed after risk of loss of the goods has passed to the buyer. And if the goods which have not yet been delivered have been identified to the contract, then the seller may recover the purchase price of them if s/he has made an effort to make a commercially reasonable resale and was not successful or if the circumstances indicate that such an effort would be unavailing.

The seller may elect to recover damages where the buyer wrongfully refuses to accept conforming goods pursuant to the contract. The measure of damages recoverable is the difference between the market price at the time and place of tender and the unpaid contract price together with incidental expenses incurred as a result of the buyer's breach, but less expenses saved in consequence of the breach. If this measure of damages would be inadequate to put the seller in the same position as if the contract has been performed, then the seller is entitled to recover as damages the profit lost on the sale including reasonable overhead and incidental damages.

If the seller has identified the goods to the contract prior to the buyer's breach, the seller may resell the goods in a commercially reasonable manner and recover from the buyer the difference between the resale price and the contract price together with the seller's incidental expenses. If the goods are in process at the time the buyer repudiates the contract, the seller may either complete the manufacture of them in a commercially reasonable manner and then resell them, or may stop the manufacture and sell the partially completed goods as scrap or salvage. In the latter case, the seller is then allowed to recover damages to put himself or herself in the same position as if the contract had been performed.

If the seller discovers that the buyer is insolvent, then the seller may reclaim any goods sold or credit their return within ten days after they are received as long as s/he makes a demand for their return within ten days after they are received by the buyer. If a written misrepresentation of solvency has been made by the buyer to the seller within the past three months, then the ten-day rule does not apply. Also, on discovering the buyer's insolvency the seller may stop delivery of any goods currently being made by a carrier or other bailee. Delivery of goods in the hands of a carrier may also be made in the event of a repudiation or default by the buyer, but only if a full carload or truckload of goods is involved. Of course, to stop delivery, reasonable notice must be given to the carrier or bailee.

Buyer's remedies. If the seller repudiates, breaches, or is in default on the contract, then the aggrieved buyer also has a number of optional remedies open. If the goods to which the contract relates have been identified as to the contract and if they are unique so that the buyer would not be able to acquire comparable goods elsewhere, then the buyer is entitled to specific performance of the contract and may replevin (and thus obtain) the goods. If the goods are not unique, then the buyer may "cover"; that is, the buyer may acquire similar goods elsewhere and then recover damages from the seller based on the difference between the cost of cover and the contract price together with the buyer's incidental expenses in covering, but less expenses saved as a result of the seller's breach. The buyer who decides not to cover may recover as damages the difference between the market price of the goods at the time and place of tender and the contract price plus incidental expenses and in some cases consequential damages, but less expenses saved.

The buyer who accepts defective goods and wants to hold the seller liable must give the seller reasonable notice of the defects and then the buyer may recover as damages the difference between the value of the goods received and the value the goods would have had if they had conformed to the contract plus incidental and, in some cases, consequential damages. Consequential damages may be recovered only if the parties at the time of contracting contemplated that a breach of contract would result in special damage to the aggrieved party and if the consequential damages could not have been prevented by cover.

General rules. The parties may include a liquidated damages clause in the contract, and such a clause will be enforced so long as it is reasonable and the damages suffered are not readily provable. The parties may also provide for additional damages or for the limitation of damages or remedies. Such agreements are enforceable so long as they are not unconscionable; an attempt to limit consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable.

The statute of limitations on sale of goods contracts under the U.C.C. is four years from the time the cause of action arises. The parties may agree to limit this period to one year, but they cannot agree to extend it.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.If the buyer wrongfully refuses to accept goods, the seller may recover the purchase price of the goods from the buyer even though the goods might readily be resold by the seller.

____2.If a buyer has misrepresented (in writing) his or her solvency to a seller within the past three months and the buyer has become insolvent, the seller can demand return of any goods that were sent to the buyer on credit only if they have been received by the buyer within the last ten days.

____3. If aggrieved buyers "cover," they may recover as damages the difference between the cost of cover and the contract price.

____4. The usual statute of limitations under the U.C.C. for the sale of goods contracts is six months from the date of shipment from the seller's plant.

1.False.The remedy of the full purchase price is available only where it is apparent that a commercially reasonable resale would be unavailing.
2.False. The ten-day rule will not apply because of the misrepresentation of solvency. The seller can claim goods that were received by the buyer longer than ten days ago.
3.True. This is the correct measure of damages in this situation although the buyer can also recover incidental expenses.
4.False. The statute of limitations under the U.C.C. is four years from the time the cause of action arises. The parties to the contract may, however, agree to reduce this to one year.

Chapter 20

NEGOTIABILITY

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Characterize the nature and list the types of negotiable instruments.
2. Explain the requirements for negotiability.

Nature and types of negotiable instruments.

Negotiable instruments are a special category of contracts which for purposes of the facilitation of commerce enable the transferees of the instrument in some instances to obtain better rights to collect from the primary obligor than the transferor has. The assignee of a simple contract obtains no greater rights than the assignor has at the time of the assignment, and the assignee may well not be familiar with all of the defenses the obligor may have to the assigned contract. This fact subjects the assignee to a number of uncertain risks. However, the assignee of a negotiable instrument who can qualify as a holder in due course takes the instrument free from all defenses to the instrument, except those that go to its validity at its inception.

The U.C.C. deals with a wide variety of negotiable instruments-checks, drafts, notes, stocks, bonds, bills of lading, and warehouse receipts, among others. The most common types of negotiable instruments are dealt with in Article 3 of the U.C.C. under the heading of commercial paper. Commercial paper is basically a simple promise to pay money, and is used in commerce in lieu of money. There are two major classes of commercial paper-orders to pay and promises to pay. Checks and drafts are orders to pay, and promissory notes and certificates of deposit are promises to pay.

Draft. A draft is a three-party instrument in which one person (the drawer) orders a second person (the drawee) to pay a sum certain in money to a third person (the payee) either on demand or at a definite future date. The drawee is normally someone who owes money to the drawer, and through the use of the draft the drawer uses his or her credit with the drawee to discharge a debt owed to the payee. In some cases, the drawee, rather than immediately paying the payee, may merely sign his or her name across the front of the instrument. This is known as "acceptance," and by this act the drawee is obligated to pay the amount of the draft when it becomes due and payable.

Check. A check is a special kind of draft. It is a draft drawn on a bank as drawee and which is payable on demand (as opposed to some specified time in the future as an ordinary draft may be).

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.Negotiable instruments are a special category of contracts.

____2.Under both simple contract law and negotiable instruments law, the assignee of the contract or instrument can obtain no better rights than the assignor has.

____3.The holder in due course of a negotiable instrument is subject to all defenses to the instrument.

____4.A check is a draft drawn on a bank and payable on demand.

1.True. Negotiable instruments are a special category of contracts.

2.False. The advantage of a negotiable instrument over a simple contract is that an assignee of a negotiable instrument who qualifies as a holder in due course can obtain better rights than the assignor.

3.False. Those who can qualify as a holder in due course take the instrument free from all defenses to the instrument, except those that go to its validity at its inception.

4.True. This is the definition of a check, and indicates how it differs from an ordinary draft.

Promissory note. A promissory note is a very simple form of commercial paper in which one person (the maker) promises to pay a sum certain in money to a second person (the payee) either on demand or at a definite future date.

Certificate of deposit. A certificate of deposit is an acknowledgment of the receipt of money by a bank along with a promise to repay the money in the future.

Requirements for negotiability

An instrument must meet certain formal requirements if it is to be accorded the special status of a negotiable instrument. *To be a negotiable instrument it must: (1) be in writing, (2) be signed by the maker or drawer, (3) contain an unconditional promise or order to pay a sum certain in money and no other promise or order, (4) be payable on demand or at a definite future time, and (5) be payable to order or to bearer.* Negotiability is only a matter of form and should not be confused with validity or collectibility. If a particular instrument meets the formal requirements for negotiability, negotiable instruments law applies to it; on the other hand, if it does not meet these requirements, it will be controlled by general contract law.

In writing and signed. The U.C.C. does not require any particular type of writing, nor does it require that the writing appear on any particular kind of material. It is sufficient that the instrument be in writing of some kind, and writing is defined to include printing, typewriting, or any other intentional reduction to tangible form. And the signing requirement is met by any symbol executed or adopted by a party with the present intention to authenticate a writing. Thus, signing may include a subscription of the *person's* name, a typed or rubber stamped signature, or any mark or design put on the instrument for purposes of authenticating the instrument.

Unconditional promise or order. The required promise or order must bind the promisor or the person ordered to pay the instrument to pay it in all events, and it must be so drafted that the

unconditional nature of the promise is determinable solely from the face of the instrument without reference to any other document. A conditional promise or order renders the instrument nonnegotiable.

Sum certain in money. The promise or order must be to pay a sum certain in money, and this sum certain must be determinable from the face of the instrument. An instrument meets this requirement even though it is to be paid with stated interest, or with different rates of interest before and after default or a specified date, or if it provides for payment of the costs of collection or an attorney's fee in the event of default.

Payable on demand or at a definite future time. An instrument is payable on demand if it is payable at sight or on presentation or if no time for payment is stated in the instrument. An instrument is considered to be payable at a definite time if it is drawn payable on or before a stated date, or at a fixed period after a stated date, or at a fixed period after sight.

Payable to order or to bearer. When the issuer of a negotiable instrument makes the instrument payable not just to a specified person, but rather makes it payable to the "bearer" of the instrument or to the "order" of a specified person, the issuer gives the promisee of the instrument the power to cut off any personal defenses the issuer might have against the promisee by negotiating the instrument to a holder in due course. An instrument payable to "cash" is payable to bearer.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.If an instrument is negotiable, it is not necessarily also valid and collectible.

____2.In a promissory note one person (the payee) promises to pay a sum certain in money to another person (the maker) either on demand or at a definite future date.

____3.The U.C.C. states that negotiable instruments must be written in ink on paper.

____4.A piece of paper which reads "I.O.U. $10, Bob Jones" is a negotiable instrument.

1.True. Negotiability is only a matter of form and should not be confused with validity and/or collectibility.

2.False. Exactly the reverse is true. In a promissory note, the *maker makes* the promise and the *payee* is *the person to* whom *the promise is made.*

3.False. The U.C.C. does not require any particular kind of writing, nor does it require that it appear on any particular kind of material.

4.False. An "I.O.U." is only an acknowledgment of a debt and not an unconditional promise or order to pay. In addition, this instrument is not payable "to order" or "to bearer" and cannot be negotiable for that reason.

Chapter 21

NEGOTIATION AND HOLDER IN DUE COURSE

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Define the term and requirements to be negotiation.
2. Describe and give an example of a holder in due course.

Negotiation

Negotiation is the transfer of an instrument in such a manner that the transferee of the instrument becomes a "holder." A "holder" is a person who is in possession of an instrument drawn, issued or endorsed to him (or her), to his order, to bearer, or in blank. Negotiation of an instrument which is payable to bearer is accomplished merely by delivering the instrument to the intended holder; if the instrument is payable to order, the negotiation is accomplished by delivery along with any necessary endorsement. An endorsement of an instrument is made by the writing of the holder's name by him (or her) or on his behalf on the instrument or on a paper so firmly attached thereto as to become a part of the instrument. If an order instrument is transferred without the necessary endorsement, then the transferee is not a holder and as a mere transferee has only those rights his transferor had. However, a transferee for value has the right to the unqualified endorsement of his transferor.

Endorsements. An endorsement has three aspects: (1) it may be necessary for the present negotiation of the instrument, (2) it may affect what is necessary for further negotiation of the instrument, and (3) unless the endorsement is qualified, the endorser makes contractual promises to the endorsee and to later holders of the instrument. There are five kinds of endorsements recognized by the U.C.C.: (1) special, (2) in blank, (3) restrictive, (4) qualified, and (5) unqualified.

Special endorsement. A special endorsement specifies the person to whom or to whose order the instrument is payable. For example, an instrument which was originally payable to "the order of Arthur Adams" and which is endorsed "pay to the order of Bob Blake, Arthur Adams" contains a special endorsement as it now is payable to the order of Bob Blake. An instrument so endorsed becomes order paper, and must be endorsed by Blake before it can be negotiated further.

Blank endorsement. A blank endorsement specifies no particular endorsee, and often consists of a mere signature. For example, an instrument originally payable to "the order of Carl Clark" which is endorsed "Carl Clark" now contains a blank endorsement. As such, it becomes bearer paper and may be negotiated by delivery alone until it is specially endorsed.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.An instrument that is payable "to the order of John Jay" may be negotiated merely by John Jay delivering it to someone else for value.

____2.If an order instrument is transferred without the necessary endorsement, the transferee is not a holder in the legal sense of the term.

____3.A special endorsement specifies the person to whom or to whose order the instrument is payable.

____4. A blank endorsement may consist only of a signature.

1.False. An order instrument requires delivery plus an endorsement (in this instance, the endorsement of John Jay) in order for there to be an effective negotiation.

2.True. A transferee is not a holder if an order instrument is transferred without the necessary endorsement.

3.True. A special endorsement does specify the person to whom or to whose order an instrument is payable.

4.True. A blank endorsement may be a mere signature.

Restrictive endorsement. A restrictive endorsement is either conditional or purports to prohibit further transfer of the instrument. An endorsement which includes the words "for deposit only" is an example of a restrictive endorsement. A restrictive endorsement does not prevent further negotiation of the instrument; however, the first taker of an instrument containing a restrictive endorsement must pay or apply any value given for the instrument consistent with the endorsement, and to the extent that s/he does so s/he becomes a holder for value and may negotiate the instrument to someone else.

Qualified endorsement. An endorsement is qualified if the words "without recourse" or words of similar import have been added to it. A qualified endorsement means that the endorser is disclaiming the usual contractual promises that are made by an endorser.

Unqualified endorsement. A special, blank, or restrictive endorsement that does not contain any qualifying words such as "without recourse" is an unqualified endorsement and, as such, the endorser makes the usual contractual promises of an endorser.

Holder in due course

General requirements. In order to occupy the *privileged position* in negotiable instruments law known as *a holder in due course,* it is first necessary that the owner of the instrument be a "holder." As was indicated earlier, a holder is a person in possession of an instrument drawn, issued, or endorsed to him, to his order, to bearer or in blank. In addition, the holder must take the instrument (1) *for value*, (2) *in good faith*, and (3) *without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person.* All of these

requirements must be complied with if the holder is to be considered to be a holder in due course.

For value. A person must give value for an instrument in order to become a holder in due course of it. A person has given value (1) to the extent that the agreed consideration for the instrument has been performed or that s/he acquires a security interest in, or a lien on, the instrument otherwise than by legal process; (2) when s/he takes the instrument in payment of or as security for an antecedent debt; or (3) when s/he gives a negotiable instrument for it or makes an irrevocable commitment to a third person. A bank which takes an instrument from its customer and credits the customer's account with the amount of the instrument has given value to the extent that the credit is drawn upon or is irrevocable.

In good faith. Good faith means honesty in fact in the conduct of the commercial transaction. It is not necessary that a person investigate an instrument before accepting it; at the same time, if s/he acquires it under circumstances that strongly infer that there is a defect in the instrument, then s/he has not taken it in good faith and cannot qualify as a holder in due course.

Before it is overdue or has been dishonored. A person who takes a negotiable instrument after it is overdue or has been dishonored is considered to be on notice of defenses to payment of the instrument and cannot take it as a holder in due course. If an instrument is payable on a certain date, it becomes overdue at the beginning of the day after the due date. If an instrument is payable on demand, then a person must take it within a reasonable time after issue in order to qualify as a holder in due course with all the facts and circumstances of the issue and type of instrument involved determining what is a reasonable time. A reasonable time for a check drawn and payable within the United States is presumed to be 30 days. An instrument is considered to have been dishonored if it has been presented for payment or acceptance, and payment or acceptance was refused.

Without notice of a defense or claim to it on the part of any person. A person has notice of a fact when s/he (1) has actual knowledge of it, or (2) has received notice or notification of it, or (3) if from all the facts and circumstances known to him (or her) at the time in question has reason to know that it exists.

A person cannot take an instrument as a holder in due course if at the time s/he takes it, it is blank as to some material term, as this is considered notice to that person that the holder has limited authority to fill in the blanks. However, if an uncompleted instrument is filled in, then a person who later takes the instrument without notice or knowledge of the unauthorized completion can be a holder in due course. A person who takes an instrument that is irregular on its face (such as one which obviously has been erased or altered) cannot be a holder in due course and takes the instrument subject to all defenses to it, whether or not the defenses have any relationship to the irregularity.

Likewise, a person who has knowledge or notice that the obligation of any party to it is voidable in whole or in part cannot be a holder in due course. And a person who takes an instrument from a fiduciary and who has notice or knowledge that the instrument was negotiated in violation of the fiduciary duties cannot qualify as a holder in due course.

Rights of a holder in due course

A holder who qualifies as a holder in due course takes the instrument free from any "personal" defenses or claims which may exist between the original parties to the instrument and free from claims to it on the part of any third parties; however, the holder in due course is subject to rear defenses to the instrument which, in general, are defenses that go to the validity of the instrument at its inception. A holder or other owner of a negotiable instrument who does not qualify as a holder in due course takes the instrument subject to "personal" and "real" defenses and claims between the original parties to the instrument as well as claims to it on the part of third parties.

Personal defenses. Personal defenses are defenses which do not go to the validity of the instrument, but rather represent reasons why the promisor of a contract would not have to fulfill part or all of his or her promise to the original promisee of the contract. Some examples of personal defenses are lack of consideration, failure of consideration, misrepresentation or fraud in the inducement, setoff, counterclaim, and breach of warranty of goods sold for which the instrument was issued.

Real defenses. Real defenses are defenses which, in general, go to the validity of the instrument at its inception and which render it a nullity. Some examples of real defenses include minority and other incapacity to the extent that it is a defense to a contract, duress, illegality of the transaction if it renders the obligation of the party void, discharge in insolvency proceedings, and fraud in the essence or "real" fraud. Fraud in the essence occurs when a person is induced to sign an instrument without realizing or having a chance to discover that it was a negotiable instrument or what its terms are. For example, an illiterate person is asked to sign a document that s/he is told is a grant of permission to bring a TV set into his or her house, whereas in reality it is a promissory note.

Changes in the holder in due course doctrine. The holder in due course doctrine as it relates to negotiable instruments signed by consumers has been abolished or modified by state laws, court decisions, and regulations recently promulgated by the Federal Trade Commission. The F.T.C. rules require that consumer installment sales contracts and consumer credit contracts must contain a statement in bold type which states that any holder of the contract is subject to all claims and defenses which the debtor (consumer) could assert against the seller of the goods or services. Inclusion of such a clause, of course, means that any later holder of the contract is subject to the same claims and defenses that the person from whom the contract was obtained was subject to-and this person is not able to get the special protection normally accorded a holder in due course. Some states have also effectively abolished the holder in due course doctrine as it relates to consumers in consumer transactions, but the means by which this has been accomplished varies from state to state.

Indicate whether each of the following statements is true or false by placing "T" or "F" in the space provided.

____1.A restrictive endorsement prevents any further negotiation of a negotiable instrument.

____2.In order to have a qualified endorsement, the words "without recourse" must be added.

____3.A holder in due course is a holder who takes an instrument for value, in good faith, without notice of any defenses or claims to it, and before it is overdue or has been dishonored.
____4.A person who takes an instrument that is blank in some material respect can be a holder in due course as long as s/he takes it in good faith.
____5.The holder in due course doctrine, as it relates to negotiable instruments signed by consumers, has been abolished or modified recently.

1.False. A restrictive endorsement only means that the next holder must apply the value s/he gives for the instrument consistent with the restrictive endorsement, and to the extent that s/he does may be a holder in due course.
2.True. The words "without recourse" must be added to have a qualified endorsement.
3.True. This is the definition of a holder in due course.
4.False. Any material term that is left blank is sufficient to put the person on notice that the holder has limited authority to fill in the blanks. Thus, the person cannot take the instrument as a holder in due course.
5.True.State laws, court decisions, and regulations recently promulgated by the Federal Trade Commission have abolished or modified the holder in due course doctrine.

Chapter 22

LIABILITY OF PARTIES; CHECKS; DOCUMENTS OF TITLE

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Determine the liability of parties.
2. Describe the rules and regulations governing negotiable checks.
3. Explain the process to achieve and process the documents of title.

Signing. A person cannot be held liable on a negotiable instrument unless his or her signature appears on it. In determining the capacity in which a person signed the instrument, the position of the signature on the instrument is of importance in determining whether s/he signed as maker, drawer, drawee, or endorser. A person who signs an instrument as the authorized agent for someone else (such as the treasurer of a corporation signing on behalf of the corporation) must clearly indicate that s/he is signing in a representative capacity or s/he will be personally liable on the instrument. If the name of a person is signed to a negotiable instrument by someone who had no authority to do so, the signature is wholly inoperative and does not bind the person whose name is signed; however, it does operate as the signature of the unauthorized signer and makes him or her liable on the instrument.

Contractual liability of parties

Primary and secondary liability. Parties to a negotiable instrument are either primarily or secondarily liable for payment of it. The party primarily liable is absolutely bound to pay the instrument, whereas the parties secondarily liable are bound to pay the instrument in the event the party primarily liable does not pay it.

Contract of the maker and acceptor. The maker of a note and the drawee of a draft who has accepted it by signing his or her name across its face are primarily liable on the note and draft, respectively. This means that they engage that they will pay the instrument according to its tenor at the time they make their engagement or as completed, if incomplete, as long as the completion is in accordance with the authority given. The drawee bank of a check is not liable on the check unless it accepts the check by certifying it; thus, unless a check has been certified, no one will be primarily liable on it and holders must proceed to collect it on the basis of secondary liability.

Contract of the drawer. The drawer of a check or draft is secondarily liable on it and engages that upon dishonor of the instrument and notice of the dishonor, s/he will pay the amount of the instrument to the holder or to any endorser who takes it up.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.Unless there is a clear indication to the contrary, a person signing a negotiable instrument will be personally liable on the instrument.

____2.A party primarily liable on a negotiable instrument is absolutely bound to pay the instrument.

____3.A person is liable on an instrument if someone else forges his name to the instrument without permission.

____4. The drawer of a check is primarily liable on the check.

1.True. The person signing a negotiable instrument is personally liable unless s/he clearly indicates that s/he is signing in another capacity (such as an authorized agent).

2.True. The party primarily liable is absolutely bound to pay the instrument.

3.False. A person is not liable on an instrument unless his signature appears on it or his name is signed to it by his authorized agent.

4.False. The drawer of a check is *secondarily* liable; that is, s/he promises to pay it if the check is dishonored on presentment to the drawee bank and if given notice of the dishonor.

Contract of endorsers. All endorsers are secondarily liable and, unless their endorsement was qualified, they engage that upon dishonor of the instrument and notice of the dishonor they will pay the instrument according to its tenor at the time they endorsed it to any holder or subsequent endorser who takes up the instrument. Endorsers are liable in the order in which their names appear on the instrument.

Presentment. Presentment for payment or acceptance within a reasonable time is usually required in order to hold parties secondarily liable on the instrument. If presentment is delayed beyond a reasonable time without excuse, then endorsers are discharged of liability and drawers, makers, and acceptors are discharged of liability to the extent that the bank at which the instrument was payable became insolvent during the delay.

Dishonor, notice, and protest. An instrument is dishonored when it is not duly paid or accepted within the prescribed time after presentment for payment or acceptance. Upon the dishonor of an instrument, the holder has an immediate right of recourse against those parties secondarily liable on the instrument provided that s/he gives the necessary protest or notice of dishonor. Notice of dishonor may be given in any reasonable manner. Protest applies only to instruments payable outside of the United States and is a very formalized procedure whereby notarized or certified notice of the dishonor is made to the parties to be held liable on the instrument on the basis of their contract. Presentment, notice, and protest may be waived by any party and delay in presentment, notice, and protest is excused when they have been waived.

Warranty liability

Whether or not a person signs a negotiable instrument, s/he may become liable on the basis of certain implied warranties imposed on persons who transfer negotiable instruments for

consideration or, who present such instruments for payment or acceptance. The transferor of an instrument warrants that: (1) s/he has good title to the instrument, (2) all signatures are genuine or authorized, (3) the instrument has not been materially altered, (4) no defenses of any party are good against him or her (if s/he qualifies the endorsement s/he warrants that s/he has no knowledge of defenses to the instrument), and (5) s/he has no knowledge of any insolvency proceedings that have been instituted against the maker or acceptor or the drawer of an unaccepted instrument. If the transfer of the instrument is accomplished without an endorsement, then these warranties run only to the immediate transferee; however, if the transfer is accompanied by an endorsement, then the transferor's warranties run to any subsequent holder who takes the instrument in good faith. Any prior transferor and any person who obtains payment or acceptance on a negotiable instrument warrants to a person who in good faith accepts or pays the instrument that: (1) s/he has good title to the instrument, (2) s/he has no knowledge that the signature of the drawer or maker is unauthorized, and (3) the instrument has not been materially altered. The presentment warranty with respect to genuineness of the maker's or drawer's signature is not made by a holder in due course acting in good faith.

Discharge

Discharge by payment, cancellation, or alteration. All parties to negotiable instruments are usually discharged of liability when the person primarily liable on the instrument pays the full amount due to a holder in due course on or after the due date. And the liability of any party is discharged to the extent that s/he pays or satisfies the holder. However, there is no discharge for payment in bad faith or otherwise to someone who is not the legitimate owner of the instrument. In fact, a person or bank who pays an instrument on a forged endorsement is deemed to have converted it and is liable for conversion to the real owner of the instrument. The holder of an instrument may discharge it by cancellation, for example, by intentionally destroying or mutilating it. Any material alteration of a negotiable instrument by a holder with fraudulent intent discharges any party whose contract is thereby altered; however, a subsequent holder in due course may still enforce the instrument according to its original tenor.

Special liability rules

Normally, a check bearing a forged payee's endorsement is not properly payable to the drawer's account and a maker of a note is not liable to pay it to a holder if the payee's signature has been forged. And the maker or drawer is normally liable for an instrument only according to its tenor at the time s/he signed it. However, the U.C.C. makes several important exceptions to these general rules of liability.

Impostor rule. Where an impostor has induced a person to issue a negotiable instrument to the order of the impostor or confederate, then an endorsement of the instrument by any person in the name of such payee is effective as a valid payee's endorsement. Thus, if the drawer of a check makes it payable to “Bob Brown” and gives it to a man claiming to be Bob Brown, then the drawer cannot later object to the fact that the payee’s endorsement on the check is that of the impostor Bob Brown and not that of the real Bob Brown whom s/he intended to pay.

Fictitious payee rule. When the person signing as or on behalf of the drawer or maker does not intend the named payee to have any interest in the instrument, or where the agent or employee of the signer supplied his or her with the name of the payee and did not intend for him or her to have any interest in the instrument, then any person can negotiate the instrument by endorsing it in the name of the named payee and the endorsement will be effective.

Negligence. If a person is so negligent in drawing, signing, or issuing a negotiable instrument so that s/he in effect invites an alteration or unauthorized endorsement, the negligent person will be precluded from asserting the alteration or unauthorized signature against a holder in due course or other drawee or payee who pays the instrument in good faith and in accordance with reasonable commercial standards.

Checks

Drawer-drawee relationship. Since checks are widely used in commerce in the United States, it is necessary to be aware of some special rules that apply only to them. The relationship between the drawer and the drawee bank is that of creditor and debtor and also that of principal and agent. As the drawer's agent, the drawee owes the drawer the duty to honor all checks properly drawn and payable if there is a sufficient balance in the account. If the bank dishonors a check when the drawer has sufficient funds in his or her account, the bank is liable for all damages proximately caused by the wrongful dishonor. If a check would overdraw the drawer's account, the drawee bank has the right to refuse to pay it or to pay it and create an overdraft in the account which, in effect, creates a debt owing from the drawer to the drawee.

Stop-payment orders. As the drawer's agent, the drawee owes a duty to follow all reasonable instructions of the drawer. If the drawer orders the drawee to stop payment on a particular check then the drawee is under an obligation to do so as long as the stop-payment order is received in time to give the bank a reasonable time to act on it. An oral stop-payment order is valid for 14 days and a written stop-payment order is valid for six months. If the drawee pays a check despite having been given reasonable notice to stop payment, then it is liable to the drawer for any loss s/he sustains because of the payment over the stop-payment order.

Forgeries and alterations. The drawer owes a duty to make a reasonable examination of his or her monthly statement and returned cancelled checks so that any alterations or forgeries may be discovered and promptly reported to the bank. If the drawer does not perform this duty, the drawee will not have to recredit the account in the amounts of the forged and altered checks; this is particularly true if the bank can show a loss because of the drawer's failure to promptly perform the duty or the drawer's negligence.

Certified checks. When a check is certified by the drawee bank it usually will immediately deduct the amount of the check from the drawer's account. The process of certification makes the drawee bank primarily liable on the check and under some circumstances discharges the drawer from liability.

Documents of title

Negotiable instruments law also covers documents of title such as warehouse receipts and bills of lading. In order for a warehouse receipt or bill of lading to be negotiable (and thus covered by negotiable instruments law), it must provide that the goods to which it represents the title are to be delivered to the bearer of the document or to the bearer's order. The main difference between commercial paper and documents of title is that the former is an obligation to pay money, whereas the latter is an obligation to deliver certain goods.

If a negotiable warehouse receipt omits certain information and terms specified by the U.C.C., the warehouser will be responsible to the holder for any loss sustained by reason of the omission. For example, the warehouser is liable to a good faith purchaser of a warehouse receipt for any loss sustained by reason of misdescription of the goods. The common carrier of goods on a bill of lading owes similar responsibilities. Both the warehouser and common carrier are bailees and owe a duty of reasonable care in relation to the goods; thus, they are liable for any damages sustained by reason of their failure to exercise reasonable care.

The rules of law relating to the negotiation of negotiable documents of title are very similar to those relating to the negotiation of commercial paper. In general the holder in due course of a negotiable document of title gets good title to the document and to the goods; however, a thief or owner of goods subject to a valid security interest cannot use a negotiable document of title to pass on greater rights than s/he has to someone else. And similarly to the law of commercial paper, a holder who transfers a negotiable document of title warrants to the transferee that: (1) the document is genuine, (2) the holder has no knowledge of any facts that would impair its value or worth, and (3) the transfer is rightful and effective with respect to the document and the goods it represents.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1. A bank can be held liable for damages if it refuses to honor a check properly drawn and payable.

____2.A bank must follow the instruction to stop payment if it has been given a reasonable time to act on it.

____3.It is solely the bank's responsibility to discover alterations or forgeries.

____4. Documents of title, such as warehouse receipts and bills of lading, are obligations to pay money.

1.True. If a bank dishonors a check when the drawer has sufficient funds in his or her account, the bank is liable for all damages proximately caused by the wrongful dishonor.

2.True. If the bank pays a check despite having been given reasonable notice to stop payment, it is liable to the drawer for any loss sustained because of the payment.

3.False. The drawer has the duty to make a prompt and reasonable examination of his or her monthly statement and returned cancelled checks; if this is not done, the drawee will not have to recredit the account in the amounts of the forged or altered checks.
4.False. Documents of title are obligations to deliver certain *goods*, not to pay money.

Chapter 23

SECURED TRANSACTIONS

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Explain the security interests in personal property.
2. Describe security interests in real property.

Today, a major portion of commercial transactions involve the use of credit where goods are sold, services rendered, and money loaned in exchange for the recipient's promise to pay at some future date. Some of this credit is unsecured; that is, it rests only on the recipient's promise.

Other credit is secured, that is, supported by the transfer of a security interest in property owned by the debtor or by the supporting promise of a third person. If the promise of the debtor to pay is not fulfilled, then the creditor can take action to recover the debt by selling the property put up as security or by proceeding against the third person to make good on the debtor's promise. In this chapter, we will cover common-law liens, security interests in personal property, security interests in real property, and sureties and guarantors.

Common-law liens

An artisan who improves property by his or her labor and the use of the artisan's materials, a common carrier who has carried the goods of some person, and the innkeeper who has provided food and lodging are entitled to claim a common-law lien on the improved goods, transported goods, or goods of the guest until their reasonable charges have been paid. The common-law lien is a possessory lien in that it allows the lienholder to retain possession of the goods until the debt is satisfied. There must be both possession of the goods and a debt created by improving or handling the goods in order for a common-law lien to have been created. The lien does not give the lienholder the right to sell the goods if the debt is not paid; if s/he wishes to foreclose on the lien, s/he must obtain a judgment against the debtor and have the local sheriff levy execution of the judgment on the goods in the lienholder's possession and sell the goods at a sheriff's sale. In some states, this procedure has been modified somewhat by statute.

Security interests in personal property

To obtain a valid security interest in personal property, a creditor must follow the procedure set forth in Article 9 of the Uniform Commercial Code. The U.C.C. sets out the rules for obtaining such a security interest in a wide variety of types of personal property: instruments, documents of title, accounts, chattel paper, general intangibles, and goods (including consumer goods, equipment, inventory, farm products, and fixtures). In general, to obtain the maximum protection for his security interest, the creditor must attach *and perfect* the security interest.

Attachment of the security interest. The first step the creditor must take to obtain a valid security interest is to attach it to the collateral. Attachment protects the creditor against the debtor as to the particular collateral secured. In order to effect attachment, the creditor must obtain an agreement from the debtor that the creditor is to have a security interest in certain personal property, then the creditor must give value to the debtor (for unless there is a debt there can be no secured interest), and finally the debtor must actually have some rights in the collateral s/he purports to grant the security interest in. Normally, the security agreement is (and must be) in writing, is signed by the debtor, and contains a description of the collateral so as to enable it to be identified. Security agreements commonly also include the terms of the arrangement between the parties as to how repayment of the debt is to be made, what events will constitute a default, and what the debtor must do to protect the collateral from damage or loss. A security agreement may create a security interest in the proceeds of the described collateral and may also purport to create a security interest in after-acquired property of the debtor, which security interest will attach when the debtor obtains an interest in the after-acquired property.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.Unsecured credit rests only on the debtor's promise to pay.

____2.In order to create a common-law lien there must be both possession of the goods and debt created by the improvement or handling of the goods.

____3.If a debt is not paid, the holder of a common-law lien may sell the goods.

____4.Normally, the first step in obtaining a valid security interest in personal property is to perfect the security interest.

1.True. By definition, unsecured credit rests only on the debtor's promise to pay.

2.True. Both requirements must be met for a common-law lien to exist.

3.False. A common-law lien does not give the lienholder the right to sell the goods if the debt is not paid.

4.False. The first step the creditor must take to obtain a valid security interest is *to attach* it to the collateral. Such attachment protects the creditor against the debtor.

Perfection of the security interest. While attachment of the security interest protects the creditor against the debtor as to the particular collateral secured, the creditor also desires protection against other creditors of the debtor who might also wish to claim an interest in this same collateral and against third persons who might purchase the collateral from the debtor without the creditor's immediate knowledge. This protection is obtained through perfection of the security interest. In essence, perfection is the giving of public notice that this particular creditor claims an interest in certain collateral belonging to a particular debtor. The three main means of perfection under the U.C.C. are (1) public filing of a financing statement either in the secretary of state's office or the county recorder's office (depending on the type of collateral involved) to serve as public notice to the world that a particular creditor claims security interest in a particular type of collateral belonging to a particular debtor; (2) the secured party's taking possession of the collateral with the intent of holding it until the debt is satisfied and (3) in some limited situations (mainly the sale of consumer goods on purchase money security contracts), the

secured party obtains a limited perfection merely by attaching a secured interest to the goods which s/he has just sold the debtor.

Priorities among security interests. Because several secured parties may all claim that they have a security interest in the same collateral of the debtor, the U.C.C. establishes a set of rules for determining which of the conflicting interests has priority. If both security interests were perfected by filing, the first security interest filed has priority. If both have not been perfected by filing, then the first security interest perfected has priority regardless of which security interest attached first. And if none of the conflicting security interests have been perfected, then the first security interest that attached has priority. However, a purchase money security interest in inventory, which was perfected when the inventory was delivered and where the holder of the purchase money security interest gave notice to prior secured creditors claiming an interest in the after-acquired inventory of the debtor, takes priority over the prior secured creditors as to the after-acquired inventory covered by the purchase money security interest. And a purchase money security interest in noninventory goods takes preference over prior secured parties if the holder of the purchase money security interest perfects it within ten days of the receipt of the goods by the debtor.

Finally, a buyer in the ordinary course of business normally takes the goods free from any security interest created by the seller even though the security interest is perfected and the buyer knows of its existence. Thus, if you buy an automobile from a dealer who had put up his or her inventory as security for a loan from the local bank you take the automobile free from the bank's security interest and the bank must look to the dealer for repayment and not to the automobile in your hands.

Default and foreclosure. When the debtor defaults on the agreement to pay or perform, the secured party is entitled to take possession of the collateral if s/he does not already have possession. Normally, the secured party will resell the collateral, in which case s/he is entitled to the debt and the costs of foreclosure and sale out of the proceeds of the sale. If the sale produced insufficient proceeds to satisfy the debt and these costs, the secured party is entitled to a deficiency judgment against the debtor; on the other hand, if the proceeds are more than sufficient, then s/he must account to the debtor for any excess. If the collateral was consumer goods and less than 60 percent of the purchase price was paid, then the creditor may propose to keep the collateral in satisfaction of the debt and not to resell; unless the debtor objects, the creditor may do so. If the debtor objects or if more than 60 percent of the purchase price had been paid, then the creditor must sell the repossessed collateral by making a commercially reasonable resale of it.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.Perfection of the security interest is the step in the process which obtains protection for the creditor against other creditors.

____2.A buyer in the ordinary course of business takes the goods subject to any security interests the seller may have granted in the goods.

____3.Even if the proceeds from a foreclosure sale exceed the amount of the debt, the creditor need not account to the debtor for the excess.

____4.If the collateral for a debt was consumer goods, the creditor may always repossess and retain the goods.

1.True. Perfection provides protection against other creditors of the buyer and against buyers of the collateral (other than in the ordinary course of business) from the debtor.
2.False. The buyer in the ordinary course of business takes the goods free from any security interests created by the seller even if the security interest is perfected and the buyer knows of its existence.
3.False. If the proceeds are more than sufficient, then the creditor must account to the debtor for the excess.
4.False. If the debtor objects or if more than 60 percent of the purchase price had been paid, the creditor must sell the repossessed collateral.

Security interests in real property

Mortgages. The mortgage is the most common device for obtaining a security interest in real property. To be valid and afford the mortgagee (creditor) the maximum protection it should be executed with all the formalities required by the state in which the real property is located, and it should also be recorded with the county land recorder so that other would-be creditors and purchasers of the property will be on notice of the security interest represented by the mortgage. The owner of mortgaged property may sell the property. But if the mortgage has been recorded, the buyer can obtain no greater rights than the seller had; that is, a piece of real property subject to a mortgage in favor of the mortgagee. The buyer may purchase the property 'subject to' the mortgage, in which case the property may be sold to satisfy the mortgage in the event it is not paid when due but where the buyer is not personally liable for any deficiency that might remain after a foreclosure sale; or the buyer may "assumed" the mortgage, in which case s/he is personally liable in the event a deficiency remains after a foreclosure sale.

On default by the mortgagor or the mortgagor's successor in interest, the mortgagee must foreclose the mortgage to cut off the mortgagor's rights in the property. Each state has fairly strict requirements which must be met in order to foreclose a mortgage, and in most states the mortgagor has a period of time--often a year--in which s/he can redeem the property by paying off the mortgage, and until this time is tolled the mortgagee usually cannot sell the property at a foreclosure sale to realize on the lien.

Deed of trust. The deed of trust is a three party device for obtaining a secured interest in real property. The borrower deeds real property to a third person-the trustee. If the borrower makes the required payments on the debt, the property is deeded back by the trustee when the debt is satisfied. On the other hand, if the borrower defaults, the trustee is under instructions to sell the property and to pay the debt to the lender out of the proceeds, with any proceeds in excess of the debt being returned to the borrower. The deed of trust was utilized for some time as a means for avoiding the strict, court-directed foreclosure provisions of most state mortgage laws; however, most states now require the same formalities to be met with respect to foreclosing deeds of trust as must be met for mortgage foreclosures.

Land contract. The land contract is a security device for securing the balance due on a contract for the sale of land. Normally, the buyer is allowed to take possession of the property and acts for the most part as if s/he was the owner by paying taxes, making repairs, and so forth. The seller remains the legal owner of the property and does not actually deed the property to the buyer until the full purchase price has been paid. If the buyer defaults in his or her payments, the seller usually has the right to immediately retake possession and cut off all rights of the buyer in the property. Thus, the secured party can obtain possession of his or her security much quicker than is true in the event of a mortgage foreclosure, which as indicated above may well take a year.

Mechanic's lien. When a contractor or subcontractor supplies labor for the improvement of real property or a materialman (such as a lumber dealer) supplies materials which are incorporated into real property the contractor or materialman is entitled to a lien on the real estate if s/he carefully complies with the state statutes providing for such liens. These statutes differ substantially from state to state and it is difficult to generalize about them.

Surety and guarantor

Sometimes the security for a promise is the promise of another person to make good on the promise in the event the original promisor defaults. A surety is a person who joins the original promisee in making the promise, whereas a guarantor makes a collateral promise. The relation of surety or guarantor is normally created by contract, and generally any defenses which are available to the principal promisee are available to the surety or guarantor. Any agreement between the principal and the creditor which alters the risks involved in performing the primary contract will discharge the surety or guarantor unless s/he consents to it or ratifies the change. A surety or guarantor who pays the principal's debt is entitled to all the rights against the principal that the creditor originally had.

Chapter 24

BANKRUPTCY

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Summarize the conditions and requirements to declare a bankruptcy.
2. Describe the types of bankruptcy.
3. Explain the process and conditions of administration of a bankruptcy.

The federal Bankruptcy Act seeks to protect both the honest debtor and his or her creditors in the event the debtor becomes insolvent and is unable to meet his or her obligations. In general, the debtor is required to make a full disclosure of all the debtor's assets and to surrender them to the bankruptcy trustee. The trustee administers, liquidates, and distributes the proceeds of the bankruptcy estate to the creditors according to a set of priorities which takes account of preferential liens. Prior to the distribution, the trustee determines the rights of the various creditors and also recovers any preferential payments that were made by the debtor to the creditor prior to the bankruptcy proceedings. The debtor who complies with the Bankruptcy Act in an honest and aboveboard manner is granted a discharge of debts.

Bankruptcy Bankruptcy may be either voluntary or involuntary. Any person, partnership, or corporation, with the exception of a few businesses such as banks, insurance companies, and railroads, may be adjudged a *voluntary bankrupt* upon its filing a petition with the U.S. district court. If a debtor has committed an act of bankruptcy within the preceding two months and owes debts amounting to at least $1,000, then s/he may be adjudged an involuntary bankrupt upon the filing of a petition by his or her creditors. Again exception is made for banks, insurance companies, railroads, and similar businesses. Acts of bankruptcy include: (1) removing or concealing of the debtor's property with the intent to hinder, delay, or defraud the debtor's creditors; (2) making a preferential transfer which operates to favor one creditor over another; (3) allowing, while insolvent, any creditor to obtain a lien on the debtor's property through legal proceedings and not having discharged the lien in a reasonable time; (4) making a general assignment for the benefit of creditors; (5) allowing a receiver or trustee to be appointed to take charge of the debtor's property at a time s/he is insolvent; and (6) admitting in writing the debtor's inability to pay his or her debts and willingness to be adjudged a bankrupt.

Chapter 11 of the Bankruptcy Law provides for reorganization in which the debtor remains in possession of the business and in control of its operation, while the debtor and creditors are allowed to work together.

Indicate whether each of the following statements is true or false by writing “T” or “F” in the space provided.

____1.In bankruptcy, the debtor makes a full disclosure of his or her assets and surrenders them to the bankruptcy trustee.

____2.A debtor who complies with all of the provisions of the Bankruptcy Act is granted a discharge of his or her debts.
____3.In a voluntary bankruptcy, the creditors file the bankruptcy petition.
____4.Making a preferential transfer of property which favors one creditor over another is an act of bankruptcy.

1.True. The debtor in bankruptcy is required to make a full disclosure of his or her assets and surrender them to the bankruptcy trustee.
2.True.A debtor who complies with the act is granted a discharge of his or her debts.
3.False.In a voluntary bankruptcy, the petition is filed by the debtor.
4.True. Preferential payments to a creditor are one of about six classes of acts of bankruptcy.

Administration. The debtor is adjudged a bankrupt by the judge of the U.S. district court where the petition was filed. The case is then referred to a referee who organizes a meeting of the debtor's creditors who, in turn, elect a trustee. The trustee is charged with the duties of taking possession of the debtor's assets, collecting the claims against the debtor and evaluating them, setting aside exemptions of the bankruptcy and liquidating the assets and distributing them among the creditors. The trustee is the representative of the creditors in the handling of the bankruptcy estate and must provide them with a detailed accounting of the handling of the estate.

The trustee may recover for the bankruptcy estate preferential payments made by the debtor to any creditor. A preferential payment is a payment made by the debtor: (1) while s/he is insolvent, (2) within four months preceding the filing of the bankruptcy petition, (3) which enables the creditor to receive a greater percentage of his or her debt than other creditors in the same class; and (4) which was received by the creditor when there were reasonable grounds to believe the debtor was insolvent. The trustee may also take action to set aside any preferential liens which were created on the debtors property within four months before the filing of the bankruptcy petition and to recover any transfer of the debtor's property which under state law is voidable as a fraudulent transfer undertaken with the purpose of hindering, delaying, or defrauding the debtor's creditors.

Priority of claims. The creditors must file and prove their claims; then the trustee must allow the claim after examining it to see if it is legally merited. The Bankruptcy Act sets up a priority system of the various classes of claims. Secured creditors rank first and recover to the extent that they have perfected liens on the debtor's property. If their security is not sufficient to satisfy their allowable claim, then to that extent they stand as unsecured creditors and are part of that class. Then the expenses of administration, including attorney fees, are paid from the estate. Wages and unpaid commissions earned within three months of the filing of the bankruptcy petition and not to exceed $600 per employee come next. To the extent that this does not satisfy the entire claim of the employee, s/he too stands as an unsecured creditor. Then federal, state, and local taxes are paid. Finally, the unsecured creditors share the remainder, if any, of the bankruptcy estates with each receiving a pro rata share determined by the proportion of his or her claim to the total claims of the class of unsecured creditors.

Discharge. If the bankrupt has complied with the Bankruptcy Act and has not been guilty of any serious breaches of business ethics, s/he is granted a discharge of his or her debts. However, a few types of debts are not dischargeable and survive a bankruptcy proceeding. These debts, in general, are: (1) federal, state, and local taxes; (2) liabilities occasioned by the committing of intentional torts and alimony and support payments; (3) debts not properly scheduled in bankruptcy through no fault of the creditor involved; (4) those due to fraud, embezzlement, or similar offenses while in a fiduciary capacity; and (5) wages earned by employees within three months prior to the filing of the bankruptcy petition. Before the bankrupt is discharged, various creditors and officials are given an opportunity to object to the discharge.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.The U.S. district court judge is responsible for collecting the debtor's assets and for liquidating the assets and distributing the proceeds among the creditors of the debtor.

____2.The trustee may recover for the bankruptcy estate any preferential payments made by the debtor to any creditor.

____3.The unsecured creditor has the first priority to the debtor's assets.

____4.At the conclusion of the bankruptcy proceeding, the debtor is discharged of any remaining liability for unpaid U.S. income taxes.

1.False. The duties described are those of the bankruptcy trustee who is elected by the creditors of the bankrupt.

2.True.Any preferential payments made by the debtor to any creditor may be recovered for the bankruptcy estate by the trustee.

3.False. The *secured* creditor has first priority. The unsecured creditors form the lowest class of priorities in bankruptcy.

4.False.While the honest debtor is normally discharged of remaining liabilities, federal tax liabilities are one of several exceptions and there is no discharge of these liabilities.

Chapter 25

ECONOMIC RELATIONS AND THE LAW

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Differentiate between competitive torts and the protection of ideas.
2. Describe and give examples of the antitrust laws.

Competitive torts and the protection of ideas

There is now a fairly substantial body of law which seeks to protect economic relations from unreasonable interference. This law is reflected in federal and state statutes as well as in the common law. At least three general areas of protection can be delineated: (1) protection against injurious falsehoods and various deceitful practices by competitors which result in the diversion of a business's patronage or damage to its goodwill; (2) protection given to ideas through the law of trade secrets, patents, and copyrights; and (3) protection against unreasonable and unjustifiable interference with contracts or economic expectations.

Deceitful diversion of patronage. Patronage may be diverted through the oral or written publication of defamatory falsehoods concerning businesspeople's products or the quality of their services. Such statements are actionable as the tort of *disparagement* so long as the defamed businesspeople are able to show that they suffered actual damage from them. This protection also covers false statements made concerning intangible property such as trademarks, patents, and copyrighted material.

If one businessperson represents his or her goods to customers as having been made by a competitor and thereby diverts patronage from the competitor, s/he has committed a tort which is actionable under the common law. Businesspeople commonly adopt *trademarks* in the form of a distinctive mark, word, design, or picture which is affixed to their goods in order that purchasers may identify the origin of the goods with the businesspeople. Similar to trademarks are *trade names* (name under which a firm operates), *service marks* (marks used to identify services), *certification marks* (marks used by people who do not own the mark but have the right to identify the product as being approved by the owner of the mark), and *collective marks* (marks such as trade union or trade association marks used to identify the group that is the source of the product of service). Under the Lanham Act, passed by Congress in 1946, a Principal Register was established where trademarks can be registered and a Supplemental Register where other marks not registerable as trademarks can be registered. Infringement of registered marks may result in liability for damages and in having an injunction issued against the infringer.

Trade secrets, patents, and copyrights. The United States places a strong emphasis on free competition; this emphasis makes it lawful to copy a competitor’s product unless the copying

infringes trademark trade secret, copyright, or patent rights. A trade secret is a formula, pattern, device, or compilation of secret information which gives its developer some differential advantage over competitors. In order to claim a trade secret, the claimant must establish that it was protected and treated as a secret within the firm and that it was not knowledge generally known in the trade or in the firm. Trade secrets are protected only against acquisition by competitors through bribery, theft, commercial espionage, or some other wrongful means, and to the extent that such wrongful appropriation can be shown, damages and an injunction may be granted.

Patents may be obtained on new and useful inventions of a process, machine, product, composition of matter, or a new and useful improvement of one of these, or on a design or a growing plant. If the invention meets the test of being new and not having been known in the trade or offered for sale or use in the country for more than a year prior to the application for it, the patentee gets the exclusive right to use, make, or sell the patented invention for 17 years. Design patents are obtainable for a shorter period ranging between 3 1/2 to 14 years. Infringement of a patent renders the infringer liable to the patentee for profits realized plus damages suffered by the patentee, and an injunction to prevent further infringement will be issued.

Copyrights confer on the holder the exclusive right to print, publish, copy, sell or perform various literary works, lectures, plays, music, maps, works of art, photographs, chemical drawings, and motion pictures for a period of 50 years beyond the death of the last surviving author of the work with no provision for renewal. Infringement of a copyright may result in liability for actual damages or statutorily provided damages where actual damages can not be proven. Within the Copyright Act is the so-called "fair use" doctrine which allows certain restricted uses for nonprofit purposes to be made of copyrighted material without the use being construed to constitute an infringement.

Interference with contractual or economic expectations. If one person actively induces another person to break his or her contract with a third person and there is no applicable privilege excusing the conduct, the third person has an action in tort against the person who induced the breach. Some courts have also sought to protect against someone who intentionally or unjustifiably seeks to interfere with another's reasonable economic expectations.

Indicate whether each of the following statements is true or false by writing "T" or "F" in the space provided.

____1.A businessperson must show that s/he has suffered actual damages from defamatory statements in order to recover under the tort of disparagement.

____2.A patent gives its holder the exclusive right to use, make, or sell the patented article for an indefinite period.

____3.Infringement of a patent renders the infringer liable to the patentee only for damages actually suffered by the patentee.

____4.The two parties to a contract are the only ones who are subject to an action concerning performance or nonperformance of the contract.

1.True. In order to be actionable as the tort of disparagement, proof of damage from defamatory falsehoods is required.
2.False. A patent gives exclusive rights for a period of 17 years.
3.False. The infringer is *also* liable to the patentee for any profits realized.
4.False. If one person actively induces another person to break his or her contract with a third person and there is no applicable privilege excusing the conduct, the third person has an action in tort against the person who induced the breach.

The antitrust laws

Antitrust laws are designed to promote more efficient allocation of resources, greater choice for consumers, greater business opportunities, fairness in economic behavior, and avoidance of concentrated political power resulting from economic power. Competition results in greater output and lower prices than other market structures. Antitrust laws include the Sherman Act, the Clayton Act, the Robinson-Patman Act, and the Federal Trade Commission Act.

The Sherman Act. Significant abuses of economic power by various large industrial combines and trusts in the period following the Civil War led to the enactment in 1890 of the Sherman Act. This act established a public policy of preserving and promoting free competition within the American economy and has served as the cornerstone of antitrust policy. It has been supplemented by several other acts including the Clayton and Robinson-Patman Acts. The Sherman Act, like other similar enactments of Congress, applies only to restraints which have a significant effect on *interstate commerce or foreign commerce*. Those activities which are local in nature and do not affect interstate commerce may be the subject of regulation by state laws.

The Sherman Act provides both civil and criminal penalties for violations of the act. The criminal penalties include both fines and imprisonment. The civil remedies may include injunctions and decrees of divorcement, divestiture, or even dissolution at the initiation of the Department of Justice. Any person who is injured as a result of the violations of the act may bring an action for *treble damages* against the violator and also recover reasonable attorney's fees for bringing the suit. A judgment against the violator in a suit by the government can be used as proof of the violation by claimants in a treble damage action. However, if the violator enters into a *consent decree* or pleads *nolo contendere* in a suit brought by the government, this cannot be used as evidence of a violation in a later treble damage action.

Section I of the Sherman Act provides that: 'Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations, is declared to be illegal. Under the act, a *"contract "* is an agreement to restrain competition, a *"combination"* is two or more persons joining together to carry out joint action, and a *"conspiracy"* is a continuing partnership in restraint of trade. Some types of joint activities are considered to be illegal per se; that is, illegal in and of themselves, because they are considered to be without justification. These activities include: (1) agreements among competitors to manipulate their production; (2) agreements to fix prices; (3) agreements to divide markets or to allocate customers among themselves; (4) boycotts to foreclose a competitor's access to the market or to the source of supply; and (5) reciprocal dealing or tying agreements.

In addition, other types of activities are considered illegal if their purpose or effect is found to be unreasonably restrictive of competition--these are known as the "rule of reason" restraints.

Section 2 makes it a misdemeanor to monopolize, or attempt to monopolize, or to conspire with any other person or persons to monopolize any part of interstate or foreign commerce. Monopolization occurs when a firm or group of firms has the power to control prices or to exclude competitors from a market along with an intent to exercise the power. The intent must be inferred either from conduct which was aimed at creating the monopoly power or from conduct aimed at preserving such power.

The Clayton Act. Continued abuses of economic power after the passage of the Sherman Act led to the passage of the Clayton Act in 1914. This act was designed to deal with monopolistic practices *at their inception* rather than waiting until they were accomplished facts as was necessary under the Sherman Act. There are three major thrusts to the Clayton Act. First, Section 2 made certain forms of price discrimination illegal. This section was later amended and strengthened by the Robinson-Patman Act in 1936 and will be discussed in detail later in this chapter. Section 3 deals with, and makes illegal, contracts to sell or lease goods which contain exclusive dealing, requirements, or tying arrangements which have the effect of substantially lessening competition or to create a monopoly in any line of commerce. This section does not apply unless there was an actual sale or lease of services containing the prohibited conditions which create a probability that the conditions will lessen competition or create a monopoly in that line of goods. Section 7 is aimed at mergers which would have an anticompetitive effect. It prohibits the acquisition by a corporation engaged in interstate or foreign commerce (except for investment) of part or all of the stock or assets of another corporation engaged in commerce where the effect of the acquisition will be *to substantially lessen* competition or to create *a monopoly* in any line of commerce in any section of the country. Thus, the statute requires a determination of what constitutes a line *of* commerce and a *section of the* country. Once these factors are determined, the statute requires only a reasonable probability that the merger will have anticompetitive effects either on existing or on potential competition in that line of commerce and in that market area.

The Robinson-Patman Act. The original Section 2 of the Clayton Act was designed to prohibit large competitors from using local and territorial price discrimination to drive out their competitors in a given area. It did not, however, deal with the complaint of many wholesalers and retailers that suppliers would discriminate in the prices charged various competing buyers in the area. For example, some chain stores were given better prices than wholesalers who were buying to resell to small retailers. The Clayton Act focused only on the anticompetitive effect of price discrimination at the seller's level and not at the customer's level. This led to passage of the Robinson-Patman Act (actually an amendment to the Clayton Act) which has two primary objectives: (1) to prevent suppliers from attempting to gain an unfair advantage over their competitors by discriminating among buyers either as to price or by providing special allowances or services to some; and (2) to prevent buyers from using their economic power to gain an advantage over their competitors by obtaining discriminatory prices from their suppliers. Thus the overall objective is to provide an equal economic opportunity for all businesses buying and selling goods in a particular line of commerce.

In essence section 2(a) of the act makes it unlawful for any person engaged in commerce to either directly or indirectly discriminate in price between different purchasers of commodities of like grade and quality, where either of the purchases involved in the discrimination are in commerce, where the commodities are sold for use, consumption, or resale, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly on any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives benefit of such discrimination, or with customers of either of them. As interpreted by the courts, the act requires that the discrimination must involve two or more states and does not apply where all the buyers, sellers, and transactions are within a single state.

Indicate whether each of the following statements is true or false by writing 'T" or "F" in the space provided.

____1.The Sherman Act provides for only civil penalties for violation of the act.

____2.A consent decree in a suit brought by the government can be used as evidence of a violation in a later treble damage action.

____3.Both the Clayton and Sherman Acts deal with monopolistic practices only when they are accomplished facts.

____4.The Clayton Act focused on anticompetitive pricing at the customer's level.

____5.The Robinson-Patman Act deals only with interstate commerce.

1.False.The Sherman Act provides for both civil and criminal penalties. The criminal penalties include both fines and imprisonment.

2.False. When the violator enters into a consent decree or pleads *nolo contendere* this cannot be used as evidence of a violation in a later treble damage action.

3.False. While this is true of the Sherman Act, the Clayton Act was designed to deal with monopolistic practices *at their inception.*

4.False. It focused only on the anticompetitive effect of price discrimination at the *seller's* level. The Robinson-Patman Act focused on anticompetitive pricing at the customer's level.

5.True. The Robinson-Patman Act is only concerned with interstate commerce.

The Robinson-Patman Act requires two or more actual sales to different purchasers at different delivered prices within a reasonable short period of time. The act also requires that the goods (services are not covered) must be of like grade and quality; if the seller can establish actual physical differences between two products, then s/he is justified in making a price differential of his or her own choosing.

Section 2(a) applies only to those discriminations which have a reasonable probability of lessening competition. This injury may be shown at three different levels: (1) the primary level which refers to competition between the sellers; (2) the secondary level which refers to the buyer’s level and might occur where a chain store was given a better price by a seller than a small independent store; and (3) the tertiary level which refers to an injury to customers of the customers receiving the discriminatory price of a seller. There are two primary defenses available to a seller in order to justify price differentials. (1) The seller can show that the differences in price can be justified on the basis of differences in cost in the manufacture, sale, or

delivery which arise from differences in the method or quantity involved. Thus, large quantity purchases are likely to result in some cost savings to a seller as compared to small volume purchases; at the same time, the exact cost differential may be difficult to establish if it is to be used as a basis for justifying a price discrimination between buyers of different quantities of goods. (2) The other defense is that the lower price was furnished in good faith to meet an equally low price furnished by a competitor. At the same time, it is not a defense to meet a competitor's price which is known to be an unlawful price discrimination nor is it a defense to undercut a competitor's lower price or to meet the competitor's price for goods of a lower quality or of a larger quantity of goods.

The Robinson-Patman Act also deals with various merchandising activities such as advertising, displays of goods, and demonstrations and distribution of samples or premiums. Section 2(d) of the act prohibits sellers from making payments to some customers to encourage such merchandising activities unless the payment or consideration is available on proportionally equal terms to all other customers competing in the distribution of those products or commodities. Section 2(e) makes it unlawful for sellers to discriminate between purchasers for resale with respect to the furnishing of various merchandising services or facilities unless such services and facilities are accorded to all purchasers on proportionally equal terms. The proportionally equal terms may be related to the quantity of goods sold or it may be the offering of different promotional services to all and allowing the buyers to choose between them.

Section 2(f) of the act makes it illegal for a buyer to knowingly induce or accept a discrimination in price which is prohibited by Section 2(a) as discussed above; this knowledge, however, need not be that there is an actual violation of 2(a) or of the injury to competition. There are four types of civil enforcement proceedings under the act. First, the Federal Trade Commission may make an investigation and issue a complaint which may result in a cease and desist order after proceedings before the Commission. Second, the Attorney General of the United States may bring an action in a U.S. District Court for an injunction. Third, an injunction may be sought by an individual or corporation. Fourth, an individual or corporation injured by a violation of the act may bring a suit for treble damages. Moreover, Section 3 of the Robinson-Patman Act makes it a crime to participate in various kinds of price discrimination, particularly where there is the purpose of eliminating or destroying competition, but there have been relatively few such criminal prosecutions.

The Federal Trade Commission Act. The Federal Trade Commission Act created the Federal Trade Commission, an administrative agency charged with giving expert and continuing enforcement of the nation's antitrust policies. Among its powers is the very broad power of policing "unfair methods of competition in commerce and unfair or deceptive practices in commerce." The Commission has various enforcement responsibilities under a number of the antitrust acts along with its powers under its own act. It issues "cease and desist" orders against violations of its act which become final unless they are appealed to the courts; violations of such orders subject the violators to rather substantial fines.

Indicate whether each of the following statements is true or false by writing "T" "F" in the space provided.

____1.The provisions of the Robinson-Patman Act apply to the sale of both goods and services.

____2.In certain instances, price discrimination can be legally justified on the basis of cost differentials to the seller.
____3.Actions under the Robinson-Patman Act must be initiated by an individual or corporation.
____4.The Federal Trade Commission is charged with the enforcement of the nation's antitrust policies.

1.False.The Robinson-Patman Act deals only with the sale of goods.
2.True.Cost differentials to the seller may be used to justify price discrimination in certain instances.
3.False. Actions may also be initiated by the Federal Trade Commission or the U.S. Attorney General.
4.True. The enforcement of the antitrust policies of the United States is a duty of the Federal Trade Commission.

Chapter 26

EMPLOYMENT LAW

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. State the purpose of employment legislation.
2. Describe Title VII.
3. Give examples of health and safety legislation.
4. Name three functions of OSHA.
5. Explain sexual harassment.
6. List other statues that prohibit discrimination in specific areas of employment

Almost all of us are either manager or employees, and we've all thought about or experienced situations in the workplace that raise legal issues. Issues like whether an employee could be legally fired, or whether certain behavior would be considered sexual harassment, or even whether a boss can legally read an employee's e-mail.

Laws regulating employment have undergone rapid and dramatic change from the early 20th century when employment law issues were regulated primarily by the Common Law of Contract and Torts. Employees had few legal rights, except those they were able to bargain for individually in contracts. The right of employees to form labor unions and collectively bargain for employment contracts was not even established until the 1930's.

Today, the employment relationship is increasingly covered by federal and state statutes and regulations, as well as tort concepts that have been developed to protect employees. For example, all states have workers' compensation statutes, and many states have minimum wage and maximum hour laws that mirror or approximate federal statutes (e.g., the Fair Labor Standards Act) and cover employees not protected by federal laws. In addition, sometimes state laws cause analogous federal laws to be developed: e.g., following much sate legislation prohibiting the use of lie detector tests (polygraphs), Congress enacted the Employee Polygraph Protection Act (EPPA) prohibiting most private employers from using polygraph, but not proscribing paper and pencil honesty questionnaires—civil penalties, injunctions, and private lawsuits are all authorized remedies for EPPA violations.

The purpose of employment legislation is to protect workers' health and safety, provide workers with a minimum level of economic support, and—overall—foster a workplace free from both discrimination and disruptive labor/management "wars".

HEALTH AND SAFETY LEGISLATION

Workers' Compensation Historically, the common law tort system imposed huge barriers on employees seeking redress against their employers for work-related injuries. A torts approach required the employee to prove for his employers' negligence caused the injury. Employers typically used three defenses to absolve themselves of responsibility. The first, the fellow-servant doctrine, absolved the employers' responsibility when a fellow employee negligently contributed to the injury. A second defense, assumption of risk, released the employer when an injured employee had voluntarily accepted the job's risks. Finally, the third defense, contributory negligence, barred an employee's suit if the employee had in any way, contributed to the cause of his own injury.

Workers' compensation laws were enacted to provide a sure remedy for injured employees. Under common law, they had to sue the employer, prove negligence, and be subject to various defenses. Workers' compensation is usually the exclusive remedy for an injured employee against the employer. Amounts awarded under typical workers' compensation laws may be for (1) wage loss, (2) medical costs and devices, (3) loss of body members, and (4) death. Only a portion of wage-earning capacity is usually awarded.

Workers' compensation statutes do not cover actions by or against parties other than the employer and employee. (Such actions are brought in tort law). Also, employers must assume financial responsibility for potential claims by obtaining insurance, paying into a state fund, or having sufficient assets to qualify as self-insured. Administrative agencies and appellate courts increasingly have allowed workers' compensation for illnesses if they truly are "occupational diseases": related to specific job hazards, with a scientifically supported casual link between hazard and injury. Agencies and courts also are recognizing the need to provide benefits for mental injuries caused by job-related stress. However, most such awards only are granted when some physical impact accompanies the mental injury.

OSHA Many States also have legislation on health and safety in the workplace. The primary statute in this area, however, is the federal Occupational Safety and Health Act (1970). This act, which applies to all employers engaged in business affecting interstate commerce, states that all workplaces are to be "free from recognized hazards," which could cause death or serious injury. The act establishes a federal agency, the Occupational Safety and Health Administration (OSHA), to ensure that both employers and employees comply with health and safety standards. OSHA conducts inspections and investigations: employers must keep comprehensive records on their research, job hazards generally, OSHA enforcement, and—most important—employees' illnesses and accidental deaths or injuries. OSHA rules further maintain that all affected employers must document and report to OSHA, not just fatal and harmful occurrences, but unsafe incidents, accidents lost work days, job transfers and terminations, medical treatments, and restrictions on work. OSHA prohibits an employer from discharging an employee for revealing OSHA violations.

Besides OSHA, the act created the National Institute for Occupational Safety and Health (NIOSH), and the Occupational Safety and Health Review Commission (OSHRC). The NIOSH is charged with conducting research into health and safety standards and recommending new rules or regulations to OSHA. It also conducts training seminars that educate employers and

employees on new ways to make the workplace safer. The OSHRC is an independent organization that reviews appeals from OSHA's decisions.

Three trends are apparent: (1) as with most other federal administrative agencies, OSHA is bound to study and verify that its new regulatory proposals, if enacted, would provide societal benefits exceeding their costs: (2) OSHA has been promulgating regulations, which set forth performance standards focusing on a level of protection rather than a particular device to achieve that protection; (3) OSHA has gone beyond just concentrating on immediate, overt dangers to life and limb, and it instead increasingly emphasizes the "hidden" hazards from relatively low-level exposure to toxic workplace chemicals sometimes linked to "delayed manifestation diseases," such as cancer and asbestoses.

The Family and Medical Leave Act of 1993 (FMLA) The FMLA requires governmental employers and the private employers of 50 or more workers to provide their employees up to 12 weeks of unpaid leave for their own serious illness, the birth or adoption of a child, or the care of a seriously ill child, spouse, or parent. Eligible employees are those who give reasonable notice and have worked for the employer at least one year—a minimum of 1250 hours annually. The leave can be taken all at once or in increments of as little as an hour at a time. Workers who take such leaves must be allowed to return to the same or equivalent jobs, with the same pay and benefits. (Employers can exempt the highest-paid 10% of their workforce, who thus are not guaranteed to get their jobs back.) When state laws or employment contracts are more generous than the federal act, employers must abide by the state law or the contract.

FAIR LABOR STANDARDS ACT

The Fair Labor Standards Act (FLSA) was enacted in 1938. The FLSA:

1. Establishes a minimum wage. The minimum wage may be reduced by equivalent rewards in the form of food or lodging. Employers also may count as salary up to one-half of the tip share when it exceeds $20 in a month.
2. Mandates payment of "time and a half" (150% of the normal wage rate) for overtime work, with a regular work week being 40 hours. Travel time to and from work generally is not compensable time unless it is part of preliminary or postliminary activities (e.g., employer transportation of workers to or from the work site). Compensable activities include preparatory actions, such as readying tools and equipment at the beginning of the work day, and post-work actions, such as winding down operations and cleaning up the work site.
3. Exempts from coverage professionals, executives, and administrative or outside sales personnel, as well as workers at very small and/or seasonal businesses, such as agriculture and fishing. Many states, though, have their own state version of the FLSA that applies to some employees not protected under the federal laws.
4. Generally forbids any employment of children under 14 years old.
5. Prohibits employment of persons under age 18 in hazardous occupations (e.g., logging or mining), and further restricts the employment of 14-and 15-year olds to non-school hours

in nonhazardous, nonmanufacturing jobs, such as retail stores, food service establishments, and gas stations.

The Secretary of Labor can sue for back wages, an equal amount as civil penalty, and injunctions. Private parties also can seek back pay, the civil penalty, and attorney's fees. Willful FLSA violations can lead to fines and imprisonment.

INCOME PROTECTION

For Workers Discharged Without Cause Unemployment compensation is a state insurance system intended to supplement unemployed workers' incomes. An unemployed workers' total payable benefits are a percentage of his average earnings when he was employed. All private, for-profit employers that have at least one employee working one or more days a week for 20 or more weeks per year, or that have a payroll of at least $1,500 per quarter, are required to participate.

Under a joint federal-state program (both governments making contributions, along with employers), a tax on the participating employers is paid into unemployment insurance plans. The tax is based on the employer's number of employees, the wages they are paid, and the employer's record in laying off or retaining workers. Workers in the covered (taxed) businesses, if discharged "without cause" (through no fault of their own), can collect unemployment compensation. The amount of and time period for this compensation varies from state to state, but there are federally prescribed minimums and the federal government often furnishes supplemental unemployment compensation.

To qualify for unemployment compensation, discharged workers must have worked for at least a minimum time period or have earned at least a minimum amount of wages, with eligibility varying from state to state. At all times the unemployed worker must be seeking a job for which he is qualified. The discharged worker may be disqualified from receiving benefits if he rejects a job offer, or is not ready and available for work, or fails to follow proper procedures in filing claims for compensation.

Another protection is the federal WARN (Worker Adjustment and Retraining Notification) Act that took effect in 1989. This act requires large businesses (those with over 4,000 total work hours per week) to give workers at least 60 day's notice before a plant closing or mass layoff. A shorter notice period is allowed only if due to *unforeseeable* business circumstances. Employees and unions may obtain monetary damages if an employer violates WARN.

For Disabled or Retired Workers The two most important federal statutes on retirement benefits are the Social Security Act of 1935 (SSA) and the Employment Retirement Income Security Act of 1974 (ERISA). Both have been frequently amended.

Social Security

SSA provides money when incomes from employment are reduced or cease because of death, disability, or retirement. The Federal Insurance Contributions Act (FICA) mandates that, for all of an employee's federal earnings up to a statutory maximum amount (now $87,000 per annum),

the employer must withhold a specified percentage of the employer's wages and also contribute a matching amount. This pool of money derived from employee contributions and matching employer contributions goes directly into the Social Security Trust Fund. This fund provides compensation when job incomes decline or cease because of death, disability, or retirement.

Employers must keep detailed records, file quarterly reports, and (usually) make monthly payments of the amounts withheld and matched. Violations can lead to severe civil and criminal penalties.

ERISA

When private pension plans were originally introduced, they were usually gratuitous rewards that could be revoked or reduced at the employer's will. The unpredictability and arbitrariness of these early plans helped lead Congress to pass ERISA. The act was designed to regulate private retirement plans. It does not require that employers establish a pension, but ERISA does contain complex vesting requirements that determine when an employee's right to receive pension benefits is irrevocable.

ERISA sets standards for the funding of private pensions. It governs eligibility for and the taxation of pension plan earnings and benefit payments. In order to be an ERISA qualified pension plan, a plan must be administered by an individual who is charged with the responsibility to handle the pension funds. This administrator has a fiduciary duty to the plan's beneficiaries. He must carefully invest funds and protect the beneficiaries. In addition, the administrator must disclose to the Labor Department of the terms of the plan, annual financial reports, and annual summaries of each beneficiary's interest.

ERISA establishes a Pension Benefit Guaranty Corporation, and both the Department of Labor and the Internal Revenue Service promulgate ERISA regulations and also for governmental or private civil actions (lawsuits by or for pension holders) alleging pension mismanagement or fraud.

PROTECTION AGAINST DISCRIMINATION

The Doctrine of Abusive (Wrongful) Discharge At common law, a worker without an employment contract was called an "at-will" employee: the employee could quit at any time, for any reason, the employer could fire him at any time for any reason. However, federal and state statutes have now limited the scope of the at-will doctrine. For example, under antidiscrimination laws, most at-will employees cannot lawfully be fired because of their race, sex, or religion. Also most state courts have ruled that certain reasons for firing any person are so pernicious as to be disallowed (i.e., the fired worker can sue for damages).

Examples: Unacceptable Reasons for Firing (thus constituting an Abusive Discharge)

1. A worker asks his superiors to obey securities or environmental laws
2. An employee is about to become entitled to a bonus.
3. A worker exercises a statutory right (e.g., files a workers' compensation claim).

4. An employee refuses to participate in antirust violations.
5. A worker seeks to have his/her employer comply with consumer protection laws.
6. An employee reports criminal activity by his/her employer (the whistleblower exception to at-will employment).

Thus, while many employment relationships remain at-will, with the employee always free to quit and the employer usually free to fire, there are now some expectations to the employer's freedom: broad statutory schemes and case-law requirements that employers obey the law and common notions of public policy. (Apart from this tort doctrine, at-will employment has also been restricted by finding implied contracts of good faith and fair dealing—e.g., implied or even express contracts based on statements in a company's Employee Handbook..)

Federal Statutes Although cases on abusive (wrongful) discharge have raised importance, federal statutes still dominate the law concerning employment disputes. The most important statue on discriminatory employment practices is Title VII of the Civil Rights Act of 1964. Under the Equal Employment Opportunity Act (1972) and subsequent amendments, the Equal Employment Opportunity Commission (EEOC) enforces Title VII and other federal statutes such as the Equal Pay Act, the Age Discrimination in Employment Act, and the Americans with Disabilities Act. The EEOC may investigate, conciliate, and litigate grievances filed by existing and prospective employees. It is also authorized to issue rules implementing the antidiscrimination laws.

Complaints may be filed by individuals, state human rights (fair employment) commissions, or the EEOC itself. Of course, as with other administrative proceedings, appeals may be taken to the courts. (Also, under federal statutes predating Title VII, if a claim includes constitutional rights allegedly deprived "under color of state law or custom," i.e., with the state's explicit or implicit approval or condonement, a plaintiff can bypass the EEOC and proceed directly to federal court.

Title VII applies to any employment agency (including unions that operate hiring halls) and any business or labor organization that affects interstate commerce and has at least 15 workers/members. Court remedies for a winning plaintiff include back pay, attorney's fees, reinstatement order, retroactive seniority and pension benefits, injunctions, and consent decrees.

Title VII outlaws discrimination in hiring, firing, promotion, compensations, or any other aspect of employment, because of an individual's race, color, religion, sex, or national origin. Title VII also prohibits any employment discrimination against someone because he/she opposed a Title VII violation or participated in a Title VII investigation or proceeding (e.g., making a charge, testifying, or otherwise assisting at a proceeding). Thus, discriminatory employment practices are illegal if based on a person's membership in a protected class (by race, sex, color, national origin, or religion); the discrimination involves treating other employees or job applicants better than members of the protected class. Employment practices are unlawful if they help perpetuate previous discrimination.

Certain exemptions are permitted, that is, courts recognize a lawful reason to discriminate (a *bona fide occupational qualification)* when religion, sex, or national origin is, in effect, a job

requirement. Examples: a Baptist church may interview only Baptist ministers for the job of parish pastor; a seminary may consider the religion of its teaching applicants; a theater company may only interview women to play the role of a woman. While employers are required to try to accommodate an employee's religious beliefs, that accommodation need only be reasonable; the employer can fire an employee rather than significantly disrupt work place productivity.

The equal Employment Opportunity Commission (EEOC) has the power to enforce Title VII and other federal statutes, such as the Equal Pay Act. Complaints may be filed by individuals, state human rights commissions, or the EEOC itself, and appeals may be taken to the courts. Since required procedures before the EEOC or comparable state agencies often are very complicated, it is important that all covered employers, unions, and employment agencies—even those not currently involved in a dispute—maintain accurate records, file even mandated reports, and keep abreast all of employment law requirements.

Title VII not only bans expressly discriminatory practices and actions (cases where discriminatory motives are clear), but it also prohibits discrimination under the judicially created doctrines of *disparate treatment, adverse impact,* and *pattern or practice*.

Disparate Treatment

To win under disparate treatment, the plaintiff must demonstrate what appears to be discrimination on its face (e.g., she interviewed for a job, she was qualified for that job, she was not hired, and the employer continued to search for a new employee). The burden then shifts to the defendant employer to show that there were genuine, legitimate, nondiscriminatory reasons for its challenged employment decision. Finally, if the defendant puts forth such reasons, the burden shifts back to the plaintiff to show that these reasons were only a pretext or pretense (that the defendant, in fact, practiced discrimination). Such pretext would be shown, for example, if the defendant's alleged hiring criteria were only applied to women, not similarly situated men.

Adverse Impact

Under this theory, plaintiffs must show that the allegedly discriminatory employment practices (tests, educational degree requirements, height and weight limits, etc.), while neutral on its face, has an unequal (disproportionate), negative (adverse) impact on one or more classes of individuals covered by Title VII. The defendant employer must establish that the practice is a "business necessity," and therefore legitimate (e.g., a test is job-related because it predicts how well a potential employee would perform tasks essential to the job that he seeks). Then, the plaintiff may still succeed if he/she demonstrates that other criteria or methods would achieve the employer's purposes with less impact on (less harm to) the protected group(s).

Pattern or Practice

Sometimes the government or private plaintiffs can use statistics to show that there are a much greater percentage of protected group members in the local labor market as compared to the group's representation in the defendant employer's work force. This fact may indicate a Title VII violation through a *pervasive pattern or practice of discrimination.* However, a defendant employer is permitted to rebut any inference of discrimination by introducing its own evidence.

Sexual Harassment There are two types of sexual harassment, both of which violate Title VII: (1) *quid pro quo*—requiring an employee to engage in sexual activity in order to keep his/her job, get an increase salary, obtain a promotion, or the like (e.g., sex with the boss in return for retaining one's job); (2) *work environment*—sexual behavior and atmosphere so severe or persuasive that it creates an intimidating, hostile or offensive work environment (e.g., a barrage of unwelcome sex-related jokes, comments and /or touching from coworkers). The EEOC has issued guidelines on sexual harassment, which include not only unwelcome sexual advances, but also requests for sexual favors and other unwelcome verbal or physical conduct of a sexual nature.

Employers tend to be strictly liable for quid pro quo harassment by supervisors and also liable for work environment harassment if higher-level managers knew or should have known about the harassment and did not take appropriate corrective action. (Also, employees unfairly treated in comparison to an employee who received a promotion or other benefits because of a sexual relationship (e.g., with a supervisor) have a claim for sexual harassment.)

In *Harris v. Forklift Systems, Inc.*, 114 S.Ct. 367 (1993), the U.S Supreme Court unanimously decided that sexual harassment plaintiffs need not show a workplace environment so hostile as to cause "severe psychological injury" (e.g., a nervous breakdown). The proper standard is that, for any variety of reasons, "the environment would reasonably be perceived and is perceived, as hostile or abusive" (a "reasonableness" standard). No single factor is required to show sexual harassment; besides psychological harm, possible circumstances include "the frequency of the discriminating conduct; its severity; whether it is physically threatening or humiliating, or a mere offensive utterance; and whether it unreasonably interferes with employee's work performance." As two concurring opinions noted, the test is not whether job performance was impaired but whether the harassment altered working conditions in a discriminatory way.

Quotas and Affirmative Action Quotas are policies mandating that certain numbers of percentages of minorities or women, be hired or promoted, even if that means better qualified persons are turned away. By only hiring or promoting from within certain groups regardless of the qualifications of others, employers subject themselves to "reverse discrimination" liability: Passed over persons (e.g., white males) successfully argue that a quota is illegal race or sex discrimination that violates Title VII.

Affirmative action programs are concerned efforts—plans—designed by the employer to hire and promote larger numbers of women and minorities that have been under-represented in its work force. The law has been that government contractors or others receiving federal funds or licenses must have affirmative action programs. However, Supreme Court cases have subjected state (*City of Richmond v. Croson* (1989)) and federal (*Adarand Constructors, Inc. v. Pena* (1995)) affirmative action programs to strict scrutiny tests, thereby dramatically increasing the probability of success for reverse discrimination claims. A growing body of case law has started to overturn much of the last 30 years of affirmative action law.

Affirmative action is more likely to survive in the purely private sector, where employees opting to have such programs are not generally subject to constitutional challenge (no "state

action"), but only statutory interpretation. So a private, voluntary plan intended to correct manifest imbalance between one class (e.g., African-Americans, women) and other classes (e.g., whites, men) may still be permitted if it is only temporary and does not "unnecessarily trammel" the rights of individuals in the (nonpreferred) class (e.g., whites, males) or create an absolute bar to their advancement. *Adarand* and many lower decisions, though, indicate profound skepticism about the public policy arguments underlying many affirmative action programs, whether public or private.

Besides Title VII, several other statutes prohibit discrimination in specific areas of employment:

1. *The Equal Pay Act* (1963), an amendment to FLSA, outlaws differences in pay between the sexes for employees performing essentially the same ("equal") work. The "equal" jobs must involve substantially the same skill, effort, responsibility, and working conditions. Pay differentials are permitted if based on seniority, merit, quality or quantity of production, training bonuses, shift differentials (e.g., paying more to the night shift), or any factor other than sex. Violations can lead to fines up to $10,000, imprisonment for as long as six months, or both. In private lawsuits, plaintiffs can seek double damages for up to three years of wages, reinstatement, promotion, and liquidated damages.

   What if the jobs are different but, arguably, worth essentially the same? The wage differential between two employers working for the same employer, one performing a predominantly male job (e.g., construction worker) and the other performing a predominantly female job (e.g., doing secretarial work), does not violate the Equal Pay Act (or Title VII) since the jobs are not substantially "equal" (same abilities, effort, responsibility, and working conditions). The jobs involve, at the very least, distinct skills and working conditions. Thus a proposed "comparable worth" standard has been rejected in federal law, but continues to be considered by state and local governments. Comparable worth now is most notably a discretionary, policy matter for large corporate or government employers worried about their own pay-scale fairness.

2. *The Age Discrimination in Employment Act of 1967* (ADEA) prohibits job discrimination against people age 40 and older. The business entities covered by the ADEA are somewhat fewer then Title VII: here the employers must have at least 20 employees, and labor organizations without hiring halls must have at least 25 members. Sometimes, age can be a bona fide occupational qualification, just as there are such exemptions under the Title VII. Furthermore, in some instances an employer may provide a ;lower level fringe benefits (e.g., life insurance) for its older workers if such treatment is justified by the costs involved (i.e., older workers' benefits cost much more to provide). ADEA, though, outlaws almost all mandatory retirement. It provides for EEOC enforcement, awards *double unpaid wages* for willful violations, and grants a broad set of private lawsuit remedies comparable to those for Title VII violations.

3. *The Americans with Disabilities Act* (ADA) was passed in 1990, and applies to virtually the same number of employers as does Title VII, with the minimal number of employees for a covered employer being 15. ADA forbids employment discrimination against

qualified individuals with mental or physical impairments limiting a major life activity (e.g., blindness, cancer, AIDS, and learning disabilities), records of such impairments, or perception—albeit false—of such impairments. Employers may not discriminate against a qualified, disabled person if he/she could perform the job with "reasonable accommodation" by the employer (e.g., modified work schedules, wheelchair-accessible facilities, job restructuring or worker retraining). Employers though are *not* required to accommodate—and thus—hire disabled individuals when that would result in an *undue hardship* for the employer (e.g., significant difficulty or expense). Furthermore, as with Title VII, if an employer can show that his hiring practice is justified as a "business necessity," then his/her refusal to hire disabled individuals will not constitute a violation of ADA. That is so even if, for example, certain job-related tests or standards reduce or eliminate opportunities for some groups of persons ordinarily protected under ADA.

4. *The pregnancy Discrimination Act* (1978) amended Title VII to command that employers treat pregnancy and childbirth just as they treat any other medical condition similarly affecting an employees' ability to work. If a pregnant woman can still perform her job's duties, her employer cannot lawfully fire her or force her to take a leave of absence. Pregnancy leaves may not be treated differently from other leaves for temporary disability. Employers have also been prohibited from firing or refusing to hire women of childbearing age because of the fear of exposure to workplace hazards or toxins. *International Union v. Johnson Controls*, 499 U.S. 187 (U.S. Supreme Court, 1991). Employers must monitor the workplace for toxins and dangers and then take measures to protect their employees.

5. *Section 1981 of the Civil Rights Act of 1866* prohibits discrimination on the basis of race, color, and sometimes national origin in the creation and execution of employment contracts, as well as in all other private contract areas. As such, Section 1981 can cover areas of discrimination *beyond simply employment contracts*. Unlike Title VII, there are no small employer exemptions. Compared to Title VII, the Section 1981 time periods to sue generally are longer, the procedures simpler, a jury trial always available, and types of possible damages sometimes more expansive.

6. *Civil Rights Law amendments,* enacted in 1991, provide that Title VII or ADA plaintiffs claiming discrimination based on disability, religion, or sex (including sexual harassment) can receive punitive damages if the employer acted "with malice or reckless indifference." Such damages are capped (between $50,000 and $300,000), depending on the employer's size. Back pay, reinstatement, and attorney's fees always have been available under Title VII, but the amendments provide for other compensation (e.g., for medical treatment) if the discrimination was intentional. While still not as broad as Section 1981 and the treatment of other forms of discrimination under Title VII.

7. Almost all states have laws similar to Title VII and ADEA, and many have ADA-like statutes. Some states impose higher standards on employers than do the federal laws; and some states or cities go beyond the federal law and, for instance, prohibit employment discrimination based on marital status, sexual orientation, political affliction, and –with a specificity not found in the ADA—having or testing positive for AIDS virus or HIV.

Also, state and local laws apply to governmental bodies and small businesses often exempted by federal employment laws.

An Update on FLSA

The Fair Labor Standards Act (FLSA) is the main law affecting worker's pay, hours and the special rules that apply to younger workers. This Act has been in the headlines lately, facing its first major overhaul in more than 50 years.

According to the multitude of proposed changes unveiled in March 2003, some low-paid salaried workers would be guaranteed overtime pay, while others with greater responsibility may lose it. The laws of white-collar exemptions that keep employees labeled executives, professionals or administrators from receiving over-time also could be revamped. As a result, labor union leaders are furious.

The Labor Department is now sifting through some 78,000 comments received in the ensuing months, hoping to release a finalized version of the proposal in early 2004.

The Fair Labor Standards Act was introduced in 1938 as a part of President Franklin Roosevelt's New Deal that established the 40-hour workweek and divided employees into hourly and salaried workers. Unfortunately, the FLSA has the dubious distinction of being the law most often violated by employers. The key components of the law are listed below. You can also check out "Avoid Employee Lawsuits" by Barbara Kate Repa, (Nob Press, 1999).

Who is covered under the FLSA?

The FLSA applies to a company if it has more than $500,000 in sales or is engaged in interstate commerce.

What does FLSA have to say about wages?

The current federal minimum wage is $5.15, although some state laws have set it higher. Hourly workers must be paid at least this wage and all fixed-rate or commission salespeople must average at least this amount.

What does the FLSA have to say about hours?

Overtime could be considered the Employment Lawyers Relief Act because it generates such a high level of litigation. People who don't currently qualify for time-and-a-half pay include exempt employees, independent contractors, outside salespeople and white-collar workers.

Do employees need to be paid for every minute they work?

It depends on your definition of the word "work," For example, many workers have time when they are "on call," meaning they can be called into service on short notice. If the employees control this time, then they don't have to be paid. If the employer controls it, then the workers should be paid.

What else is covered under the FLSA?

Child labor is another key component The law limits the hours that people under 18 years of age can work, and it limits the type of work they can do.

GLOSSARY

ACCEPTANCE an assent to an offer in accordance with its terms.

AGENCY RELATIONSHIP a consensual arrangement between two persons whereby one agrees to act for the benefit of and under the control of the other person.

BAILMENT exists when possession of property belonging to one person is delivered to another person who intends to assume custody or control over the property and who expressly or implicitly promises to return it to the owner or to dispose of it as directed by the "owner".

TENANTS IN COMMON co-owners of real property, whose undivided ownership of the property passes on their deaths to their heirs or devisees.

CAPACITY the ability to perform legally valid acts; that is, the ability to incur legal liability or to acquire legal rights.

CAVEAT EMPTOR a Latin term meaning "let the buyer beware" before she buys. According to this principle, the buyers purchase at their own risk, in the absence of misrepresentations. This does not obligate the seller to volunteer information. In recent years, however, the law requires full disclosure by the seller of known defects in the product or service.

CAVEATVENDITOR a Latin term meaning "let the vendor beware." Without specific exemptions, the seller is liable for action on the part of the buyer for any alterations in the contract or warranty, whether explicit or implied. This is the basis for the consumer rights movement.

CHECK a special kind of draft.

COLLATERAL CONTRACT one made with an obligee whereby a third person promises to pay the debt, default, or miscarriage of the obligor in the event the obligor fails to perform as obligated.

CONSIDERATION either a detriment to the promisee or a benefit to the promisor, which was bargained for and given in exchange for the promise.

CONTRACTS essentially promises, or groups of promises, to do something in the future.

CORPORATION a legal entity which has a legal existence separate from its owners.

CRIME an act done by an individual which society considers to be a wrong against it and for the commission of which society prescribes certain penalties or punishment.

CYBER TORTS torts committed in cyberspace.

DEED OF TRUST a three party device for obtaining a secured interest in real property. The land contract is a security device for securing the balance due on a contract for the sale of land.

DRAFT a three-party instrument in which one person (the drawer) orders a second person (the drawee) to pay a sum certain in money to a third person (the payee) either on demand or at a definite future date.

E-CONTRACTS any contract entered into in e-commerce, whether business to business (B2B) or business to consumer (B2C), including licenses, as well as sales and leases of goods and services.

E-SIGNATURE an electronic sound, symbol, or process attached to or logically associated with a record, such as an e-mail message or an online contract form or a contract form sent as an attachment via e-mail, and executed or adopted by a person with the intent to sign the record.

FRAUD an intentional misrepresentation of a material fact made with the intent to induce another to rely on it and to surrender a legal right or piece of property; thus fraud essentially is an intentional misrepresentation.

GIFT a voluntary transfer of personal property from one person to another person without any consideration being given for the transfer.

JOINT TENANCY undivided ownership of property where the surviving tenant succeeds to the ownership interest of the deceased tenant with the deceased tenant having no opportunity to pass his or her interest to someone else by will.

MORTGAGE the most common device for obtaining a security interest in real property.

NEGLIGENCE the failure to use due care to avoid foreseeable injury which might be caused to another person or property as a result of the failure to exercise due care.

NEGOTIATION the transfer of an instrument in such a manner that the transferee of the instrument becomes a "holder."

OFFER a proposal made by one person to another.

PERSONAL DEFENSES defenses which do not go to the validity of the instrument, but rather represent reasons why the promisor of a contract would not have to fulfill part or all of his or her promise to the original promisee of the contract.

PROPERTY (OR OWNERSHIP OF PROPERTY) a bundle of rights which includes, among others, the exclusive right to possess, use, and dispose of objects or rights having economic value.

RATIFICATION the subsequent adoption of an act done by another person who was not authorized at the time it was performed, although that person was purporting to act as an agent. A partnership is an organization created for the purpose of carrying on a business for profit.

DISSOLUTION OF A PARTNERSHIP a change in the relation of the partners caused by any partner ceasing to be associated in the carrying on of the business.

REAL DEFENSES defenses which, in general, go to the validity of the instrument at its inception and which render it a nullity.

SPAM junk e-mail.

STOCK SUBSCRIPTION an agreement to buy a certain number of shares of stock in a corporation when they are issued.

TENANCY BY THE ENTIRETY a joint tenancy with the right to survivorship in which the tenants must be husband and wife.

TITLE VII statue in the Federal Civil Lights Act of 1964 that prohibits discrimination in the hiring, firing, promotion, compensation, or any other aspect of employment because of a person's race, color, religion, sex, or national origin.

TORT a private wrong against a person or his/her property.
WARRANTIES contractual grounds for this liability, whereas negligence and strict liability are usually considered to be tort grounds for it.

WORKERS' COMPENSATION a law, found in all states, requiring employees to relinquish their right to sue their employers for accidental death, injury, or disease arising from or during the course of their employment.