



The Legal and Social Environment of Business

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The Nature and Sources of Law



1-1 Nature of Law and Legal Rights

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Learning Outcomes <<<

After studying this chapter, you should be able to

LO.1 Discuss the nature of law and legal rights

LO.2 List the sources of law

LO.3 Describe the classifications of law

1-1 Nature of Law and Legal Rights

Why have law? If you have ever been stuck in a traffic jam or jostled in a crowd leaving a stadium, you have observed the need for order to keep those involved moving in an efficient and safe manner. The issues with bloggers' use of others' materials and continuing downloading of music and films without compensation to copyright holders illustrate the need for rules and order in this era of new technology. When our interactions are not orderly, whether at our concerts or through our e-mail, all of us and our rights are affected. The order or pattern of rules that society uses to govern the conduct of individuals and their relationships is called **law**. Law keeps society running smoothly and efficiently.

Law consists of the body of principles that govern conduct and that can be enforced in courts or by administrative agencies. The law could also be described as a collection or bundle of rights.

law—the order or pattern of rules that society establishes to govern the conduct of individuals and the relationships among them.

right—legal capacity to require another person to perform or refrain from an action.

duty—an obligation of law imposed on a person to perform or refrain from performing a certain act.

1-1a Legal Rights

A **right** is a legal capacity to require another person to perform or refrain from performing an act. Our rights flow from the U.S. Constitution, state constitutions, federal and state statutes, and ordinances at the local levels, including cities, counties, and boroughs. Within these sources of rights are also duties. A **duty** is an obligation of law imposed on a person to perform or refrain from performing a certain act.

Duties and rights coexist. No right exists in one person without a corresponding duty resting on some other person or persons. For example, if the terms of a lease provide that the premises will remain in a condition of good repair so that the tenant can live there comfortably, the landlord has a corresponding duty to provide a dwelling that has hot and cold running water.

1-1b Individual Rights

The U.S. Constitution gives individuals certain rights. Those rights include the right to freedom of speech, the right to due process or the right to have a hearing before any freedom is taken away, and the right to vote. There are also duties that accompany individual rights, such as the duty to speak in a way that does not cause harm to others. For example, individuals are free to express their opinions about the government or its officials, but they would not be permitted to yell "Fire!" in a crowded theater and cause unnecessary harm to others. The rights given in the U.S. Constitution are rights that cannot be taken away or violated by any statutes, ordinances, or court decisions. These rights provide a framework for the structure of government and other laws.

1-1c The Right of Privacy

One very important individual legal right is the right of privacy, which has two components. The first is the right to be secure against unreasonable searches and seizures by the government. The Fourth Amendment of the U.S. Constitution guarantees this portion of the **right of privacy**. A police officer, for example, may not search your home unless the officer has a reasonable suspicion (which is generally established through a warrant) that your home contains evidence of a crime, such as illegal drugs. If your home or business is searched unlawfully, any items obtained during that unlawful search could be excluded as evidence in a criminal trial because of the Fourth Amendment's exclusionary rule. **For Example**, in *Riley v. California*, 134 S. Ct. 2473 (2014), David Riley was stopped by a police officer for driving with expired registration tags. The officer discovered that Mr. Riley's license had been suspended, so his car was impounded and searched. Officers

right of privacy—the right to be free from unreasonable intrusion by others.

also found Mr. Riley's smart phone and, in going through the phone, found pictures and information related to a gang shooting, and Mr. Riley was then charged with that earlier shooting. However, the court held that evidence from the smart phone could not be used at trial because there was no warrant and Mr. Riley had a right of privacy in the data on that phone.¹

A second aspect of the right of privacy protects individuals against intrusions by others. Your private life is not subject to public scrutiny when you are a private citizen. This right is provided in many state constitutions and exists through interpretation at the federal level through the landmark case of *Roe v. Wade*,² in which the U.S. Supreme Court established a right of privacy that gives women the right to choose whether to have an abortion.

These two components of the right to privacy have many interpretations. These interpretations are often found in statutes that afford privacy rights with respect to certain types of conduct. **For Example**, a federal statute provides a right of privacy to bank customers that prevents their banks from giving out information about their accounts except to law enforcement agencies conducting investigations. Some laws protect the rights of students. **For Example**, the Family Educational Rights and Privacy Act of 1974 (FERPA, also known as the *Buckley Amendment*) prevents colleges and universities from disclosing students' grades to third parties without the students' permission. From your credit information to your Social Security number, you have great privacy protections.



1-1d Privacy and Technology

Technology creates new situations that may require the application of new rules of law. Technology has changed the way we interact with each other, and new rules of law have developed to protect our rights. Today, business is conducted by computers, wire transfers of funds, e-mail, electronic data interchange (EDI) order placements, and the Internet. We still expect that our communication is private. However, technology also affords others the ability to eavesdrop on conversations and intercept electronic messages. The law has stepped in to reestablish that the right of privacy still exists even in these technologically nonprivate circumstances. Some laws now make it a crime and a breach of privacy to engage in such interceptions of communications.³

CASE SUMMARY

If You Shout It Out the Window or on Facebook, Is It Private?

FACTS: Gina L. Fawcett (plaintiff) and her then-minor son, John, sued Sea High School and the parents of Nicholas Altieri (defendants) to recover damages for John's eye injury that he sustained in an altercation with Nicholas during a tennis match with St. Joseph High School. The defendants made a discovery request for access to John's social media accounts, including Facebook, MySpace, Friendster, Flickr,

and others. Ms. Fawcett moved for a protective order to prevent discovery of the information on these sites because John's sites were not publicly available.

DECISION: The court held that a variety of factors must be considered before granting broad access to social media accounts, including privacy settings by the holder of the

¹ Police officers do not need a warrant in order to use the content of an incoming text message on a suspect's phone that is received while they are questioning the suspect because the sender does not have a right of privacy in the suspect's smart phone's content. *State v. Varle*, 337 P.3d 904 (Or. App. 2014).

² 410 U.S. 113 (1973).

³ *Luangkhot v. State*, 722 S.E.2d 193 (Ga. App. 2012).

If You Shout It Out the Window or on Facebook, Is It Private? continued

account, relevancy of the information to the litigation, and protections afforded by the various social media sites. The court's decision provides the guidelines for determining whether the litigants in cases will be able to have discovery access to each other's social media sites. The parties will

have to do depositions and then renew the request once more factual information is available for the analysis of the request for access. [*Fawcett v. Altieri*, 960 N.Y.S.2d 592 (2013)]



ETHICS & THE LAW

Maybe a Little Too "LinkedIn"

LinkedIn, the popular professional connection service, has a tool called "Reference Search." A premium service, employers and recruiters are using the tool to cull their connections to see who knows job applicants in order to get background on them. Employers are checking with references that the applicants did not list, references that may not have all good things to say about them. The service provides employers with the list of LinkedIn contacts that they have who worked at the same companies as the applicants and at the same time.*

Applicants are worried that employers are basing employment decisions on the information that they receive, information that may not be true or verified or verifiable. The applicants do not always know that the employer is checking with other sources or which ones and do not have the opportunity to respond to negative information.

Discuss the ethical issues in the use of this LinkedIn service by employers.

*Natasha Singer, "Funny, They Don't Look Like My References," *New York Times Magazine*, November 10, 2014, p. BU4.



E-COMMERCE & CYBERLAW

A University's Access to Your Computer

Scott Kennedy, a computer system administrator for Qualcomm Corporation in San Diego, California, discovered that somebody had obtained unauthorized access (or "hacked into," in popular parlance) the company's computer network. Kennedy contacted the Federal Bureau of Investigation (FBI). Working together, Kennedy and the FBI were able to trace the intrusion to a computer on the University of Wisconsin at Madison network. They contacted Jeffrey Savoy, the University of Wisconsin computer network investigator, who found evidence that someone using a computer on the university network was in fact hacking into the Qualcomm system and that the user had gained unauthorized access to the university's system as well. Savoy traced the source of intrusion to a computer located in university housing, the room of Jerome Heckenkamp, a computer science graduate student at the university. Savoy knew that Heckenkamp had been terminated from his job at the university computer help desk two years earlier for similar unauthorized activity.

While Heckenkamp was online and logged into the university's system, Savoy, along with detectives, went to Heckenkamp's room. The door was ajar, and nobody was in the room. Savoy entered the room and disconnected the network cord that attached the computer to the network. In order to be sure that the computer he had disconnected from the network was the computer that had gained unauthorized access to the university server, Savoy wanted to run some commands on the computer. Detectives located Heckenkamp, explained the situation, and asked for Heckenkamp's password, which Heckenkamp voluntarily provided. Savoy then ran tests on the computer and copied the hard drive without a warrant. When Heckenkamp was charged with several federal computer crimes, he challenged the university's access to his account and Savoy's steps that night, including the copy of the hard drive, as a breach of his privacy.

Was Heckenkamp correct? Was his privacy breached? [*U.S. v. Heckenkamp*, 482 F.3d 1142 (9th Cir. 2007)]

1-2 Sources of Law

Several layers of law are enacted at different levels of government to provide the framework for business and personal rights and duties. At the base of this framework of laws is constitutional law.

1-2a Constitutional Law

constitution—a body of principles that establishes the structure of a government and the relationship of the government to the people who are governed.

Constitutional law is the branch of law that is based on the constitution for a particular level of government. A **constitution** is a body of principles that establishes the structure of a government and the relationship of that government to the people who are governed. A constitution is generally a combination of the written document and the practices and customs that develop with the passage of time and the emergence of new problems. In each state, two constitutions are in force: the state constitution and the federal Constitution.

1-2b Statutory Law

statutory law—legislative acts declaring, commanding, or prohibiting something.

Statutory law includes legislative acts. Both Congress and the state legislatures enact statutory law. Examples of congressional legislative enactments include the Securities Act of 1933 (Chapter 45), the Sherman Antitrust Act (Chapter 5), the bankruptcy laws (Chapter 34), and consumer credit protection provisions (Chapter 32). At the state level, statutes govern the creation of corporations, probate of wills, and the transfer of title to property. In addition to the state legislatures and the U.S. Congress, all cities, counties, and other governmental subdivisions have some power to adopt ordinances within their sphere of operation. Examples of the types of laws found at this level of government include traffic laws, zoning laws, and pet and bicycle licensing laws.

1-2c Administrative Law

administrative regulations—rules made by state and federal administrative agencies.

Administrative regulations are rules promulgated by state and federal administrative agencies, such as the Securities and Exchange Commission (SEC) and the Environmental Protection Agency (EPA). For example, the restrictions on carbon emissions by businesses have all been promulgated by the EPA. These regulations generally have the force of statutes.

1-2d Private Law

private law—the rules and regulations parties agree to as part of their contractual relationships.

Even individuals and businesses create their own laws, or **private law**. Private law consists of the rules and regulations parties agree to as part of their contractual relationships. **For Example,** landlords develop rules for tenants on everything from parking to laundry room use. Employers develop rules for employees on everything from proper computer use to posting pictures and information on bulletin boards located within the company walls. Homeowner associations have rules on everything from your landscaping to the color of your house paint.

1-2e Case Law, Statutory Interpretation, and Precedent

case law—law that includes principles that are expressed for the first time in court decisions.

Law also includes principles that are expressed for the first time in court decisions. This form of law is called **case law**. Case law plays three very important roles. The first is one of clarifying the meaning of statutes, or providing statutory interpretation. **For Example,** in *King v. Burwell*, the U.S. Supreme Court interpreted the phrase, “an Exchange

established by the State” in the Affordable Care Act to determine whether tax credits were available to insurance exchanges operated by the federal government and not the states. The court held that “State,” meant either the federal government or any of the states so that all exchanges qualified for the tax credits.⁴ The second role that courts play is in creating precedent. When a court decides a new question or problem, its decision becomes a **precedent**, which stands as the law in future cases that involve that particular problem.

precedent—a decision of a court that stands as the law for a particular problem in the future.

stare decisis—“let the decision stand”; the principle that the decision of a court should serve as a guide or precedent and control the decision of a similar case in the future.

common law—the body of unwritten principles originally based upon the usages and customs of the community that were recognized and enforced by the courts.

Using precedent and following decisions is also known as the doctrine of *stare decisis*. However, the rule of *stare decisis* is not cast in stone. Judges have some flexibility. When a court finds an earlier decision to be incorrect, it overrules that decision. For example, in *National Federation of Independent Business v. Sebelius*, 132 S.Ct. 2566 (2012) the U.S. Supreme Court held that the Affordable Care Act (Obama Care) was constitutional. However, in 2014, the Court held, based on new issues raised, that a portion of the act violated the First Amendment because it mandated health care coverage of certain types of birth controls that were in violation of the religious beliefs of the owners of a corporation. *Burwell v. Hobby Lobby Stores, Inc.*, 134 S. Ct. 2751 (2014).

The third role courts play is in developing a body of law that is not statutory but addresses long-standing issues. Court decisions do not always deal with new problems or make new rules. In many cases, courts apply rules as they have been for many years, even centuries. These time-honored rules of the community are called the **common law**. **For Example**, most of law that we still follow today in determining real property rights developed in England, beginning in 1066. Statutes sometimes repeal or redeclare the common law rules. Many statutes depend on the common law for definitions of the terms in the statutes.

1-2f Other Forms of Law: Treaties and Executive Orders

Law also includes treaties made by the United States and proclamations and executive orders of the president of the United States or of other public officials. President Obama’s executive order altering immigration policy is the subject of a constitutional challenge to the scope of executive orders.

1-2g Uniform State Laws

To facilitate the national nature of business and transactions, the National Conference of Commissioners on Uniform State Laws (NCCUSL), composed of representatives from every state, has drafted statutes on various subjects for adoption by the states. The best example of such laws is the Uniform Commercial Code (UCC).⁵ (See Chapters 22–30, Chapter 33.) The UCC regulates the sale and lease of goods; commercial paper, such as checks; fund transfers; secured transactions in personal property; banking; and letters of credit. Having the same principles of law on contracts for the sale of goods and other commercial transactions in most of the 50 states makes doing business easier and less expensive. Other examples of uniform laws across the states include the Model Business Corporation Act (Chapter 43), the Uniform Partnership Act (Chapter 41), and the Uniform Residential Landlord Tenant Act (Chapter 50). The Uniform Computer Information Transactions Act (UCITA) as well as the Uniform Electronic Transactions Act

⁴ *King v. Burwell*, 135 S.Ct. 2480 (2015).

⁵ The UCC has been adopted in every state, except that Louisiana has not adopted Article 2. Sales. Guam, the Virgin Islands, and the District of Columbia have also adopted the UCC. The United Nations Convention on Contracts for the International Sale of Goods (CISG) has been adopted as the means for achieving uniformity in sale-of-goods contracts on an international level. Provisions of CISG were strongly influenced by Article 2 of the UCC.

(UETA) are two uniform laws that have taken contract law from the traditional paper era to the paperless computer age.

1-3 Classifications of Law

1-3a Substantive Law vs. Procedural Law

substantive law—the law that defines rights and liabilities.

procedural law—the law that must be followed in enforcing rights and liabilities.

Substantive law creates, defines, and regulates rights and liabilities. The law that determines when a contract is formed is substantive law. **Procedural law** specifies the steps that must be followed in enforcing those rights and liabilities. For example, once that contract is formed, you have rights to enforce that contract, and the steps you take through the court system to recover your damages for a breach of contract are procedural laws. The laws that prohibit computer theft are substantive laws. The prosecution of someone for computer theft follows procedural law.

1-3b Criminal Law vs. Civil Law

criminal laws—the laws that define wrongs against society.

civil laws—the laws that define the rights of one person against another.

Criminal laws define wrongs against society. **Civil laws** define the rights of one person against another. Criminal law violations carry fines and imprisonment as penalties. Civil laws carry damage remedies for the wronged individual.

For Example, if you run a red light, you have committed a crime and you will be punished with a fine and points on your license. If you run a red light and strike a pedestrian, you will also have committed a civil wrong of injury to another through your



SPORTS & ENTERTAINMENT LAW

When Players Break the Law and Owners Are Offensive

During 2014, professional sports had three events that resulted in a public engaged in the business decisions of the teams and their leagues. Baltimore Ravens player Ray Rice was accused of striking his fiancé (who would shortly become his wife) in an elevator. Local authorities declined to prosecute because his wife refused to cooperate with the investigation or the prosecution. Nonetheless, Roger Goodell, the NFL commissioner, suspended Mr. Rice from play indefinitely. Public opinion swung both ways, and Mr. Rice eventually won his appeal on the suspension and was reinstated. However, he lost his endorsement contracts with various companies, including Nike.

In the NBA, Donald Sterling was forced by the league to sell the LA Clippers franchise after an audio tape emerged of him making racist comments to his girlfriend. Steve Ballmer, the former CEO of Microsoft, bought the team for \$2 billion. The team owners in the NBA made the decision by a vote to require Sterling to sell the team, a provision permitted under the bylaws of the corporation.

Back in the NFL, Adrian Peterson of the Minnesota Vikings was arrested for child abuse. Mr. Peterson entered a

no-contest plea to the charges, which were based on his using a branch to hit his four-year-old son. The court's determination of guilt was postponed for two years as Mr. Peterson serves 80 hours of community service and pays a \$4,000 fine. Under its bylaws, the NFL imposed a temporary suspension, and Mr. Peterson and the NFL are locked in a court and arbitration dispute over the suspension.

The three cases have these topics in common:

- Private conduct affected business ownership and employment.

- There were private bylaws involved that permitted league action against team owners and players.

- There were also civil and criminal laws involved that required prosecution in two of the cases.

The law at various levels, including the authority of the leagues to do what they did, was at the center of these very public controversies.

carelessness. Civil laws provide that in addition to taking care of your wrong to society, you must take care of your wrong to the pedestrian and pay damages for the cost of her injuries (see Chapter 8 for more information about recovery of damages for accidents such as this).

1-3c Law vs. Equity

equity—the body of principles that originally developed because of the inadequacy of the rules then applied by the common law courts of England.

Equity is a body of law that provides justice when the law does not offer an adequate remedy or the application of the law would be terribly unfair. Equity courts developed in England as a means of getting to the heart of a dispute and seeing that justice was done. **For Example**, Christian Louboutin shoes have a distinctive red bottom that is their trademark. Yves Saint Laurent began producing its shoes with a red bottom. Common and statutory law provide for Louboutin to collect damages—the amount the company lost in sales through the copycat efforts of Yves Saint Laurent. However, if the Yves Saint Laurent shoes continue in production, Louboutin is never adequately compensated. Equity provides for an injunction, a court order to stop Yves Saint Laurent from making the red-soled shoes.⁶

At one time, the United States had separate law courts and equity courts, but today these courts have been combined so that one court applies principles of both law and equity. A party may ask for both legal and equitable remedies in a single court.⁷ **For Example**, suppose a homeowner contracts to sell his home to a buyer. If the homeowner then refuses to go through with the contract, the buyer has the legal remedy of recovering damages. The rules of equity go further and could require the owner to convey title to the house, an equitable remedy known as *specific performance*. Equitable remedies may also be available in certain contract breaches (see Chapters 2, 11, and 19).

Make the Connection

Summary

Law provides rights and imposes duties. One such right is the right of privacy, which affords protection against unreasonable searches of our property and intrusion into or disclosure of our private affairs.

Law consists of the pattern of rules established by society to govern conduct and relationships. These rules can be expressed as constitutional provisions, statutes, administrative regulations, and case decisions. Law can be classified as substantive or procedural, and it can be

described in terms of civil or criminal law. Law provides remedies in equity in addition to damages.

The sources of law include constitutions, federal and state statutes, administrative regulations, ordinances, and uniform laws generally codified by the states in their statutes. The courts are also a source of law through their adherence to case precedent under the doctrine of *stare decisis* and through their development of time-honored principles called the common law.

⁶ *Christian Louboutin S.A. v. Yves Saint Laurent America, Inc.*, 778 F. Supp. 2d 445 (S.D.N.Y. 2011). The court eventually held that other companies could not copy the distinctive red sole. They could have colored soles but not the Louboutin trademark red sole.

⁷ For example, when Jennifer Lopez and Marc Anthony were married, they filed suit against the manufacturer of a British company that produces baby carriages for using their images on its Web site and in ads without permission; they asked for \$5 million in damages as well as an injunction to stop use of their photos and likenesses in the company's ads. *Lopez v. Silver Cross*, 2009 WL 481386 (C.D. Cal.). The case was settled prior to the dissolution of the Lopez and Anthony marriage. Silver Cross no longer uses the images of Lopez and Anthony in its ads.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

1-1 Nature of Law and Legal Rights

- LO.1** Discuss the nature of law and legal rights
See Ethics & the Law for a discussion on the use of LinkedIn for finding more honest references about potential employees, page 6.
See E-Commerce & Cyberlaw for a discussion of a university student's privacy rights in using the university's server, page 6.

1-2 Sources of Law

- LO.2** List the sources of law
See the *For Example* discussion of landlords developing rules for tenants on everything from parking to laundry room use, page 7.

See the list and explanation of uniform laws, page 8.
See the Sports & Entertainment Law discussion of leagues taking action against players for their private conduct, page 9.

1-3 Classifications of Law

- LO.3** Describe the classifications of law
See the discussion of law, equity, procedural, substantive, criminal, and civil, pages 9–10.
See the Christian Louboutin example on its red-bottomed shoe being copied and footnote 8 with the discussion of the Jennifer Lopez/Marc Anthony suit. Explain uniform state laws, page 10.

Key Terms

administrative regulations
case law
civil law
common law
constitution
criminal law

duty
equity
law
precedent
private law
procedural law

right
right of privacy
stare decisis
statutory law
substantive law

Questions and Case Problems

- The Family Educational Rights and Privacy Act (FERPA) protects students' rights to keep their academic records private. What duties are imposed and upon whom because of this protection of rights? Discuss the relationship between rights and duties.
- List the sources of law.
- What is the difference between common law and statutory law?
- Classify the following laws as substantive or procedural:
 - A law that requires public schools to hold a hearing before a student is expelled.
 - A law that establishes a maximum interest rate for credit transactions of 24 percent.
 - A law that provides employee leave for the birth or adoption of a child for up to 12 weeks.
 - A law that requires the county assessor to send four notices of taxes due and owing before a lien can be filed (attached) to the property.
- What do uniform laws accomplish? Why do states adopt them? Give an example of a uniform law.
- Cindy Nathan is a student at West University. While she was at her 9:00 A.M. anthropology class, campus security entered her dorm room and searched all areas, including her closet and drawers. When Cindy returned to her room and discovered what had happened, she complained to the dorm's senior resident. The senior resident said that this was the university's property and that Cindy had no right of privacy. Do you agree with the senior resident's statement? Is there a right of privacy in a dorm room?
- Professor Lucas Phelps sent the following e-mail to Professor Marlin Jones: "I recently read the opinion piece you wrote for the *Sacramento Bee* on affirmative action. Your opinion is incorrect, your reasoning and analysis are poor, and I am embarrassed that you are a member of the faculty here at Cal State Yolinda." Professor Jones forwarded the note from Professor Phelps to the provost of the university and asked that

Professor Phelps be disciplined for using the university e-mail system for harassment purposes. Professor Phelps objected when the provost contacted him: “He had no right to forward that e-mail to you. That was private correspondence. And you have no right of access to my e-mail. I have privacy rights.” Do you agree with Professor Phelps? Was there a breach of privacy?

8. Under what circumstances would a court disregard precedent?
9. What is the difference between a statute and an administrative regulation?
10. The Eminem ad for Chrysler that ran during the Super Bowl in February 2011 was rated as one of the best ads for the game. In May 2011, Audi ran an ad at a German auto show that had the “feel” of the Eminem Chrysler “Lose Yourself” ad. Subsequently, the German auto show ad made its way onto the Internet.

The German ad caught the attention of Eminem and 8 Mile, Eminem’s publishing company. They notified Audi that the ad constituted an unauthorized use of their intellectual property. Explain what rights Eminem and 8 Mile have and how the courts can help.
11. Give examples of areas covered by federal laws. Give examples of areas covered by city ordinances. What are the limitations on these two sources of laws? What could the laws at these two levels not do?
12. What is the principle of *stare decisis*?
13. Explain how Twitter, Facebook, and LinkedIn have resulted in the development of new laws and precedent.

14. During the 2001 baseball season, San Francisco Giants player Barry Bonds hit 73 home runs, a new record that broke the one set by Mark McGwire in 2000 (72 home runs). When Mr. Bonds hit his record-breaking home run, the ball went into the so-called cheap seats. Alex Popov was sitting in those seats and had brought along his baseball glove for purposes of catching any hits that might come into the stands.

Everyone sitting in the area agreed that Mr. Popov’s glove touched Bonds’s home-run ball. Videotape also shows Mr. Popov’s glove on the ball. However, the ball dropped and, following a melee among the cheap-seat fans, Patrick Hayashi ended up with Bonds’s home-run ball.

Mr. Popov filed suit for the ball, claiming it as his property. Such baseballs can be very valuable. The baseball from Mr. McGwire’s record-breaking home run in 2000 sold for \$3 million. List those areas of law that will apply as the case is tried and the owner of the baseball is determined.

15. Janice Dempsey has just started her own tax preparation firm. She has leased office space in a building, and she is incorporating her business as a Subchapter S corporation under the Internal Revenue Code. She has purchased desks, chairs, computers, and copiers from Staples through a line of credit they have established for her. Janice is a CPA in the state of Arizona and her license fees and continuing education hours are due within 90 days. Janice will begin with only a clerical person as an employee to serve as receptionist and bookkeeper. List all of the areas of the law that affect Janice in her new business.

The Court System and Dispute Resolution



2-1 The Court System

- 2-1a The Types of Courts
- 2-1b The Federal Court System
- 2-1c State Court Systems

2-2 Court Procedure

- 2-2a Participants in the Court System
- 2-2b Which Law Applies—Conflicts of Law
- 2-2c Initial Steps in a Lawsuit
- 2-2d The Trial
- 2-2e Post-trial Procedures

2-3 Alternative Dispute Resolution (ADR)

- 2-3a Arbitration
- 2-3b Mediation
- 2-3c MedArb
- 2-3d Expert Panel
- 2-3e Reference to a Third Person
- 2-3f Association Tribunals
- 2-3g Summary Jury Trial
- 2-3h Rent-A-Judge
- 2-3i Minitrial
- 2-3j Contract Provisions

Learning Outcomes <<<

After studying this chapter, you should be able to

- LO.1** Explain the federal and state court systems
- LO.2** Describe court procedures
- LO.3** List the forms of alternative dispute resolution and distinguish among them

2-1 The Court System

court—a tribunal established by government to hear and decide matters properly brought to it.

jurisdiction—the power of a court to hear and determine a given class of cases; the power to act over a particular defendant.

subject matter jurisdiction—judicial authority to hear a particular type of case.

original jurisdiction—the authority to hear a controversy when it is first brought to court.

general jurisdiction—the power to hear and decide most controversies involving legal rights and duties.

limited (special) jurisdiction—the authority to hear only particular kinds of cases.

appellate jurisdiction—the power of a court to hear and decide a given class of cases on appeal from another court or administrative agency.

appeal—taking a case to a reviewing court to determine whether the judgment of the lower court or administrative agency was correct. (Parties—appellant, appellee)

Despite carefully negotiated and well-written contracts and high safety standards in the workplace or in product design and production, businesses can end up in a lawsuit. **For Example**, you could hire the brightest and most expensive lawyer in town to prepare a contract with another party and believe the final agreement is “bulletproof.” However, even a bulletproof contract does not guarantee performance by the other party, and you may have to file a suit to collect your damages.

Business disputes can be resolved in court or through alternative dispute resolution. This chapter covers the structure of the court system and the litigation process as well as the forms of alternative dispute resolution.

A **court** is a tribunal established by government to hear evidence, decide cases brought before it, and provide remedies when a wrong has been committed. As discussed in Chapter 1, sometimes courts prevent wrongs by issuing the equitable remedy of an injunction. **For Example**, in March 2012, a federal court issued an injunction against Cardinal Health because it was shipping too much oxycodone to its pharmacies in Florida, and the FDA had discovered that the prescriptions were fraudulent. The FDA needed to stop the flow of the drug while it pulled the prescriptions.¹

2-1a The Types of Courts

Each type of court has the authority to decide certain types or classes of cases. The authority of courts to hear cases is called **jurisdiction**. One form of jurisdiction, **subject matter jurisdiction**, covers the type of cases the court has the authority to hear. Courts that have the authority to hear the original proceedings in a case (the trial court) are called courts of **original jurisdiction**. **For Example**, in a court of original jurisdiction witnesses testify, documents are admitted into evidence, and the jury, in the case of a jury trial, hears all the evidence and then makes a decision.

Other types of subject matter jurisdiction give courts the authority over particular legal topic areas. A court with **general jurisdiction** has broad authority to hear general civil and criminal cases. When a general jurisdiction trial court hears criminal cases, it serves as the trial court for those charged with crimes. General trial courts also have the authority to hear civil disputes, such as breach of contract cases and personal injury lawsuits.

A court with **limited or special jurisdiction** has the authority to hear only particular kinds of cases. **For Example**, many states have courts that can hear only disputes in which the damages are \$10,000 or less. Other examples of limited or special jurisdiction courts are juvenile courts, probate courts, and domestic relations courts. States vary in the names they give these courts, but these courts of special or limited jurisdiction have very narrow authority for the types of cases they hear. In the federal court system, limited or special jurisdiction courts include bankruptcy courts and the U.S. Tax Court.

A court with **appellate jurisdiction** reviews the work of a lower court. **For Example**, a trial court may issue a judgment that a defendant in a breach of contract suit should pay \$500,000 in damages. That defendant could appeal the decision to an appellate court and seek review of the decision itself or even the amount of the damages.² An **appeal** is a

¹ *Holiday CVS, LLC. v. Holder*, 839 F. Supp. 2d 145 (D.D.C. 2012).

² A case that is sent back for a redetermination of damages is remanded for what is known as *remititur*. For example, an appeal of Oracle’s \$1.3 billion verdict against SAP was sent back for another determination of damages, with the judge indicating \$272 million was in the right range. *Oracle USA, Inc. v. SAP AG*, 2012 WL 29095 (N.D. Cal.).

reversible error—an error or defect in court proceedings of so serious a nature that on appeal the appellate court will set aside the proceedings of the lower court.

review of the trial and decision of the lower court. An appellate court does not hear witnesses or take testimony. An appellate court, usually a panel of three judges, simply reviews the transcript and evidence from the lower court and determines whether there has been **reversible error**. A reversible error is a mistake in applying the law or a mistake in admitting evidence that affected the outcome of the case. An appellate court can **affirm** or **reverse** a lower court decision or **remand** that decision for another trial or additional hearings.

CASE SUMMARY

Horseback Riding Videos and Judging Hairy Chest Contests—Good Evidence?

FACTS: Mary Kay Stanford (Stanford) was driving a truck for V.F. in late evening of February 7, 2006, when she began to feel nauseous. She pulled into a truck scale house to rest for the evening. She parked the truck, and as she attempted to climb into the sleeper compartment, she tripped over a cooler. Stanford fell into the sleeper compartment and hit her head on the bed rail; the fall knocked her unconscious. Stanford’s husband, William Stanford, who was riding with her, attempted to revive her. After she regained consciousness, William offered to take her to the emergency room. Stanford declined and decided to stay in the sleeper compartment and rest until morning. Stanford contacted V.F. dispatch and made the notifications to the company about her injury. The company arranged for the two to return home.

On February 8, 2006, Mary Kay went to Dr. Allie Prater whose notes reflect that Stanford’s chief complaints were blackouts, syncope, and slurred speech. Stanford told Dr. Prater that her symptoms had begun one week prior to her visit. Dr. Prater’s notes do not mention Stanford’s fall in the truck or that she was knocked unconscious. Dr. Prater diagnosed Stanford with benign essential hypertension and ordered blood tests, an ultrasound, and a brain MRI.

Dr. Prater referred Mary Kay to Dr. Glenn Crosby, a neurosurgeon. Before seeing Dr. Crosby, Stanford went to Dr. Johnny Mitias, an orthopedic surgeon, on March 15, 2006. There was no mention of her fall in Dr. Mitias’s notes. In fact, he noted that “[t]here was no injury that started this.” Dr. Mitias diagnosed Stanford with right sciatica and ordered physical therapy.

Dr. Crosby recommended and performed spinal surgeries on August 8, 2006. After surgery, Stanford began complaining of pain in her left buttock and down her left leg. Dr. Crosby ordered a lumbar MRI, which revealed a large

rupture of the lumbar spine at L4. On November 28, 2006, Dr. Crosby performed a discectomy at the L4 level.

Dr. Crosby’s notes indicate that Stanford “had a fall this past year” that may have aggravated her back. However, Dr. Crosby’s notes do not mention that Stanford suffered a fall at work until her follow-up visit with Dr. Crosby on May 30, 2008. Dr. Crosby testified that prior to that visit, Stanford had not disclosed any history of an accident at work. However, he testified that the problems with her neck and back were probably related to her work injury.

A hearing was held before an administrative judge (AJ), who denied Stanford’s claim for workers’ compensation benefits. There was evidence submitted at the hearing that Stanford had taken a cruise despite her medical issues. In addition, there was video of her riding horses during the time of her treatment. There were also videos of Stanford at parties and bars. In one video she appeared to be having a great time as a judge in a “hairy chest contest.” Stanford appealed the AJ’s decision to the Commission, which affirmed the AJ’s decision. Stanford appealed the Commission’s decision to the Circuit Court of Union County, and the circuit court affirmed the Commission’s decision denying benefits. Stanford then appealed.

DECISION: The court affirmed the denial of workers’ compensation benefits because the evidence indicated clearly that Stanford did not tell the doctors about her work injury. The testimony about the cruise and the videos of horseback riding were damaging to Stanford’s case, but they did not indicate bias particularly because the AJ had allowed evidence from Stanford’s husband, friends, and relatives about her condition. Because evidence is damaging to one party does not mean that it should not be admitted. [*Stanford v. V.F. Jeanswear, LP*, 84 So. 3d 825 (Miss. App. 2012)]

affirm—action taken by an appellate court that approves the decision of the court below.

reverse—the term used when the appellate court sets aside the verdict or judgment of a lower court.

remand—term used when an appellate court sends a case back to trial court for additional hearings or a new trial.

federal district court—a general trial court of the federal system.

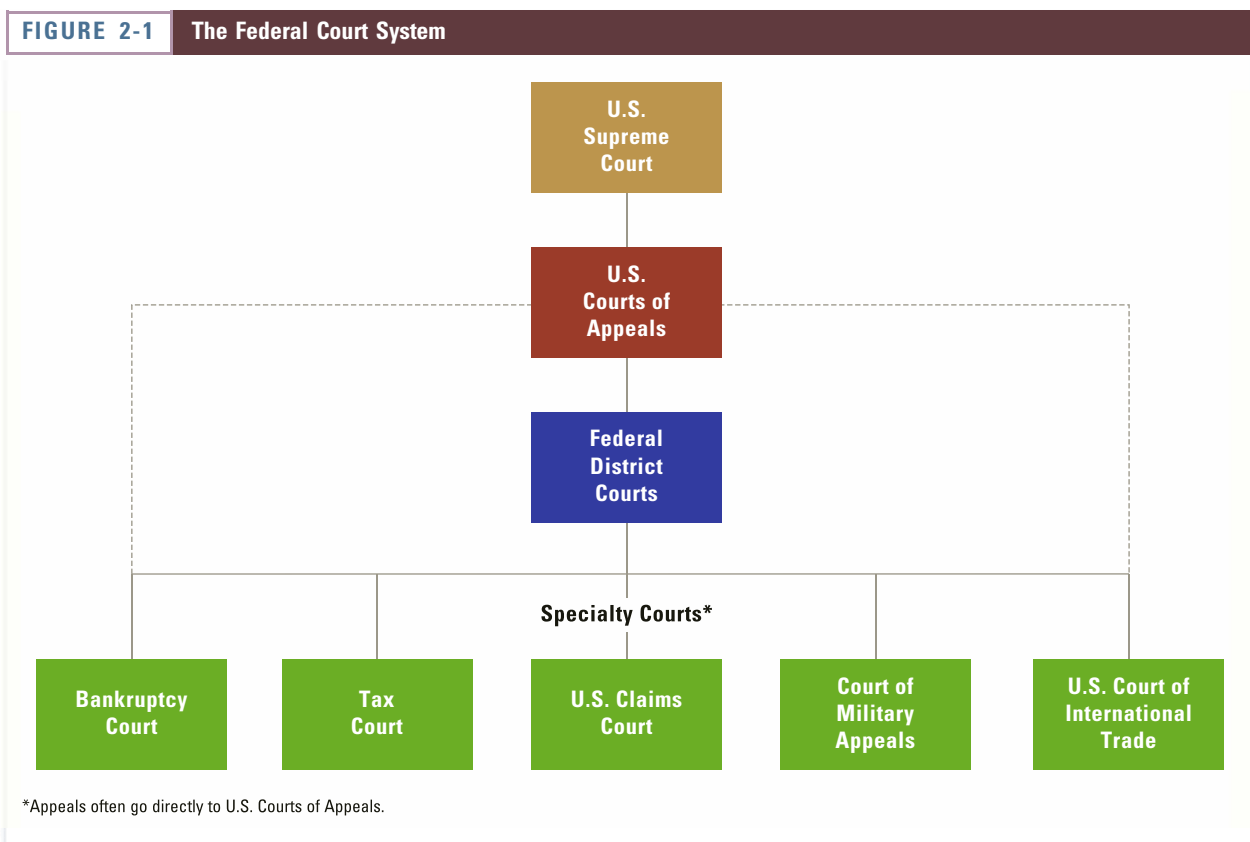
2-1b The Federal Court System

The federal court system consists of three levels of courts. Figure 2-1 illustrates federal court structure.

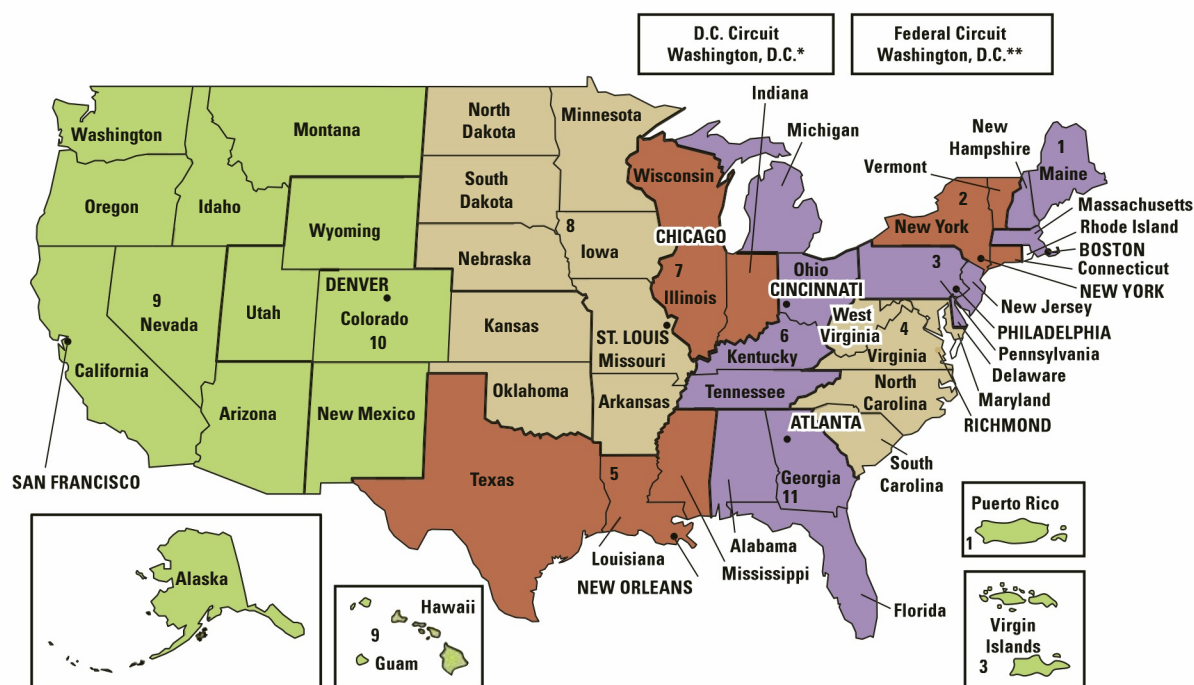
Federal District Courts

The **federal district courts** are the general trial courts of the federal system. They are courts of original jurisdiction that hear both civil and criminal matters. Criminal cases in federal district courts are those in which the defendant is charged with a violation of federal law (the U.S. Code). In addition to the criminal cases, the types of civil cases that can be brought in federal district courts include (1) civil suits in which the United States is a party, (2) cases between citizens of different states that involve damages of \$75,000 or more, and (3) cases that arise under the U.S. Constitution or federal laws and treaties.

Federal district courts are organized within each of the states. There are 94 federal districts (each state has at least one federal district and there are 89 federal districts in the United States with the remaining courts found in Puerto Rico, Guam, etc.). Judges and courtrooms are assigned according to the caseload in that geographic area of the state.³ Some states, such as New York and California, have several federal districts because



³For complete information about the courts and the number of judgeships, go to 28 U.S.C. §§81-144 and 28 U.S.C. §133.

FIGURE 2-2 The Thirteen Federal Judicial Circuits

*A sizable portion of the caseload of the D.C. Circuit comes from the federal administrative agencies and offices located in Washington, D.C., such as the Securities and Exchange Commission, the National Labor Relations Board, the Federal Trade Commission, the Secretary of the Treasury, and the Labor Department, as well as appeals from the U.S. District Court of the District of Columbia.

**Rather than being defined by geography like the regional courts of appeals, the Federal Circuit is defined by subject matter, having jurisdiction over such matters as patent infringement cases, appeals from the Court of Federal Claims and the Court of International Trade, and appeals from administrative rulings regarding subject matter such as unfair import practices and tariff schedule disputes.

of the population base and the resulting caseload. Figure 2-2 shows the geographic structure of the federal court system, including the appellate circuits.

The federal system has additional trial courts with limited jurisdiction, differing from the general jurisdiction of the federal district courts. These courts include, for example, the federal bankruptcy courts, Indian tribal courts, Tax Court, Court of Federal Claims, Court of Veterans Appeals, and the Court of International Trade.

U.S. Courts of Appeals

The final decision in a federal district court can be appealed to a court with appellate jurisdiction. In the federal court system, the federal districts are grouped together geographically into 12 judicial circuits, including one for the District of Columbia. Additionally, a thirteenth federal circuit, called the *Federal Circuit*, hears certain types of appeals from all of the circuits, including specialty cases such as patent appeals. Each circuit has an appellate court called the U.S. Court of Appeals, and the judges for these courts review the decisions of the federal district courts. Generally, a panel of three judges reviews the cases. However, some decisions, called *en banc* decisions, are made by the circuit's full panel of judges. **For Example**, in 2003, the Ninth Circuit heard an appeal on a father's right to challenge the requirement that his daughter recite the Pledge of Allegiance in the public school she attended. The contentious case had so many issues that the Ninth

en banc—the term used when the full panel of judges on the appellate court hears a case.

Circuit issued three opinions and the third opinion was issued after the case was heard *en banc*.⁴

U.S. Supreme Court

The final court in the federal system is the U.S. Supreme Court. The U.S. Supreme Court has appellate jurisdiction over cases that are appealed from the federal courts of appeals as well as from state supreme courts when a constitutional issue is involved in the case or a state court has reversed a federal court ruling. The U.S. Supreme Court does not hear all cases from the federal courts of appeals but has a process called granting a **writ of certiorari**, which is a preliminary review of those cases appealed to decide whether a case will be heard or allowed to stand as ruled on by the lower courts.⁵

The U.S. Supreme Court is the only court expressly created in the U.S. Constitution. All other courts in the federal system were created by Congress pursuant to its Constitutional power. The Constitution also makes the U.S. Supreme Court a court of original jurisdiction. The U.S. Supreme Court serves as the trial court for cases involving ambassadors, public ministers, or consuls and for cases in which two states are involved in a lawsuit. **For Example**, the U.S. Supreme Court has served for a number of years as the trial court for a Colorado River water rights case in which California, Nevada, and Arizona are parties.

writ of certiorari—the U.S. Supreme Court granting a right of review by the court of a lower court decision.

2-1c State Court Systems

General Trial Courts

Most states have trial courts of general jurisdiction that may be called superior courts, circuit courts, district courts, or county courts. These courts of general and original jurisdiction usually hear both criminal and civil cases. Cases that do not meet the jurisdictional requirements for the federal district courts would be tried in these courts. Figure 2-3 illustrates a sample state court system.

Specialty Courts

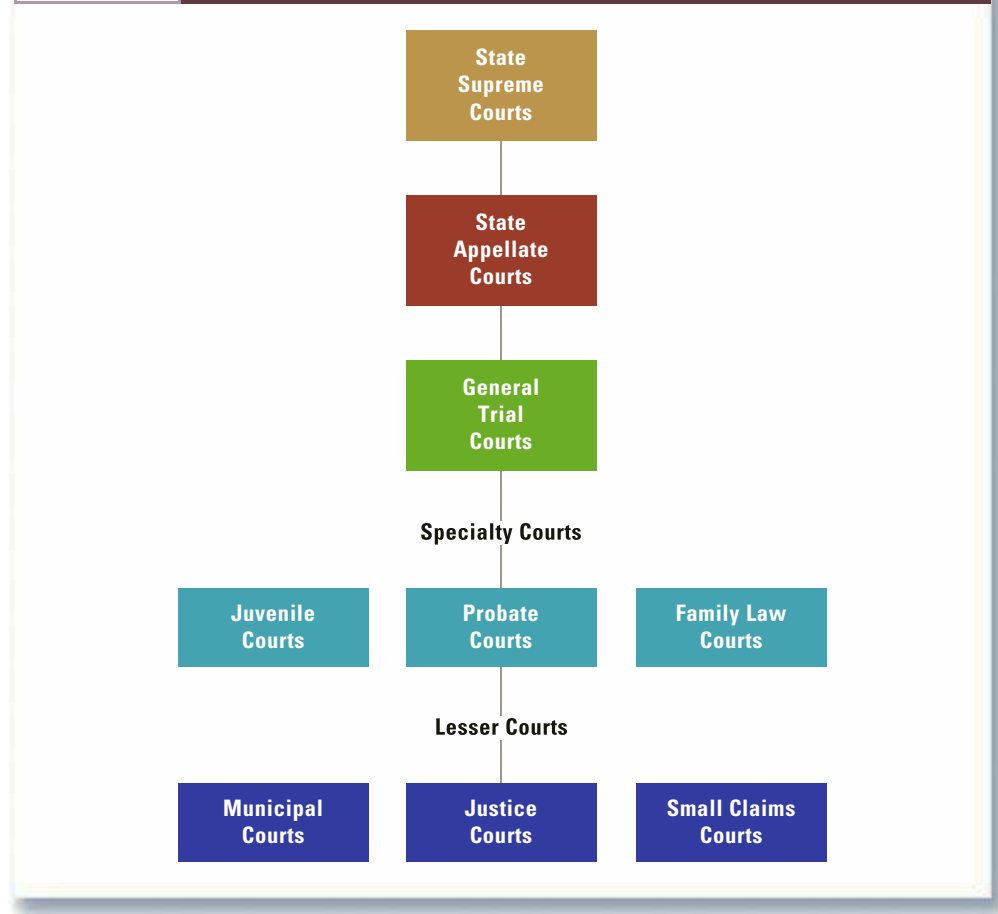
Most states also have courts with limited jurisdiction, sometimes referred to as *specialty courts*. **For Example**, most states have juvenile courts, or courts with limited jurisdiction over criminal matters that involve defendants who are under the age of 18. Other specialty courts or lesser courts in state systems are probate and family law courts.

City, Municipal, and Justice Courts

Cities and counties may also have lesser courts with limited jurisdiction, which may be referred to as *municipal courts* or *justice courts*. These courts generally handle civil matters in which the claim made in the suit is an amount below a certain level, such as \$5,000 or

⁴ *Newdow v. U.S. Congress*, 292 F.3d 597 (9th Cir. 2002) (*Newdow I*); *Newdow v. U.S. Congress*, 313 F.3d 500, 502 (9th Cir. 2002) (*Newdow II*); and *Newdow v. U.S. Congress*, 328 F.3d 466, 468 (9th Cir. 2003) (*Newdow III*). The U.S. Supreme Court eventually heard the case. *Elkgrove Unified School District v. Newdow*, 542 U.S. 1 (2004). Another *en banc* hearing occurred at the Ninth Circuit over the issues in the California gubernatorial recall election. The three-judge panel held that the voting methods in California violated the rights of voters and therefore placed a stay on the election. However, the Ninth Circuit then heard the case *en banc* and reversed the decision of the original three-judge panel.

⁵ For example, the Supreme Court refused to grant *certiorari* in a Fifth Circuit case on law school admissions at the University of Texas. However, it granted *certiorari* in a later case involving law school admissions at the University of Michigan. *Gratz v. Bollinger*, 539 U.S. 244 (2003). A case challenging undergraduate admissions at the University of Texas (*Fisher v. University of Texas*) was heard by the U.S. Supreme Court (133 S. Ct. 2411 (2013)) and remanded, but the appellate court refused to remand the case for trial on a strict scrutiny basis. That decision of the federal court of appeals is on appeal again with *certiorari* granted. *Fisher v. University of Texas at Austin*, 2015 WL 629286.

FIGURE 2-3 Sample State Court System

\$10,000. These courts may also handle misdemeanor types of offenses, such as traffic violations or violations of noise ordinances, and the trials for them.

Small Claims Courts

small claims courts—courts that resolve disputes between parties when those disputes do not exceed a minimal level; no lawyers are permitted; the parties represent themselves.

Most states also have **small claims courts** at the county or city level. These are courts of limited jurisdiction where parties with small amounts in dispute may come to have a third party, such as a justice of the peace or city judge, review their disputes and determine how they should be resolved. A true small claims court is one in which the parties are not permitted to be represented by counsel. Rather, the parties present their cases to the judge in an informal manner without the strict procedural rules that apply in courts of general jurisdiction. Small claims courts provide a faster and inexpensive means for resolving a dispute that does not involve a large amount of claimed damages.

State Appellate Courts

Most states also have intermediate-level courts similar to the federal courts of appeals. They are courts with appellate jurisdiction that review the decisions of lower courts in that state. Decisions of the general trial courts in a state would be appealed to these courts.

State Supreme Courts

The highest court in most states is generally known as the *state supreme court*, but a few states, such as New York, may call their highest court the *court of appeals*; Maine and Massachusetts, for example, call their highest court the *supreme judicial court*. State supreme courts primarily have appellate jurisdiction, but some states' courts do have original jurisdiction, such as in Arizona, where counties in litigation have their trial at the supreme court level. Most state supreme courts also have a screening process for cases. They are required to hear some cases, such as criminal cases in which the defendant has received the death penalty. A decision of a state supreme court is final except in those circumstances in which a federal law or treaty or the U.S. Constitution is involved. Cases with these federal subject matter issues can then be appealed to the U.S. Supreme Court.

2-2 Court Procedure

Once a party decides to use the court system for resolution of a dispute, that party enters a world with specific rules, procedures, and terms that must be used to have a case proceed.

2-2a Participants in the Court System

The **plaintiff** is the party that initiates the proceedings in a court of original jurisdiction. In a criminal case in which charges are brought, the party initiating the proceedings would be called the **prosecutor**. The party against whom the civil or criminal proceedings are brought is the **defendant**. A **judge** is the primary officer of the court and is either an elected or an appointed official who presides over the matters brought before the court. Attorneys or lawyers are representatives for the plaintiff and the defendant for purposes of presenting their cases. Lawyers and clients have a privilege of confidentiality known as the **attorney-client privilege**. Lawyers cannot disclose what their clients tell them unless the client is committing, or plans to commit, a crime.

A **jury** is a body of citizens sworn by a court to reach a verdict on the basis of the case presented to them. Jurors are chosen for service based on lists compiled from voter registration and driver's license records.

2-2b Which Law Applies—Conflicts of Law

When a lawsuit is brought, there is not just the question of where a case will be tried but also of what law will be applied in determining the rights of the parties. The principle that determines when a court applies the law of its own state—the law of the forum—or some foreign law is called *conflict of laws*. Because there are 50 state court systems and a federal court system, as well as a high degree of interstate activity, conflicts of law questions arise frequently.

Some general rules apply. For example, the law of the state in which the court is located governs the case on procedural issues and rules of evidence. In contract litigation, the court applies the law of the state in which the contract was made for determining issues of formation. Performance disputes and damages for nonperformance are generally governed by the law of the state where the contract is to be performed. International contracts follow similar rules. **For Example**, a California court will apply Swiss law to a contract made in Switzerland that is to be performed in that country.

However, it is becoming more common for the parties to specify their choice of law in their contract.⁶ In the absence of a law-selecting provision in the contract, there is a

plaintiff—party who initiates a lawsuit.

prosecutor—party who originates a criminal proceeding.

defendant—party charged with a violation of civil or criminal law in a proceeding.

judge—primary officer of the court.

attorney-client privilege—right of individual to have discussions with his/her attorney kept private and confidential.

jury—a body of citizens sworn by a court to determine by verdict the issues of fact submitted to them.

⁶For example, when tourists from other countries engage in activities there, they sign a combination waiver and contract that provides in the event of an injury that they agree to be governed by the laws of that country in terms of recovery and not those of the United States. *E & H Cruises, Ltd. v. Baker*, 88 So. 3d 291 (Fla. App. 2012).

growing acceptance of the rule that a contract should be governed by the law of the state that has the most significant contacts with the transaction.

For Example, assume the buyer's place of business and the seller's plant are located in Nebraska, and the buyer is purchasing goods from the seller to resell to Nebraska customers. Many courts will hold that this is a contract governed by the law of Nebraska. In determining which state has the most significant contacts, the court considers the place of contracting, negotiating, and performing; the location of the subject matter of the contract; and the domicile (residence), states of incorporation, and principal place of business of the parties.

complaint—the initial pleading filed by the plaintiff in many actions, which in many states may be served as original process to acquire jurisdiction over the defendant.

process—paperwork served personally on a defendant in a civil case.

answer—what a defendant must file to admit or deny facts asserted by the plaintiff.

motion to dismiss—a pleading that may be filed to attack the adverse party's pleading as not stating a cause of action or a defense.

demurrer—a pleading to dismiss the adverse party's pleading for not stating a cause of action or a defense.

counterclaim—a claim that the defendant in an action may make against the plaintiff.

pleadings—the papers filed by the parties in an action in order to set forth the facts and frame the issues to be tried, although, under some systems, the pleadings merely give notice or a general indication of the nature of the issues.

discovery—procedures for ascertaining facts prior to the time of trial in order to eliminate the element of surprise in litigation.

2-2c Initial Steps in a Lawsuit

The following steps in a lawsuit generally apply in cases brought in courts of original jurisdiction. Not every step applies in every case, but understanding litigation steps and terms is important for businesspeople.

Commencement of a Lawsuit

A lawsuit begins with the filing of a **complaint**. The complaint generally contains a description of the wrongful conduct and a request for damages, such as a monetary amount. **For Example**, a plaintiff in a contract suit would describe the contract, when it was entered into, and when the defendant stopped performance on the contract. A copy of the contract would be attached to the complaint.

Service of Process

Once the plaintiff has filed the complaint with the proper court, the plaintiff has the responsibility of notifying the defendant that the lawsuit has been filed. The defendant must be served with **process**. Process, often called a *writ*, *notice*, or *summons*, is delivered to the defendant and includes a copy of the complaint and notification that the defendant must appear and respond to the allegations in the complaint.

The Defendant's Response and the Pleadings

After the defendant is served with process in the case, the defendant is required to respond to or **answer** the complaint within the time provided under the court's rules. In answering the plaintiff's complaint, the defendant has several options. For example, the defendant could make a **motion to dismiss**, which is a request to the court to dismiss the lawsuit on the grounds that, even if everything the plaintiff said in the complaint were true, there is still no right of recovery. A motion to dismiss is also called a **demurrer**.

A defendant could also respond and deny the allegations. **For Example**, in a contract lawsuit, the defendant-seller could say he did not breach the contract but stopped shipment of the goods because the plaintiff-buyer did not pay for the goods in advance as the contract required. A defendant could also **counterclaim** in the answer, which is asking the court for damages as a result of the underlying dispute. The defendant-seller in the contract lawsuit might ask for damages in the counterclaim for the plaintiff-buyer's failure to pay as the contract required.

All documents filed in this initial phase of the case are referred to as the **pleadings**. The pleadings are a statement of the case and the basis for recovery if all the facts alleged can be proved.

Discovery

The Federal Rules of Civil Procedure and similar rules in all states permit one party to obtain from the adverse party information about all witnesses, documents, and any other items relevant to the case. **Discovery** requires each side to name its potential witnesses

and to provide each side the chance to question those witnesses in advance of the trial. Each party also has the opportunity to examine, inspect, and photograph books, records, buildings, and machines. Even examining the physical or mental condition of a party is part of discovery when it has relevance in the case. The scope of discovery is extremely broad because the rules permit any questions that are likely to lead to admissible evidence.

deposition—the testimony of a witness taken out of court before a person authorized to administer oaths.

impeach—using prior inconsistent evidence to challenge the credibility of a witness.

interrogatories—written questions used as a discovery tool that must be answered under oath.

request for production of documents—discovery tool for uncovering paper evidence in a case.

motion for summary judgment—request that the court decide a case on basis of law only because there are no material issues disputed by the parties.

expert witness—one who has acquired special knowledge in a particular field as through practical experience or study, or both, whose opinion is admissible as an aid to the trier of fact.

voir dire examination—the preliminary examination of a juror or a witness to ascertain fitness to act as such.

Deposition. A **deposition** is the testimony of a witness taken under oath outside the courtroom; it is transcribed by a court reporter. Each party is permitted to question the witness. If a party or a witness gives testimony at the trial that is inconsistent with her deposition testimony, the prior inconsistent testimony can be used to **impeach** the witness's credibility at trial.

Depositions can be taken either for discovery purposes or to preserve the testimony of a witness who will not be available during the trial. Some states now permit depositions to be videotaped. A videotape is a more effective way of presenting deposition testimony than reading that testimony at trial from a reporter's transcript because jurors can see the witness and the witness's demeanor and hear the words as they were spoken, complete with inflection.

Other Forms of Discovery. Other forms of discovery include medical exams, particularly in cases in which the plaintiff is claiming damages for physical injuries. Written **interrogatories** (questions) and written **requests for production of documents** are discovery requests that can be very time consuming to the answering party and often lead to pretrial legal disputes between the parties and their attorneys as a result of the legal expenses involved.

Motion for Summary Judgment

If a case has no material facts in dispute, either party can file a **motion for summary judgment**. Using affidavits or deposition testimony obtained in discovery, the court can find that there are no factual issues and decide the case as a matter of law. **For Example,** suppose that the parties can agree that they entered into a life insurance contract but dispute whether the policy applies when there is a suicide. The facts are not in dispute; the law on payment of insurance proceeds in the event of a suicide is the issue. Such a case is one that is appropriate for summary judgment.

Designation of Expert Witnesses

In some cases, such as those involving product safety, the parties may want to designate an expert witness. An **expert witness** is a witness who has some special expertise, such as an economist who gives expert opinion on the value of future lost income or a scientist who testifies about the safety of a prescription drug. There are rules for naming expert witnesses as well as for admitting into evidence any studies or documents of the expert.⁷ The purpose of these rules is to avoid the problem of what has been called *junk science*, or the admission of experts' testimony and research that has not been properly conducted or reviewed by peers.

2-2d The Trial

Selecting a Jury

Jurors drawn for service are questioned by the judge and lawyers to determine whether they are biased or have any preformed judgments about the parties in the case. Jury selection is called **voir dire examination**. **For Example,** in the trial of Martha Stewart, the multimedia home and garden diva, it took a great deal of time for the lawyers to question

⁷ *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993).



E-COMMERCE & CYBERLAW

Google's Impact on Trials

The courts continue to struggle with the effects of the Internet on the jury selection process as well as with the jurors themselves in accessing social media sites while serving on a jury. There have been 134 cases in the past three years that involved issues with Google and jurors. In *McGaha v. Com.*, 414 S.W.3d 1 (Ky. 2013), the court held that a juror's failure to disclose being a friend of the defendant's wife on Facebook is not a presumed reason for disqualification of that juror on the basis of bias or lack of impartiality. In *People v. Levack*, 2014 WL 2118088 (Mich. App.), the jurors used Google Maps to determine whether there was a shortcut to the victim's home, as claimed in the testimony. The jurors did not consider the Google information in their deliberations and the court found that a new trial was not necessary.

The key points of these cases are that prospective jurors should disclose online connections with any of the parties in a case and that jurors should not consider any information that was not provided through the trial process. The courts follow these basic principles when evaluating whether a mistrial is necessary when the Internet has affected jurors or prospective jurors. In fact, judges often include an instruction similar to this one in turning the case over to a jury:

*Do not visit or view any place discussed in this case, and do not use any internet maps or Google Earth or any other program or device to search for or view any place discussed in the testimony.**

**State v. Feliciano*, 2014 WL 1577768 (N.J. Sup.).

opening statements—statements by opposing attorneys that tell the jury what their cases will prove.

admissibility—the quality of the evidence in a case that allows it to be presented to the jury.

direct examination—examination of a witness by his or her attorney.

cross-examination—the examination made of a witness by the attorney for the adverse party.

redirect examination—questioning after cross-examination, in which the attorney for the witness testifying may ask the same witness other questions to overcome effects of the cross-examination.

recross-examination—an examination by the other side's attorney that follows the redirect examination.

the potential jurors about their prior knowledge concerning the case, which had received nationwide attention and much media coverage. Lawyers have the opportunity to remove jurors who know parties in the case or who indicate they have already formed opinions about guilt or innocence. The attorneys question the potential jurors to determine if a juror should be *challenged for cause* (e.g., when the prospective juror states he is employed by the plaintiff's company). Challenges for cause are unlimited, but each side can also exercise six to eight peremptory challenges.⁸ A peremptory challenge is a challenge that is used to strike (remove) a juror for any reason except on racial grounds.⁹

Opening Statements

After the jury is chosen, the attorneys for each of the parties make their **opening statements** to the jury. An opening statement, as one lawyer has explained, makes a puzzle frame for the case so jurors can follow the witnesses and place the pieces of the case—the various forms of evidence—within the frame.

The Presentation of Evidence

Following the opening statements, the plaintiff presents his case with witnesses and other evidence. A judge rules on the **admissibility** of evidence. Evidence can consist of documents, testimony, expert testimony, medical information from exams, and even physical evidence.

In the case of testimony, the attorney for the plaintiff conducts **direct examination** of his witnesses during his case, and the defense attorney conducts **cross-examination** of the plaintiff's witnesses. The plaintiff's attorney can then ask questions again of his witnesses in what is called **redirect examination**. Finally, the defense attorney may question the plaintiff's witnesses again in **recross-examination**. The defendant presents her case after the plaintiff's case concludes. During the defendant's case, the lawyer for the

⁸The number of peremptory challenges varies from state to state and may also vary within a particular state depending on the type of case. For example, in Arizona, peremptory challenges are unlimited in capital cases.

⁹*Felkner v. Jackson*, 562 U.S. 594 (2011).



THINKING THINGS THROUGH

Why Do We Require Sworn Testimony?

There is a difference between what people say in conversation (and even what company executives say in speeches and reports) and what they are willing to say under oath. Speaking under oath often means that different information and recollections emerge. The oath is symbolic and carries the penalty of criminal prosecution for perjury if the testimony given is false.

The *Wall Street Journal* has reported that the testimony of executives in the Microsoft antitrust trial and their statements regarding their business relationships outside the courtroom are quite different. For example, the following quotations indicate some discrepancies. Eric Benhamou, the chief executive officer (CEO) of Palm, Inc., said:

We believe that the handheld opportunity remains wide open Unlike the PC industry, there is no monopoly of silicon, there is no monopoly of software.

However, at the Microsoft trial, another officer of Palm, Michael Mace, offered the following testimony:

We believe that there is a very substantial risk that Microsoft could manipulate its products and its

standards in order to exclude Palm from the marketplace in the future.

Likewise, Microsoft has taken different positions inside and outside the courtroom. For example, an attorney for Microsoft stated that Microsoft had “zero deployments of its interactive TV middleware products connected to cable systems in the United States.” However, Microsoft’s marketing materials provide as follows:

*Microsoft’s multiple deployments around the world now including Charter-show Microsoft TV is ready to deploy now and set the standard for what TV can be.**

Explain why the executives had differing statements. For more information on the Microsoft antitrust cases, go to <http://www.usdoj.gov> or <http://www.microsoft.com>.

*Rebecca Buckman and Nicholas Kulish, “Microsoft Trial Prompts an Outbreak of Doublespeak,” *Wall Street Journal*, April 15, 2002, B1, B3.

directed verdict—a

direction by the trial judge to the jury to return a verdict in favor of a specified party to the action.

summation—the attorney address that follows all the evidence presented in court and sums up a case and recommends a particular verdict be returned by the jury.

mistrial—a court’s declaration that terminates a trial and postpones it to a later date; commonly entered when evidence has been of a highly prejudicial character or when a juror has been guilty of misconduct.

defendant conducts direct examination of the defendant’s witnesses, and the plaintiff’s lawyer can then cross-examine the defendant’s witnesses.

Motion for a Directed Verdict

A motion for a **directed verdict** asks the court to grant a verdict because even if all the evidence that has been presented by each side were true, there is either no basis for recovery or no defense to recovery.

For Example, suppose that a plaintiff company presented evidence that an employee who quit working for the company posted on his Facebook page, “I just wasn’t happy there.” The company might not feel good about the former employee’s post, but there is no false statement and no breach of privacy. The evidence is true, but there is no legal right of recovery. The defendant employee would be entitled to a directed verdict. A directed verdict means that the party has not presented enough evidence to show that there is some right of recovery under the law.

Closing Arguments or Summation

After the witnesses for both parties have been examined and all the evidence has been presented, each attorney makes a closing argument. These statements are also called **summations**; they summarize the case and urge the jury to reach a particular verdict.

Motion for Mistrial

During the course of a trial, when necessary to avoid great injustice, the trial court may declare a **mistrial**. A mistrial requires a do-over, a new jury. A mistrial can be declared for

jury or attorney misconduct. **For Example**, if a juror were caught fraternizing with one of the lawyers in the case, objectivity would be compromised and the court would most likely declare a mistrial. See also E-Commerce & Cyberlaw (Google's Impact on Trials) for more information on juror misconduct and case dismissals.

Jury Instructions and Verdict

instruction—summary of the law given to jurors by the judge before deliberation begins.

After the summation by the attorneys, the court gives the jurors **instructions** on the appropriate law to apply to the facts presented. The jury then deliberates and renders its verdict. After the jury verdict, the court enters a judgment. If the jury is deadlocked and unable to reach a verdict, known as a hung jury or a mistrial, the case is reset for a new trial at some future date.

Motion for New Trial; Motion for Judgment *n.o.v.*

judgment *n.o.v.*—or *non obstante veredicto* (notwithstanding the verdict), a judgment entered after verdict upon the motion of the losing party on the ground that the verdict is so wrong that a judgment should be entered the opposite of the verdict.

A court may grant a **judgment *non obstante veredicto*** or a **judgment *n.o.v.*** (notwithstanding the verdict) if the verdict is clearly wrong as a matter of law. The court can set aside the verdict and enter a judgment in favor of the other party. Perhaps one of the most famous judgments *n.o.v.* occurred in Boston in 1997 when a judge reversed the murder conviction of nanny Louise Woodward, who was charged with the murder of one of her young charges.

2-2e Post-trial Procedures

Recovery of Costs/Attorney Fees

Generally, the prevailing party is awarded costs. Costs include filing fees, service-of-process fees, witness fees, deposition transcript costs, and jury fees. Costs do not



ETHICS & THE LAW

Honesty, Lawyers, and BP Claims

Following the Deepwater Horizon oil spill in the Gulf of Mexico, BP established a \$20 billion recovery fund. The purpose of the fund was to reimburse businesses and individuals who were affected by the spill, such as fishers, resorts, and boating companies that provided tours and other services.

Several lawyers and accountants were assigned to the Claims Administration Office (CAO) with the responsibilities for the receipt, evaluation, and payment of claims. In 2013, the federal judge overseeing the claims process became concerned about the conduct of those who were administering the trust. As a result, the judge appointed Louis Freeh, a former federal judge and director of the FBI, to investigate.

Among the many findings of the cases were conflicts, such as Lionel Sutton and Christine Reitano, husband and wife, two lawyers working at the CAO who had practiced law together in New Orleans as Sutton & Reitano. They referred a client, Casey Thonn, to Glen Lerner of AndryLerner, a law firm representing claimants to the CAO. Ms. Reitano then requested a referral fee from AndryLerner. The referral arrangement was never disclosed to the client, Casey Thonn,

as Louisiana's code of professional ethics requires, nor the CAO office. Mr. Sutton continued his representation of Casey Thonn in a personal injury case but did not disclose that client relationship to anyone at the CAO. Mr. Sutton also did not disclose that he had a business relationship in a reclamation company, Crown LLC, and that he was one of two equity owners of that company, with Glen Lerner, a partner at AndryLerner, being the other owner. AndryLerner had a total of \$7,908,460 in claims before the CAO. Mr. Sutton approved 496 of the claims.

On November 25, 2014, the U.S. Attorney for the Middle District of Florida announced 27 indictments against individuals who are alleged to have submitted fraudulent claims for reimbursement, ranging from \$11,000 to \$122,000, and totaling over \$1,000,000.

BP began running full-page ads in major newspaper around the country with examples of the fraudulent claims. The judge is seeking restitution from many of the claimants.

What should the lawyers have done in their situations? Why did they not do it?

include compensation spent by a party for preparing the case or being present at trial, including the time lost from work because of the case and the fee paid to the attorney, although lost wages from an injury are generally part of damages.

Attorney fees may be recovered by a party who prevails if a statute permits the recovery of attorney fees or if the complaint involves a claim for breach of contract and the contract contains a clause providing for recovery of attorney fees.

execution—the carrying out of a judgment of a court, generally directing that property owned by the defendant be sold and the proceeds first be used to pay the execution or judgment creditor.

garnishment—the name given in some states to attachment proceedings.

Execution of Judgment

After a judgment has been entered or all appeals or appeal rights have ended, the losing party must pay that judgment. The winning party can also take steps to execute, or carry out, the judgment. The **execution** is accomplished by the seizure and sale of the losing party's assets by the sheriff according to a writ of execution or a writ of possession.

Garnishment is a common method of satisfying a judgment. When the judgment debtor is an employee, the appropriate judicial authority in the state garnishes (by written notice to the employer) a portion of the employee's wages on a regular basis until the judgment is paid.

2-3 Alternative Dispute Resolution (ADR)

Parties can use means other than litigation to resolve disagreements or disputes. Litigation takes significant time and money, so many businesses use alternative methods for resolving disputes. Those methods include arbitration, mediation, and several other formats. Figure 2-4 provides an overall view of alternative dispute resolution procedures.

2-3a Arbitration

arbitration—the settlement of disputed questions, whether of law or fact, by one or more arbitrators by whose decision the parties agree to be bound.

In **arbitration**, arbitrators (disinterested persons selected by the parties to the dispute) hear evidence and determine a resolution. Arbitration enables the parties to present the facts before trained experts familiar with the industry practices that may affect the nature and outcome of the dispute. Arbitration first reached extensive use in the field of commercial contracts and was encouraged as a means of avoiding expensive litigation and easing the workload of courts. However, over the past decade the popularity of arbitration has declined because of increasing procedural burdens and longer and more complex hearings. There have been an increasing number of cases in which arbitration clauses have been set aside as too onerous for a consumer or small business party to the agreement.¹⁰

A number of states have adopted the Uniform Arbitration Act.¹¹ Under this act and similar statutes, the parties to a contract may agree in advance that all disputes arising under it will be submitted to arbitration. In some instances, the contract will name the arbitrators for the duration of the contract. The uniform act requires a written agreement to arbitrate.¹²

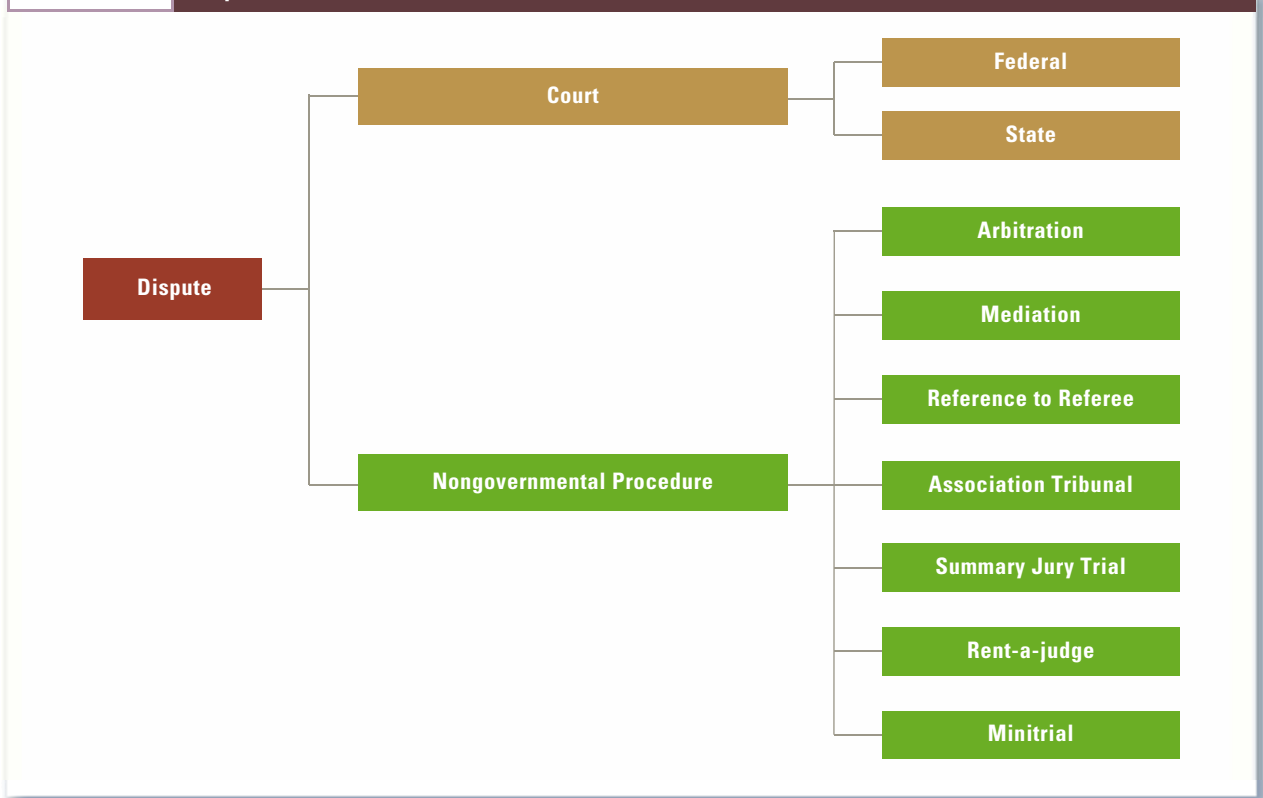
The Federal Arbitration Act¹³ provides that an arbitration clause in a contract relating to an interstate transaction is valid, irrevocable, and enforceable. When a contract subject to the Federal Arbitration Act provides for the arbitration of disputes, the parties are

¹⁰ *College Park Pentecostal Holiness Church v. General Steel Corp.*, 847 F. Supp. 2d 807 (D. Md. 2012).

¹¹ On August 3, 2000, the National Conference of Commissioners on Uniform State Laws unanimously passed major revisions to the Uniform Arbitration Act (UAA). These revisions were the first major changes in 45 years to the UAA, which is the basis of arbitration law in 49 states, although not all states have adopted it in its entirety or most current form. Only 18 states and the District of Columbia have adopted the UAA 2000 revisions. John Lande, "A Framework for Advancing Negotiation Theory: Implications from a Study of How Lawyers Reach Agreement in Pretrial Litigation," 16 *Cardozo Journal of Conflict Resolution* 1 (2014).

¹² *Minkowitz v. Israeli*, 77 A.3d 1189 (N.J. Super. 2013).

¹³ 9 U.S.C. §§114 *et seq.*

FIGURE 2-4 Dispute Resolution Procedures

bound to arbitrate in accordance with the federal statute even if the agreement to arbitrate would not be binding under state law.

Mandatory Arbitration

In contrast with statutes that merely regulate arbitration when it is selected voluntarily by the parties, some statutes require that certain kinds of disputes be submitted to arbitration. In some states, by rule or statute, the arbitration of small claims is required.

Finality of Arbitration

Most parties provide, within their arbitration agreements, that the decision of the arbitrator will be final. Such a clause is binding on the parties, even when the decision seems to be wrong, and can be set aside only if there is clear proof of fraud, arbitrary conduct, or a significant procedural error.¹⁴

mediation—the settlement of a dispute through the use of a messenger who carries to each side of the dispute the issues and offers in the case.

2-3b Mediation

In **mediation**, a neutral person acts as a messenger between opposing sides of a dispute, carrying to each side the latest settlement offer made by the other. The mediator has no authority to make a decision, although in some cases the mediator may make suggestions that might ultimately be accepted by the disputing parties.

¹⁴ *PoolRE Ins. Corp. v. Organizational Strategies, Inc.*, 2014 WL 1320188 (S.D. Tex. 2014).

The use of mediation has the advantage of keeping discussions going when the disputing parties have developed such fixed attitudes or personal animosity that direct discussion between them has become impossible.

2-3c MedArb

In this new form of alternative dispute resolution (ADR), the arbitrator is also empowered to act as a mediator. Beyond just hearing a case, the arbitrator acts as a messenger for the parties on unresolved issues.

2-3d Expert Panel

Particularly in the construction industry, one of the tools of alternative dispute resolution is the submission of a case, or perhaps a particular issue, to a panel of experts in the industry. This method has gained popularity in the construction industry where there can be technical questions about breach, including issues related to materials, process, and delays. These experts can focus on these issues and not be caught in the procedural grind of either litigation or arbitration.

2-3e Reference to a Third Person

reference to a third person—settlement that allows a nonparty to resolve the dispute.

Many types of transactions provide for **reference to a third person**, in which a third person or a committee makes an out-of-court determination of the rights of persons. **For Example**, employees and an employer may have agreed as a term of the employment contract that claims of employees under retirement plans will be decided by a designated board or committee. In a sales contract, the seller and buyer can select a third person to determine the price to be paid for goods. Construction contracts often include a provision for disputes to be referred to the architect in charge of the construction with the architect's decision being final.

These referrals often eliminate the disputes or pursuit of remedies. **For Example**, fire insurance policies commonly provide that if the parties cannot agree on the amount of the loss, each will appoint an appraiser, the two appraisers will appoint a third appraiser, and the three will determine the amount of the loss the insurer is required to pay.

2-3f Association Tribunals

association tribunal—a court created by a trade association or group for the resolution of disputes among its members.

Many disputes never reach the courts because both parties to a dispute belong to a group or an association, and the **association tribunal** created by the group or association disposes of the matter. Trade associations commonly require their members to employ out-of-court methods of dispute settlement. **For Example**, the National Association of Home Builders requires its member builders to use arbitration. The National Automobile Dealers Association provides for panels to determine warranty claims of customers. The decision of such panels is final as to the builder or dealer, but the consumer can still bring a regular lawsuit after losing before the panel. Members of an association must use the association tribunal, which means they cannot bypass the association tribunal and go directly to a law court.¹⁵

2-3g Summary Jury Trial

summary jury trial—a mock or dry-run trial for parties to get a feel for how their cases will play to a jury.

A **summary jury trial** is a dry-run or mock trial in which the lawyers present their claims before a jury of six persons. The object is to get the reaction of a sample jury. No evidence is presented before this jury, and it bases its opinion solely on what the lawyers state. The determination of the jury has no binding effect, but it has value in that it

¹⁵The securities industry follows this process as well.

gives the lawyers some idea of what a jury might think if there were an actual trial. This type of ADR has special value when the heart of a case is whether something is reasonable under all circumstances. When the lawyers and their clients see how the sample jury reacts, they may moderate their positions and reach a settlement.

2-3h Rent-A-Judge

rent-a-judge plan—dispute resolution through private courts with judges paid to be referees for the cases.

Under the **rent-a-judge plan**, the parties hire a judge to hear the case. In many states, the parties voluntarily choose the judge as a “referee,” and the judge acts under a statute authorizing the appointment of referees. Under such a statute, the referee hears all evidence just as though there were a regular trial, and the rented judge’s determination is binding on the parties unless reversed on appeal if such an appeal (like a court trial) is permitted under the parties’ agreement.

2-3i Minitrial

minitrial—a trial held on portions of the case or certain issues in the case.

When only part of a case is disputed, the parties may stay within the framework of a lawsuit but agree that only the disputed issues will be taken to trial and submitted to a jury. **For Example**, if there is no real dispute over who is liable but the parties disagree as to the damages, the issue of damages alone may be submitted to the jury. This shortened trial is often called a **minitrial**. A minitrial may use a retired judge to make a decision on just the disputed issues. The parties may also specify whether this decision will be binding on the parties. As a practical matter, the evaluation of a case by a neutral person often brings the opposing parties together to reach a settlement.

2-3j Contract Provisions

The parties’ contract may pave the way for the settlement of future disputes by including clauses that require the parties to use one of the means of ADR. Other provisions in contracts that serve to keep the parties calm with the hope of resolving differences without a lawsuit include waiting periods before a suit can be filed and obligations to continue performing even as they try to resolve differences and issues.

Make the Connection

Summary

Courts have been created to hear and resolve legal disputes. A court’s specific power is defined by its jurisdiction. Courts of original jurisdiction are trial courts, and courts that review the decisions of trial courts are appellate courts. Trial courts may have general jurisdiction to hear a wide range of civil and criminal matters, or they may be courts of limited jurisdiction—such as a probate court or the Tax Court—with the subject matter of their cases restricted to certain areas.

The courts in the United States are organized into two different systems: the state and federal court systems.

There are three levels of courts, for the most part, in each system, with trial courts, appellate courts, and a supreme court in each. The federal courts are federal district courts, federal courts of appeals, and the U.S. Supreme Court.

In the states, there may be specialized courts, such as municipal, justice, and small claims courts, for trial courts. Within the courts of original jurisdiction, there are rules for procedures in all matters brought before them. A civil case begins with the filing of a complaint by a plaintiff, which is then answered by a defendant. The parties may be represented by their attorneys. Discovery is the pretrial

process used by the parties to find out the evidence in the case. The parties can use depositions, interrogatories, and document requests to uncover relevant information.

The case is managed by a judge and may be tried to a jury selected through the process of *voir dire*, with the parties permitted to challenge jurors on the basis of cause or through the use of their peremptory challenges. The trial begins following discovery and involves opening statements and the presentation of evidence, including the direct examination and cross-examination of witnesses. Once a judgment is entered, the party who has won can

collect the judgment through garnishment and a writ of execution.

Alternatives to litigation for dispute resolution are available, including arbitration, mediation, MedArb, reference to a third party, association tribunals, summary jury trials, rent-a-judge plans, minitrials, and expert panels. Court dockets are relieved and cases consolidated using judicial triage, a process in which courts hear the cases involving the most serious medical issues and health conditions first. Triage is a blending of the judicial and alternative dispute resolution mechanisms.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

2-1 The Court System

- LO.1** Explain the federal and state court systems
 See Figure 2-1 and accompanying text, page 16.
 See Figure 2-3 and accompanying text, page 19.
 See the *Stanford* case on page 15 for a discussion of reversible error.

2-2 Court Procedure

- LO.2** Describe court procedures
 See the discussion of steps in litigation, pages 21–22.
 See the *For Example* discussion of the Martha Stewart *voir dire* example, page 22.

- See the Google jury issues box on page 23.
 See the “Why Do We Require Sworn Testimony” box on page 24.

2-3 Alternative Dispute Resolution (ADR)

- LO.3** List the forms of alternative dispute resolution and distinguish among them
 See the discussion of arbitration, page 26.
 See the discussion of other forms of ADR, mediation, minitrials, rent-a-judge, MedArb, judicial triage, and referral to a third party, pages 27–29.
 See the discussion of employee and employer referrals of disputes to a designated board or committee, page 28.

Key Terms

admissibility	expert witness	plaintiff
affirm	federal district courts	pleadings
answer	garnishment	process
appeal	general jurisdiction	prosecutor
appellate jurisdiction	impeach	recross-examination
arbitration	instructions	redirect examination
association tribunal	interrogatories	reference to a third person
attorney-client privilege	judge	remand
complaint	judgment <i>n.o.v.</i> or judgment <i>non obstante veredicto</i>	rent-a-judge plan
counterclaim	jurisdiction	requests for production of documents
court	jury	reverse
cross-examination	limited (special) jurisdiction	reversible error
defendant	mediation	small claims courts
demurrer	minitrial	subject matter jurisdiction
deposition	mistrial	summary jury trial
direct examination	motion for summary judgment	summations
directed verdict	motion to dismiss	<i>voir dire</i> examination
discovery	opening statements	writ of <i>certiorari</i>
<i>en banc</i>	original jurisdiction	
execution		

Questions and Case Problems

1. List the steps in a lawsuit. Begin with the filing of the complaint, and explain the points at which there can be a final determination of the parties' rights in the case.
2. Explain why a business person would want to use alternative dispute resolution methods. Discuss the advantages. What disadvantages have you learned?
3. Ralph Dewey has been charged with a violation of the Electronic Espionage Act, a federal statute that prohibits the transfer, by computer or disk or other electronic means, of a company's proprietary data and information. Ralph is curious. What type of court has jurisdiction? Can you determine which court?
4. Jerry Lewinsky was called for jury duty. When *voir dire* began, Jerry realized that the case involved his supervisor at work. Can Jerry remain as a juror on the case? Why or why not?
5. Carolyn, Elwood, and Isabella are involved in a real estate development. The development is a failure, and Carolyn, Elwood, and Isabella want to have their rights determined. They could bring a lawsuit, but they are afraid the case is so complicated that a judge and jury not familiar with the problems of real estate development would not reach a proper result. What can they do?
6. Larketta Randolph purchased a mobile home from Better Cents Home Builders, Inc., and financed her purchase through Green Tree Financial Corporation. Ms. Randolph signed a standard form contract that required her to buy Vendor's Single Interest insurance, which protects the seller against the costs of repossession in the event of default. The agreement also provided that all disputes arising from the contract would be resolved by binding arbitration. Larketta found that there was an additional \$15 in finance charges that were not disclosed in the contract. She and other Green Tree customers filed a class-action suit to recover the fees. Green Tree moved to dismiss the suit because Larketta had not submitted the issue to arbitration. Larketta protests, "But I want the right to go to court!" Does she have that right? What are the rights of parties under a contract with an arbitration clause? [*Green Tree Financial Corp. v. Randolph*, 531 U.S. 79]
7. John Watson invested \$5,000,000 in SmartRead, Inc., a company that was developing an electronic reading device. Within a few months, the \$5,000,000 was spent but SmartRead never developed the reading device. John filed suit against the directors of SmartRead for their failure to supervise SmartRead's CEO in his operation of the company. The directors used an expert on corporate governance to testify that the directors had done all that they could to oversee the company. The expert did not disclose that he had served as a director of a company and had been found to be negligent in his role there and had been required to pay \$370,000 to shareholders. The directors won the case. Is there anything Watson can do?
8. Indicate whether the following courts are courts of original, general, limited, or appellate jurisdiction:
 - a. Small claims court
 - b. Federal bankruptcy court
 - c. Federal district court
 - d. U.S. Supreme Court
 - e. Municipal court
 - f. Probate court
 - g. Federal court of appeals
9. The Nursing Home Pension Fund filed suit against Oracle Corporation alleging that Larry Ellison, the company's CEO, misled investors in 2001 about the true financial condition of the company. During the time of the alleged misrepresentation, Mr. Ellison was working with a biographer on his life story and there are videotapes of Mr. Ellison's interviews with his biographer as well as e-mails between the two that discuss Oracle. Could the Nursing Home Pension Fund have access to the tapes and e-mails? Explain how. [*Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226 (9th Cir.)]
10. Mostek Corp., a Texas corporation, made a contract to sell computer-related products to North American Foreign Trading Corp., a New York corporation. North American used its own purchase order form, on which appeared the statement that any dispute arising out of an order would be submitted to arbitration, as provided in the terms set forth on the back of the order. Acting on the purchase order, Mostek delivered almost all of the goods but failed to deliver the final installment. North American then demanded that the matter be arbitrated. Mostek refused to do so. Was arbitration required? [*Application of Mostek Corp.*, 502 N.Y.S.2d 181 (App. Div.)]

11. Caesar Wright was a longshoreman in Charleston, South Carolina, and a member of the International Longshoremen's Association (AFL-CIO). Wright used the union hiring hall. The collective bargaining agreement (CBA) of Wright's union provides for arbitration of all grievances. Another clause of the CBA states: "It is the intention and purpose of all parties hereto that no provision or part of this Agreement shall be violative of any Federal or State Law."

On February 18, 1992, while Wright was working for Stevens Shipping and Terminal Company (Stevens), he injured his right heel and back. He sought permanent compensation from Stevens and settled his claims for \$250,000 and another \$10,000 in attorney fees. Wright was also awarded Social Security disability benefits.

In January 1995, Wright, whose doctor had approved his return to work, returned to the hiring hall and asked to be referred for work. Wright did work between January 2 and January 11, 1995, but when the companies realized that Wright had been certified as permanently disabled, they deemed him not qualified for longshoreman work under the CBA and refused to allow him to work for them.

Wright did not file a grievance under the union agreement but instead hired a lawyer and proceeded with a claim under the Americans with Disabilities Act. The district court dismissed the case because Wright had failed to pursue the grievance procedure provided by the CBA. Must Wright pursue the dispute procedure first, or can he go right to court on the basis of his federal rights under the Americans with Disabilities Act? [*Wright v. Universal Maritime Service Corp.*, 525 U.S. 70]

12. Winona Ryder was arrested for shoplifting from Saks Fifth Avenue in California. One of the members of the jury panel for her trial was Peter Guber, a Hollywood executive in charge of the production of three films in which Ms. Ryder starred, including

Bram Stoker's Dracula, *The Age of Innocence*, and *Little Women*. If you were the prosecuting attorney in the case, how could you discover such information about this potential juror, and what are your options for excluding him from selection? [Rick Lyman, "For the Ryder Trial, a Hollywood Script," *New York Times*, November 3, 2002, SL-1]

13. Two doctors had a dispute over who was doing how much work at their clinic. Their dispute was submitted to arbitration and the arbitrator held in favor of the less experienced doctor. The senior doctor wants the arbitration set aside. Is it possible for the arbitrator's decision to be set aside?
14. Martha Simms is the plaintiff in a contract suit she has brought against Floral Supply, Inc., for its failure to deliver the green sponge Martha needed in building the floral designs she sells to exclusive home decorators. Martha had to obtain the sponge from another supplier and was late on seven deliveries. One of Martha's customers has been called by Martha's lawyer as a witness and is now on the witness stand, testifying about Martha's late performance and the penalty she charged. The lawyer for Floral Supply knows that Martha's customer frequently waives penalties for good suppliers. How can Floral Supply's lawyer get that information before the jury?
15. Saint Claire Adams was hired by Circuit City as a sales counselor. When he was hired he signed an employment contract that included a mandatory arbitration clause. Two years later he filed a suit against Circuit City for discrimination in the workplace. Circuit City moved to have the suit dismissed because of the arbitration requirement. Mr. Adams responded that he has certain rights under Title VII of the federal anti-discrimination laws that cannot be taken away through an arbitration clause. Is he correct? [*Circuit City Stores, Inc. v. Adams*, 532 U.S. 105]

Business Ethics, Social Forces, and the Law



3-1 What Is Business Ethics?

- 3-1a The Law as the Standard for Business Ethics
- 3-1b The Notion of Universal Standards for Business Ethics
- 3-1c Ethical Theories and Standards
- 3-1d The Business Stakeholder Standard of Behavior

3-2 Why Is Business Ethics Important?

- 3-2a The Importance of Trust

- 3-2b Business Ethics and Financial Performance
- 3-2c The Importance of a Good Reputation
- 3-2d Business Ethics and Business Regulation: Public Policy, Law, and Ethics

3-3 How to Recognize and Resolve Ethical Dilemmas

- 3-3a Categories of Ethical Behavior
- 3-3b Resolving Ethical Dilemmas

Learning Outcomes <<<

After studying this chapter, you should be able to

- LO.1** Define business ethics
- LO.2** Discuss why ethics are important in business
- LO.3** Describe how to recognize and resolve ethical dilemmas

3-1 What Is Business Ethics?

Much of what businesspeople do is simply a matter of their word. Executives arrive at a 9:00 A.M. meeting because they promised they would be there. An employee meets a deadline for an ad display board because she said she would. Business transactions are completed through a combination of the values of the parties and the laws that reflect those values and the importance of one's word in business.

ethics—a branch of philosophy dealing with values that relate to the nature of human conduct and values associated with that conduct.

business ethics—balancing the goal of profits with values of individuals and society.

Ethics is a branch of philosophy dealing with values that relate to the nature of human conduct and values associated with that conduct. Balancing the goal of profits with the values of individuals and society is the focus of **business ethics**. Some economists make the point that insider trading is an efficient way to run that market. To an economist, inside information allows those with the best information to make the most money. This view ignores some issues: What about those who trade stock who do not have access to that information? What will happen to the stock market if investors perceive there is not a level playing field? In the U.S. Supreme Court decision *United States v. O'Hagan*¹ on insider trading, Justice Ruth Ginsburg noted, "Investors likely wouldn't invest in a market where trading based on misappropriated nonpublic information is unchecked." The field of business ethics deals with the balance between society's values and the need for businesses to remain profitable.

3-1a The Law as the Standard for Business Ethics

positive law—law enacted and codified by governmental authority.

Philosophers debate the origin of moral and ethical standards as well as which of those standards should be applied. One view of ethics is simply following what codified or **positive law** requires. The test of whether an act is legal is a common moral standard used frequently in business. Codified law, or law created by governmental authority, is used as the standard for ethical behavior. Absent illegality, all behavior is ethical under this simple standard. The phrase "AS IS," on a contract (see Chapter 24 for further discussion), means by law that there are no warranties for the goods being sold. **For Example**, if a buyer purchases a used car and the phrase "AS IS" is in the contract, the seller has no legal obligation, in most states, if the transmission falls apart the day after the buyer's purchase. Following a positive law standard only, the seller who refuses to repair the transmission has acted ethically. However, other ethical standards are different from just a legal standard. We know there was no legal obligation to fix the transmission, but was it fair that the car fell apart the day after it was purchased?

natural law—a system of principles to guide human conduct independent of, and sometimes contrary to, enacted law and discovered by man's rational intelligence.

civil disobedience—the term used when natural law proponents violate positive law.

3-1b The Notion of Universal Standards for Business Ethics

Another view of ethics holds that standards exist universally and cannot be changed or modified by law. In many cases, universal standards stem from religious beliefs. In some countries today, the standards for business are still determined by religious tenets. **Natural law** imposes higher standards of behavior than those required by positive law and they must be followed even if those higher standards run contrary to codified law. **For Example**, in the early nineteenth century when slavery was legally permissible in the United States, a positive law standard supported slavery. However, slavery violates the natural law principle of individual freedom and would be unethical. **Civil disobedience** is the remedy natural law proponents use to change positive law.

¹ 521 U.S. 657 (1997). Another court explained that inside information creates a disadvantage "other investors cannot overcome with research or skill." *U.S. v. McGee*, 763 F.3d 304 (3rd Cir. 2014). See Chapter 45 for more information.

Former Supreme Court Justice Sandra Day O'Connor, who was second in her class at Stanford Law School (the late Chief Justice William Rehnquist was first), was offered a job as a receptionist for a law firm while her male classmates were hired as attorneys. At that time, no law prohibited discrimination against women, so law firms' hiring practices, using only a positive law standard, were ethical. However, if the natural law standard of equality is applied, the refusal to hire Sandra O'Connor as a lawyer, a position for which she was qualified, was a violation of the natural law principle of equality and unethical.

3-1c Ethical Theories and Standards

There are many different views about the correct theory or standard we should apply when we face ethical dilemmas. Some of those theories and standards are covered here.

The Categorical Imperative and Immanuel Kant

Kant's categorical imperative—a standard of ethics that requires that we avoid one-sided benefit for us as a result of the conduct or decision.

Philosopher Immanuel Kant does not allow any resolution of an ethical dilemma in which human beings are used as a means by which others obtain benefits. **Kant's categorical imperative** theory, reduced to simplest terms, is that you cannot use others in a way that gives you a one-sided benefit. Everyone must operate under the same usage rules. In Kant's words, "One ought only to act such that the principle of one's act could become a universal law of human action in a world in which one would hope to live." **For Example**, if you hit a car in a parking lot and damaged it but you could be guaranteed that no one saw you do it, would you leave a note on the other car with contact information? If you answered, "No, because that's happened to me 12 times before and no one left me a note," then you are unhappy with universal behaviors but are unwilling to commit to universal standards of honesty and disclosure to remedy those behaviors.

International business presents some interesting Kantian dilemmas. For example, there are some U.S. companies that use suppliers in developing nations. Those suppliers have employees in sweatshop atmospheres who work for pennies per hour. The pennies-per-hour wage seems unjust. However, suppose the company was operating under one of its universal principles: Always pay a fair wage to those who work for it. A "fair wage" in that country might be pennies, and the company owner could argue, "I would work for that wage if I lived in that country." The company owner could also argue, "But, if I lived in the United States, I would not work for that wage, would require a much higher wage, and would want benefits, and we do provide that to all of our U.S. workers."

The company has developed its own ethical standard that is universally applicable, and those who own the company could live with it if it was applied to them, but context is everything under the categorical imperative. The basic question is: Are you comfortable living in a world operating under the standards you have established, or would you deem them unfair or unjust?

There is one more part to Kant's theory: You not only have to be fair but also have to want to do it for all the right reasons. Kant wants you to adopt and accept these ethical standards because you do not want to use other people as a means to your enrichment at their expense, and not, for example, because it will be good public relations.

theory of justice—the Locke and Rawlsian standard for ethics that requires that we all agree on certain universal principles in advance.

social contract—the agreement under Locke and Rawls as to what our ethical standards will be.

The Contractarians and Justice

John Locke and John Rawls developed what is sometimes called the **theory of justice** and sometimes referred to as the **social contract**. Rawls and Locke believe that Kant was

wrong in assuming that we could all have a meeting of the minds on what were the good rules for society. Locke and Rawls preferred just putting the rules into place with a social contract. Under this theory we imagine what it would be like if we had no rules or laws at all. If we started with a blank slate, or *tabula rasa* as these philosophers would say, rational people would agree—perhaps in their own self-interest, or perhaps to be fair—that certain universal rules must apply. Rational people, thinking through the results and consequences if there were not rules, would develop rules that would result in fairness. **For Example**, we would probably develop rules such as “Don’t take my property without my permission” and “I would like the same rights in court that rich people have even if I am not so rich.” Locke and Rawls want us to step back from the emotion of the moment and make universal principles that will survive the test of time.

Rights Theory

rights theory—Nozick’s theory of ethics that we all have a set of rights that must be honored and protected by government.

entitlement theory—another name for Nozick’s theory that we all have certain rights that must be honored and protected by government.

ethical egoism—theory of ethics that we should all act in our own self-interest; the Ayn Rand theory that separates guilt from acting in our own self-interest.

utilitarians—theory of ethics based on doing the most good for the most people in making decisions.

moral relativists—those who make decisions based on circumstances and not on the basis of any predefined standards.

The **rights theory** is also known as an **entitlement theory** and is one of the more modern theories of ethics. Robert Nozick is the key modern-day philosopher on this theory, which has two big elements: (1) everyone has a set of rights, and (2) it is up to the governments to protect those rights. **For Example**, there are rights issues related to sweatshops, abortion, slavery, property ownership and use, justice (as in court processes), animal rights, privacy, and euthanasia. Nozick dealt with all the controversial and emotional issues of ethics including everything from human dignity in suffering to third-trimester abortions.

Ethical Egoism Theory: Ayn Rand and Atlas

Ethical egoism holds that we all act in our own self-interest and that all of us should limit our judgment to our own ethical egos and not interfere with the exercise of ethical egoism by others. This view holds that everything is determined by self-interest. We act as we do and decide to behave as we do because we have determined that it is in our own self-interest.

Ayn Rand, who wrote books about business and business leaders’ decisions in ethical dilemmas, such as *The Fountainhead* and *Atlas Shrugged*, was an ethical egoist. These two famous books made Ms. Rand’s point about ethical dilemmas: The world would be better if we did not feel so guilty about the choices we make in ethical dilemmas and just acknowledged that it is all self-interest.

The Utilitarian Theory: Bentham and Mill

Utilitarians resolve ethical dilemmas by doing the most good for the most people. **For Example**, suppose that the FBI has just arrested a terrorist who is clearly a leader in a movement that plans to plant bombs in the nation’s trains, subways, and airports. This individual has critical information about upcoming planned attacks but refuses to speak. A utilitarian would want the greatest good for the greatest number and would feel that harsh interrogation methods would be justified to save thousands of lives. Rights theorists would disagree with using torture to obtain the information because human rights must be protected.

Moral Relativists

Moral relativists resolve ethical dilemmas according to time and place. For example, suppose that you live in a neighborhood in which drug dealers are operating a crystal meth lab or crack house, something that is causing violence in your neighborhood. A relativist would feel justified in committing arson to get rid of the drug house. Another classic example would be a parent stealing a loaf of bread to feed a starving child. Moral



relativists resolve ethical dilemmas by weighing competing factors at the moment and then taking the lesser of the evils as the solution. **For Example,** Google and other Internet service providers have agreed to do business in China despite the restrictions the Chinese government places on the use of the Internet and the content of search engines. Such restrictions in the United States would be an unconstitutional violation of our First Amendment. In China, however, government control of information is legal. Google and others testified before Congress that some entry, however restricted, was better for the Chinese people than no access at all. Their decision did not focus on the rights theory, but, rather, weighed the conflicting values and concluded that they would use the standard of honoring the law of China despite the censorship.

Plato and Aristotle: Virtue Ethics

Aristotle and Plato taught that solving ethical dilemmas requires training, that individuals solve ethical dilemmas when they develop and nurture a set of virtues. Aristotle encouraged his students to solve ethical dilemmas using virtues such as honesty, justice, and fairness.



THINKING THINGS THROUGH

Corrupt Climates: Good or Bad for Business?

As you examine the following list of countries, those in the column labeled “Least Corrupt” (countries in which government officials are least likely to accept bribes) and those in the column marked “Most Corrupt” (countries in which

government officials are most likely to accept bribes), can you comment on the business climates in them? What can you conclude about following the cultural practices of paying bribes? Who is harmed when a company pays bribes?

Least Corrupt (Least Likely to Accept Bribes)

- Denmark
- New Zealand
- Finland
- Sweden
- Norway
- Switzerland
- Singapore
- Netherlands
- Luxembourg
- Canada
- Australia
- Germany
- Iceland
- United Kingdom
- Belgium
- Japan
- Barbados
- Hong Kong
- Ireland
- United States
- Chile
- Uruguay
- Austria
- Bahamas

Most Corrupt (Most Likely to Accept Bribes)

- Somalia
- Korea (North)
- Sudan
- Afghanistan
- South Sudan
- Iraq
- Turkmenistan
- Uzbekistan
- Libya
- Eritrea
- Yemen
- Venezuela
- Haiti
- Guinea Bissau
- Angola
- Syria
- Burundi
- Zimbabwe
- Myanmar
- Cambodia
- Congo, Democratic Republic of
- Chad
- Tajikistan
- Congo, Republic of
- Paraguay
- Central African Republic
- Papua New Guinea
- Laos
- Kenya
- Guinea
- Bangladesh
- Ukraine

*From 2014 Transparency International annual survey, <http://www.transparency.org>.

stakeholders—those who have a stake, or interest, in the activities of a corporation; stakeholders include employees, members of the community in which the corporation operates, vendors, customers, and any others who are affected by the actions and decisions of the corporation.

stakeholder analysis—the term used when a decision maker views a problem from different perspectives and measures the impact of a decision on various groups.

3-1d The Business Stakeholder Standard of Behavior

Businesses have different constituencies, referred to as **stakeholders**, often with conflicting goals for the business. Shareholders, for example, may share economists' view that earnings, and hence dividends, should be maximized. Members of the community where a business is located are also stakeholders in the business and have an interest in preserving jobs. The employees of the business itself are stakeholders and certainly wish to retain their jobs. Balancing the interests of these stakeholders is a standard used in resolving ethical dilemmas in business.

As Figure 3-1 indicates, stakeholder analysis requires a view of an issue from different perspectives in a transparent way. **Stakeholder analysis** measures the impact of a decision on various groups and then asks whether public disclosure of that decision is defensible. The questions provide insight in a variety of situations and ethical dilemmas. **For Example**, if a lender gives a loan to a debtor without checking income, the lapse seems harmless. But suppose someone purchases that loan believing the debtor met the standards and the lender verified income. The debtor defaults on the loan. The purchaser has to write down or write off the loan. If enough loans that were not documented go into default, you create the kind of ripples in the real estate and stock markets that occurred in late 2008. Stakeholder analysis helps you to see that the decisions we make in business are not made in isolation or limited in their impact. Figure 3-1 summarizes ethical analysis.

In other ethical dilemmas, a business faces the question of taking voluntary action or simply complying with the law. Some experts maintain that the shareholders' interest is paramount in resolving these conflicts among stakeholders. Others maintain that a business must assume some responsibility for social issues and their resolution. Economist Milton Friedman expresses his views on resolving the conflicts among stakeholders as follows:

A corporate executive's responsibility is to make as much money for the shareholders as possible, as long as he operates within the rules of the game. When an executive decides to take action for reasons of social responsibility, he is taking money from someone else—from the stockholders, in the form of lower dividends; from the employees, in the form of lower wages; or from the consumer, in the form of higher prices. The responsibility of the corporate executive is to fulfill the terms of his contract. If he can't do that in good conscience, then he should quit his job and find another way to do good. He has the right to promote what he regards as desirable moral objectives only with his own money.²

FIGURE 3-1 Guidelines for Analyzing a Contemplated Action

1. Define the problem from the decision maker's point of view.
2. Identify who could be injured by the contemplated action.
3. Define the problem from the opposing point of view.
4. Would you (as the decision maker) be willing to tell your family, your supervisor, your CEO, and the board of directors about the planned action?
5. Would you be willing to go before a community meeting, a congressional hearing, or a public forum to describe the action?
6. With full consideration of the facts and alternatives, reach a decision about whether the contemplated action should be taken.

²"Interview: Milton Friedman," *Playboy*, February 1973. © 1973 *Playboy*.



ETHICS & THE LAW

Edward Snowden: Contractor with a Cause

Edward Snowden was a contractor working at the National Security Agency (NSA). During the course of his contract work at the agency, Snowden believed that the NSA engaged in global surveillance programs that were not disclosed or supervised and represented a violation of privacy rights.

Mr. Snowden leaked classified information as a way of bringing attention to the conduct. Many maintain that the leaks breached the U.S. national security.

Discuss which ethical theories and standards Snowden was following. List the stakeholders in Snowden's actions.

Many businesses feel an obligation to solve social problems because those problems affect their stakeholders. **For Example**, programs such as flextime, job sharing, and telecommuting for work are not legal requirements but voluntary options businesses offer their employees to accommodate family needs. These options are a response to larger societal issues surrounding children and their care but may also serve as a way to retain a quality workforce that is more productive without the worry of poor child care arrangements.

Some businesses are also involved in their communities through employees' volunteer work and companies' charitable donations. **For Example**, a painting company in Phoenix donates paint, and its employees work on weekends painting Habitat for Humanity homes and helping churches get their facilities painted. Apple was able to capture future customers through its donations of computers to schools. Many companies also provide support for employees to participate in volunteer programs in their communities.

3-2 Why Is Business Ethics Important?

Ethics and values represent an important part of business success. Business ethics is important for more than the simple justification that "it's the right thing to do." This section covers the significance of ethics in business success.

3-2a The Importance of Trust

Capitalism succeeds because of trust. Investors provide capital for a business because they believe the business will provide a return on their investment. Customers are willing to purchase products and services from businesses because they believe the businesses will honor their commitments to deliver quality and then stand behind their product or service. Businesses are willing to purchase equipment and hire employees on the assumption that investors will continue to honor their commitment to furnish the necessary funds and will not withdraw their promises or funds. Business investment, growth, and sales are a circle of trust. Although courts provide remedies for breaches of agreements, no economy could grow if it were based solely on positive law and court-mandated performance. It is the reliance on promises, not the reliance on litigation, that produces good business relationships.

3-2b Business Ethics and Financial Performance

Studies centering on a business's commitment to values and its financial performance suggest that those with the strongest value systems survive and do so successfully. According to the book *Building and Growing a Business Through Good Times and Bad* by Louis Grossman and Marianne Jennings,³ an in-depth look at companies that paid 100 years

³Greenwood Press (2002).

of consistent dividends produced a common thread: the companies' commitment to values. All firms studied had focused on high standards for product quality, employee welfare, and customer service.

Poor value choices do have an effect on financial performance. A study of the impact of just breaches of federal law by companies showed that for five years after their regulatory or legal misstep, these companies were still struggling to recover the financial performances they had achieved prior to their legal difficulties.⁴

Over the past few years, there have been devastating stories of companies' fates after ethical lapses. For example, after the congressional hearings revealed that Goldman Sachs took positions in the market that were the opposite of recommendations to its clients, its revenue dropped 18 percent and its share price dropped 32 percent.⁵ When Netflix overpromised on its number of new subscribers and then fell short, its shares dropped 26.4 percent.⁶ When the subprime lender New Century Financial announced that it was finally writing down all the subprime loans it had made that had gone into default but that it had been concealing, it was forced to declare bankruptcy because it was insolvent. On January 1, 2007, New Century had \$1.75 billion in market capitalization, but by the middle of March, that figure was \$55 million and its stock was delisted by the New York Stock Exchange.

In 2011, MF Global had to declare bankruptcy after its risky bets on Greek bonds resulted in \$1.6 billion in losses. Over 1,000 employees lost their jobs and the firm was liquidated.⁷ In 2014, GM paid a \$35 million fine to the National Highway Transportation Safety Administration for its failure to report a parts change in 2006 that resulted in covering up the flaws in its ignition that led to accidents, deaths, and, eventually, the recall of 17 million vehicles. Following the recall, GM took a \$1.2 billion charge to earnings to cover the costs.⁸



ETHICS & THE LAW

The Veterans Affairs (VA) and the Queues

The VA put into place incentives and bonuses for administrators to “reduce the queue.” That is, the goal of the VA was to reduce the amount of time it took for veterans seeking care to actually receive that care to two weeks. Staffs at VA facilities all over the United States did meet those reduction goals and earn their bonuses. However, the way they earned those bonuses was through falsified patient appointment schedules.* The real results showed that three of every five veterans did not receive their care within two weeks as the documents showed. An Inspector General’s report found that the falsifications caused patients to be dropped, with many dying while awaiting calls back from VA facilities.

Thirteen percent to 62 percent of VA schedulers (depending on the facility) were instructed on how to falsify records that were submitted to central administration for purposes of awarding bonuses.** The VA used Darrell Huff’s book, *How to Lie with Statistics*, in training VA staffers.

Evaluate what went wrong at the VA and discuss how employees were able to be talked into participating.

*Eric Lichtblau, “V.A. Punished Critics on Staff, Doctors Assert,” *New York Times*, June 16, 2014, p. A1.

**Meghan Hoyer and Gregg Zoroya, “Fraud Masks VA Wait Times,” *USA Today*, June 14, 2014, p. 1A.

⁴Melinda S. Baucus and David A. Baucus, “Paying the Piper: An Empirical Examination of Longer-Term Financial Consequences of Illegal Corporate Behavior,” *40 Academic Management Journal* 129 (1997).

⁵Susanne Craig, “Goldman’s Safer Position Eats Deeply Into Its Profits,” *New York Times*, July 20, 2011, p. B4.

⁶Shalini Ramachandran and Tes Styne, “Netflix Shares Plunge As Results Fall Short,” *Wall Street Journal*, October 16, 2014, p. B1.

⁷Mike Spector, Aaron Lucchetti, and Liam Plevin, “Corzine Firm’s Final Struggles,” *Wall Street Journal*, November 5–6, 2011, p. A1.

⁸James R. Healey, “Recall Hits the Brakes on Income,” *USA Today*, July 28, 2014, p. 1B.

3-2c The Importance of a Good Reputation

Richard Teerlink, the CEO of Harley-Davidson, once said, “A reputation, good or bad, is tough to shake.”⁹ A breach of ethics is costly to a firm not only in the financial sense of drops in earnings and possible fines. A breach of ethics also often carries with it a lasting memory that affects the business and its sales for years to come. **For Example**, the Peanut Corporation of America had to declare bankruptcy in 2009 after government officials discovered that its plant was the source of salmonella poisonings among those customers who had eaten peanut products that used the Peanut Corporation’s base in their production. Records showed that the Peanut Corporation continued to produce the product even after salmonella warnings and questions arose. The company’s name and image became so damaged that it could not continue to make sales. When an ethical breach occurs, businesses lose that component of trust important to customers’ decisions to buy and invest. Four employees, including the CEO, were convicted of federal felonies for falsification of records related to salmonella testing.

3-2d Business Ethics and Business Regulation: Public Policy, Law, and Ethics

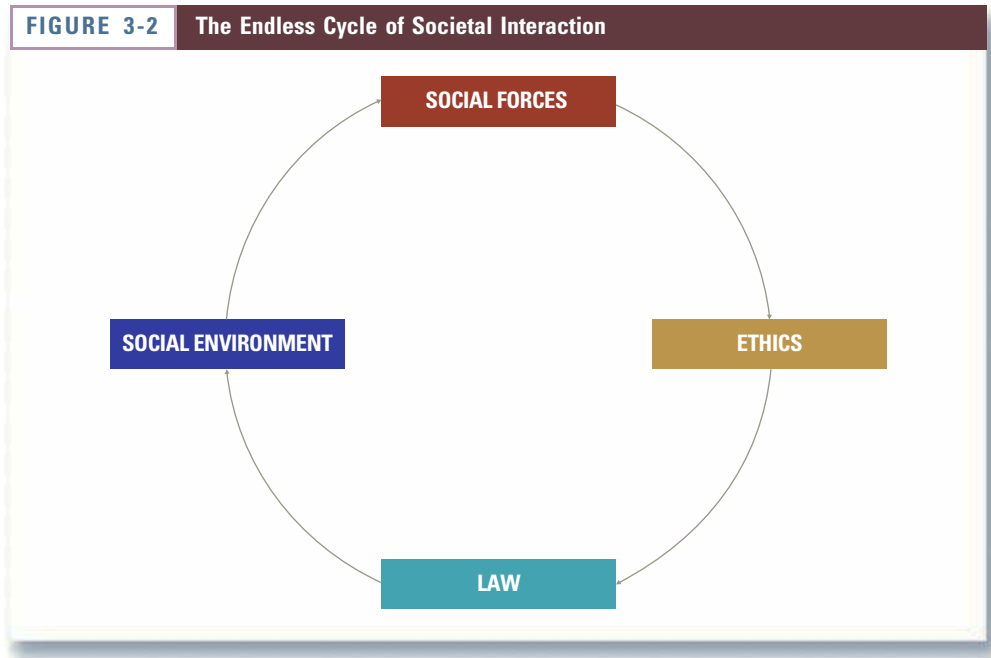
When business behavior results in complaints from employees, investors, or customers, laws or regulations are often used to change the behavior. **For Example**, the bankruptcy of Lehman Brothers, the near-collapse of Bear Stearns, and the losses at Merrill Lynch and AIG in 2008–2009 all resulted from the subprime mortgage financial derivative investment market, a market that had previously been a relatively regulation-free environment. The companies had billions of dollars of exposure because of their sales and purchases of financial instruments that were tied to the subprime mortgage market that ultimately resulted in high rates of foreclosure and nearly worthless loans. Congress, the Securities and Exchange Commission (SEC), and the Federal Reserve all stepped in to regulate virtually all aspects of mortgage transactions, including the lenders and others who were involved in packaging the loans into financial products.

Confusion among consumers about car leasing and its true costs and the fees applicable at the end of the lease terms caused the Federal Reserve (now the Consumer Financial Protection Bureau) to expand its regulation of credit to car leases. Figure 3-2 depicts the relationships among ethics, the social forces of customers and investors, and the laws that are passed to remedy the problems raised as part of the social forces movement.

Businesses that act voluntarily on the basis of value choices often avoid the costs and the sometimes arbitrariness of legislation and regulation. Voluntary change by businesses is less costly and is considered less intrusive.

Businesses that respond to social forces and the movements of the cycle of societal interaction often gain a competitive advantage. Businesses that act irresponsibly and disregard society’s views and desire for change speed the transition from value choice to enforceable law. Businesses should watch the cycle of social forces and follow trends there to understand the values attached to certain activities and responses. These values motivate change either in the form of voluntary business activity or legislation. All values that precipitate change have one of several basic underlying goals. These underlying goals are discussed in the following sections.

⁹David K. Wright, *The Harley-Davidson Motor Co.: An Official Ninety-Year History* (Milwaukee: Motorbook International, 1993).



Protection of the State

A number of laws exist today because of an underlying goal or value of protection of the state. The USA Patriot Act and airport security regulations are examples of government programs and regulations created with the protection and security of the state as the goal.

Protection of the Person

A second social force is protection of the person. Criminal laws are devoted to protection of individuals and their properties. In addition, civil suits permit private remedies for wrongful acts toward people and their property. Over time, the protection of personal rights has expanded to include the rights of privacy and the protection of individuals from defamation. Laws continue to evolve to protect the reputations, privacy, and mental and physical well-being of individuals.

Protection of Public Health, Safety, and Morals

Food-labeling regulations are an example of laws grounded in the value of protecting the safety and health of individuals. Food and restaurant inspections, mandatory inoculation, speed limits on roadways, mandatory smoke detectors and sprinkler systems in hotels, and prohibitions on the sale of alcohol to minors are all examples of laws based on the value of safety for the public. Zoning laws that prohibit the operation of adult bookstores and movie theaters near schools and churches are examples of laws based on moral values.

Protection of Property: Its Use and Title

Someone who steals another's automobile is a thief and is punished by law with fines and/or imprisonment. A zoning law that prohibits the operation of a steel mill in a residential



ETHICS & THE LAW

Ethics, Trust, and Markets

The cover of *Fortune* magazine from May 14, 2001, featured a picture of Wall Street financial analyst Mary Meeker and the words, “Can we ever trust again?”* The inside story focused on the relationship of underwriters, analysts, and brokerage houses with the high-tech companies whose stocks they were touting and selling, knowing there were questionable accounting practices and a lack of earnings at these companies. When the dot-com market bubble burst, the losses to shareholders were catastrophic. Those in the financial markets had too much at stake to be honest with investors. They did not break the law, however.

In 2002, when companies, such as Enron, WorldCom, and Tyco had to take write-downs because of years of overstating earnings, the market once again looked at analysts, wondering how they had failed to catch the accounting issues. The cover of *Fortune* read, “In Search of the Last Honest Analyst.”**

During 2007, *Fortune* ran a cover with the pictures of the CEOs of the major Wall Street investment firms (such as Merrill Lynch, Bear Stearns, and Lehman Brothers) who had managed to lose trillions of investors’ pension and 401(k) plans to risky investments in subprime mortgages that were marketed as low-risk investments. The cover’s headline asked, “What Were They Smoking?”*** In 2011, following the collapse of Jon Corzine’s MF Global hedge fund, a headline read, “Trustee Says More Cash Is Missing at MF Global.” The estimated loss to investors at the firm was \$1.6 billion.****

What do these headlines convey about the importance of trust and its role in markets?

*“Can We Ever Trust Again?” *Fortune*, May 14, 2001 (cover).

**“In Search of the Last Honest Analyst,” *Fortune*, June 10, 2002 (cover).

***“What Were They Smoking?” *Fortune*, November 26, 2007 (cover).

****Michael J. de la Merced and Ben Protess, “Trustee Says More Cash Is Missing at MF Global,” *New York Times*, November 22, 2011, p. B1.

area also provides protection for property. A civil suit brought to recover royalties lost because of another’s infringement of one’s copyrighted materials is based on federal laws that afford protection for property rights in nontangible or intellectual property (see Chapter 9). Laws afford protection of title for all forms of property. The deed recorded in the land record is the legal mechanism for protecting the owner’s title. The copyright on a software program or a song protects the creator’s rights in that intellectual property. The title documents issued by a department of motor vehicles afford protection of title for the owner of a vehicle.

Those who have title to property are generally free to use the property in any manner they see fit. However, even ownership has restrictions imposed by law. A business may operate a factory on its real property, but if the factory creates a great deal of pollution, adjoining landowners may successfully establish it as a nuisance (see Chapter 49) that interferes with their use and enjoyment of their land. Environmental laws also emerged as regulation of land use in response to concerns about legal, but harmful, emissions by companies.

Protection of Personal Rights

The desire for freedom from economic domination resulted in the free enterprise philosophy that exists in the United States today. Individual freedoms and personal rights continue as a focus of value discussions followed by legislation if those individual rights are violated.

Enforcement of Individual Intent

When we voluntarily enter into a contract, we have a responsibility to fulfill the promises made in that agreement. Principles of honesty and the honoring of commitments are the ethical values at the heart of the parties’ conduct in carrying out contracts. If, however,

the parties do not keep their promises, the law does enforce transactions through sets of rules governing requirements for them. **For Example**, the law will carry out the intentions of the parties to a business transaction through judicial enforcement of contract rights and damages.

Protection from Exploitation, Fraud, and Oppression

Many laws have evolved because businesses took advantage of others. Minors, or persons under legal age (see Chapter 13), are given special protections under contract laws that permit them to disaffirm their contracts so they are not disadvantaged by excessive commitments without the benefit of the wisdom of age and with the oppressive presence of an adult party.

The federal laws on disclosure in the sales of securities and shareholder relations (see Chapters 44 and 45) were developed following the 1929 stock market crash when many investors lost all they had because of the lack of candor and information by the businesses in which they were investing.

Furtherance of Trade

Some laws are the result of social forces seeking to simplify business and trade. Credit laws, regulations, and protections have made additional capital available for businesses and provided consumers with alternatives to cash purchases. The laws on checks, drafts, and notes have created instruments used to facilitate trade.

Protection of Creditors and Rehabilitation of Debtors

Mortgages, security interests, and surety relationships (see Chapters 31, 32, and 33) are mechanisms created by law to provide creditors the legal mechanisms for collecting their obligations.

When collection techniques became excessive and exploitative, new laws on debtors' rights were enacted. Debtors' prisons were abolished. Congress mandated disclosure requirements for credit contracts. The Fair Debt Collections Practices Act (see Chapter 32) limited collection techniques. The remedy of bankruptcy was afforded debtors under federal law to provide them an opportunity to begin a new economic life when their existing debts reached an excessive level and could no longer be paid in a timely fashion (see Chapter 34).

Stability and Flexibility

Because of the desire for stability, courts will ordinarily follow former decisions unless there is a strong reason to depart from them. (See Chapter 1 for more discussion of precedent.) Similarly, when no former case bears on the point involved, a court will try to reach a decision that is a logical extension of some former decision or that follows a former decision by analogy rather than strike out on a new path to reach a decision unrelated to the past.

3-3 How to Recognize and Resolve Ethical Dilemmas

Business managers often find themselves in circumstances in which they are unclear about right and wrong and are confused about how to resolve the dilemmas they face. A recent survey showed that 98 percent of all Fortune 500 companies have codes of ethics

FIGURE 3-3 Categories of Ethical Behavior

1. Integrity and truthfulness
2. Promise keeping
3. Loyalty—avoiding conflicts of interest
4. Fairness
5. Doing no harm
6. Maintaining confidentiality

designed to help their employees recognize and resolve ethical dilemmas. Nearly 81 percent of those firms provide their employees some form of training in ethics.¹⁰ Almost 70 percent of companies now include ethical conduct as a performance measure. These codes of ethics provide employees information about categories of behavior that constitute ethical breaches. Regardless of the industry, the type of business, or the size of the company, certain universal categories can help managers recognize ethical dilemmas. Figure 3-3 provides a list of those categories.

3-3a Categories of Ethical Behavior

Integrity and Truthfulness

A famous anonymous quote on truth is, “Circumstances beyond your control will cause the truth to come out, no matter what.” As discussed earlier, trust is a key component of business relationships and of the free enterprise system. Trust begins with the belief that honesty is at the heart of relationships. Many contract remedies in law are based on the failure of the parties to be truthful with each other. **For Example**, if you purchase a home that has been certified as termite free but you discover termites in the home shortly after you move in, someone has not been truthful. If you also discover that two termite inspections were conducted and that the first one, which revealed there were termites, was concealed from you, your trust in both the sellers and their exterminators is diminished.

integrity—the adherence to one’s values and principles despite the costs and consequences.

Integrity is the adherence to one’s values and principles despite the costs and consequences. **For Example**, an executive contracted with a variety of companies to sell his hard-to-find computer components. When he was approached by one of his largest customers to break a contract with a small customer, the executive refused. The customer assured the executive it would be his last order with the company if he did not get more components. Despite facing the threat of losing a multimillion-dollar customer, the executive fulfilled his promises to the small purchasers. The executive kept his word on all of his contracts and demonstrated integrity.

Promise Keeping

If we examined the types of things we do in a day, we will find that most of them are based on promises. We promise to deliver goods either with or without a contract. We promise to pay the dentist for our dental work. We promise to provide someone with a

¹⁰Ethics Resource Center, The National Business Ethics Survey 2013, <http://www.ethics.org/downloads/2013NBESFinal-Web.pdf>.



ETHICS & THE LAW

Lying to Get into a Top School

The University of California at Berkeley has implemented a new step in its admission process. The Haas School of Business has begun running background checks on students who have applied to determine whether the information in their applications is correct. The Wharton School implemented a similar procedure and charges applicants a \$35 fee for these background checks.

Of the 100 students admitted to Berkeley in the fall of 2003, 5 students were found to have offered false information on their admissions applications. The most common type of

false information was the job titles they held, and the second most common type was their number of years of work experience. Haas admissions officers indicated that had the students not lied, they otherwise met the GMAT score and GPA standards for admission to Haas.

What risk do the students take in lying on their applications? What are the long-term consequences?

Source: "Cheaters Don't Make the Grade at Berkeley Business School," <http://www.azcentral.com>, March 14, 2003, AP wire reports.

ride. Keeping those promises, regardless of whether there is a legal obligation to do so, is a key component of being an ethical person and practicing ethical business. Keeping promises is also evidence of integrity for example.

Loyalty—Avoiding Conflicts of Interest

conflict of interest—conduct that compromises an employee's allegiance to that company.

An employee who works for a company owes allegiance to that company. Conduct that compromises that loyalty is a **conflict of interest**. **For Example**, suppose that your sister operates her own catering business. Your company is seeking a caterer for its monthly management meetings. You are responsible for these meetings and could hire your sister to furnish the lunches for the meetings. Your sister would have a substantial contract, and your problems with meal logistics would be solved. Nearly all companies have a provision in their codes of ethics covering this situation. An employee cannot hire a relative, friend, or even her own company without special permission because it is a conflict of interest. Your loyalty to your sister conflicts with the loyalty to your employer, which requires you to make the best decision at the best price.

A conflict of interest arises when a purchasing agent accepts gifts from suppliers, vendors, or manufacturers' representatives. The purchasing agent has introduced into the buy-sell relationship an element of *quid pro quo*, or the supplier's expectation that the gift will bring about a return from the agent in the form of a contract. Some companies have zero tolerance for conflicts and establish a complete prohibition on employees accepting any gifts from suppliers and manufacturers. **For Example**, Wal-Mart buyers are not permitted to accept even a cup of coffee from potential merchandise suppliers, and Amgen's buyers can go out to dinner with a supplier only if Amgen pays.

Doing No Harm

Imagine selling a product that your company's internal research shows presents significant health dangers to its users. Selling the product without disclosure of the information is unfair. There is the additional ethical breach of physical harm to your customers and users. GM sold its Cobalt and other model cars knowing that a heavy key chain or hitting a pothole could cause the ignition switch to shut down. Some drivers were on freeways when the switches shut down, bringing their cars to a sudden halt. When collisions



SPORTS & ENTERTAINMENT LAW

The Bounty Program and the New Orleans Saints

The New Orleans Saints defensive coordinator, Greg Williams, established a bounty program for the team, a program that rewarded players for injuring other players. For example, a \$1,500 bonus was offered if a Saints player knocked out an opposing team player. There was \$1,000 more if the player had to be carted from the field. There was an offer of \$10,000 for any player who could knock Brent Favre out of the NFC Championship in 2009 when the Saints were vying for the Super Bowl. The result was that Mr. Favre was hit almost every play, many times after he had thrown the ball.*

The word around the league was that Mr. Williams rounded corners. “If you were looking at somebody to hire for an ability to coordinate defense, you would hire the guy. You have to understand what you’re getting—he may take chances you may not want.”** During the NFL investigation of the Saints’ practices, Mr. Williams admitted that he did create the bounty program, “It was a terrible mistake, and

we knew it was wrong while we were doing it.”*** And team owner Tom Benson said, “Instead of getting caught up in it, I should have stopped it.”****

Why do you think everyone was so willing to go along with the bounty program? As a penalty, the Saints lost their head coach (Sean Payton) for one year, and Greg Williams was suspended indefinitely. Various other coaches were suspended, and the Saints paid a \$500,000 fine. What are the flaws in thinking processes when we make decisions to go ahead with a bounty program?

*Fran Tarkenton, “Football’s Bounty Hunters Must Be Clipped,” *Wall Street Journal*, March 7, 2012, p. A17.

**Judy Battista, “The Man Behind the Bounties,” *New York Times*, March 7, 2012, p. B11.

***Peter King, “Way Out of Bounds,” *Sports Illustrated*, March 12, 2012, p. 34.

*****Id.*

primum non nocere—
above all, do no harm.

occurred, the airbag protections did not deploy because the cars were off. Internal memos and e-mails from engineers at GM revealed that they were aware of the problem in 2006 but opted not to notify regulators and do the necessary recalls until 2014. The late Peter Drucker’s advice on ethics for businesses is **primum non nocere**, or “above all, do no harm.” Such a rule might have helped GM.

Maintaining Confidentiality

Often the success of a business depends on the information or technology that it holds. If the competitive edge that comes from the business’s peculiar niche or knowledge is lost through disclosure, so are its profits. Employees not only owe a duty of loyalty to their employers, but they also owe an obligation of confidentiality. Employees should not use, either personally or through a competitor, information they have obtained through their employer’s work or research. Providing customer lists or leads is a breach of employees’ obligation of confidentiality.

In addition, managers have responsibilities regarding their employees’ privacy. Performance evaluations of individual employees are private and should never be disclosed or revealed, even in one-on-one conversations outside the lines of authority and the workplace.

3-3b Resolving Ethical Dilemmas

Recognizing an ethical dilemma is perhaps the easiest part of business ethics. Resolution of that dilemma is more difficult. The earlier section on stakeholders offers one model for resolution of ethical dilemmas (see Figure 3-1). Other models have been developed to provide managers analytical methods for resolving dilemmas in a timely fashion.



E-COMMERCE & CYBERLAW

Piggybacking on Wireless Networks

A legal and ethical issue that has evolved because of technology is the practice of “piggybacking,” or people tapping onto their neighbors’ wireless Internet connection. The original subscriber pays a monthly fee for the service, but without security, people located in the area are able to tap into the wireless network, which bogs down the speed of the service. Once limited to geeks and hackers, the practice is now common among the ordinary folk who just want free Internet service.

One college student said, “I don’t think it’s stealing. I always find [p]eople out there ... aren’t protecting their connection, so I just feel free to go ahead and use it.”* According to a recent survey, only about 30 percent of the 4,500 wireless networks onto which the surveyors logged were encrypted, and another survey shows that 32 percent of us do engage in Wi-Fi piggybacking.

An apartment dweller said she leaves her connection wide open because “I’m sticking it to the man. I open up my network, leave it wide open for anyone to jump on.” One of the users of another’s wireless network said, “I feel sort of bad about it, but I do it anyway. It just seems harmless.” She said that if she gets caught, “I’ll just play the dumb card.”

Some neighbors offer to pay those with wireless service in exchange for their occasional use rather than paying a wireless company for full-blown service. However, the original subscribers do not really want to run their own Internet service.

Do you think we need new legislation to cover this activity? What do you think of the users’ statements? Is their conduct legal? Is it ethical?

*Michael Marriott, “Hey Neighbor, Stop Piggybacking on My Wireless,” *New York Times*, March 5, 2006, A1, A23.

Blanchard and Peale Three-Part Test

Dr. Kenneth Blanchard, author of the books on the *One-Minute Manager*, and the late Dr. Norman Vincent Peale developed a model for evaluating ethical breaches that is widely used among Fortune 500 companies.¹¹ To evaluate situations, ask the following three questions: Is it legal? Is it balanced? How does it make me feel?

In answering the questions on legality, a manager should look to positive law both within and outside the company. If the proposed conduct would violate antitrust laws, the manager’s analysis can stop there. If the proposed conduct would violate company policy, the manager’s analysis can stop. In the field of business ethics, there is little room for civil disobedience. Compliance with the law is a critical component of a successful ethics policy in any company.

The second question on balance forces the manager to examine the ethical value of fairness. A good follow-up question is, “How would I want to be treated in this circumstance?” Perhaps the decision to downsize must be made, but couldn’t the company offer the employees a severance package and outplacement assistance to ease the transition?

The final question of the Blanchard and Peale model is conscience based. Although some managers may employ any tactics to maximize profits, this final question forces a manager to examine the physical impact of a decision: Does it cause sleeplessness or appetite changes? Personalizing business choices often helps managers to see the potential harm that comes from poor ethical choices.

The Front-Page-of-the-Newspaper Test

This simple but effective model for ethical evaluation helps a manager visualize the public disclosure of proposed conduct. When he temporarily took over as the leader of Salomon

¹¹ Kenneth Blanchard and Norman Vincent Peale, *The Power of Ethical Management* (1986).

Brothers after its bond-trading controversy, Warren Buffett described the newspaper test as follows:

*Contemplating any business act, an employee should ask himself whether he would be willing to see it immediately described by an informed and critical reporter on the front page of his local paper, to be read by his spouse, children, and friends. At Salomon, we simply want no part of any activities that pass legal tests but that we, as citizens, would find offensive.*¹²

Laura Nash Model

In her work, business ethicist Laura Nash has developed a series of questions to help businesspeople reach the right decision in ethical dilemmas. These are her questions: Have you defined the problem accurately? How would you define the problem if you stood on the other side of the fence? How did this situation occur in the first place? What is your intention in making this decision? How does the intention compare with the probable results? Whom could your decision or action injure? Can you discuss your decision with the affected parties? Are you confident that your position will be as valid over a long period of time as it seems now? Could you discuss your decision with your supervisor, coworkers, officers, board, friends, and family?

The Nash model requires an examination of the dilemma from all perspectives. Defining the problem and how the problem arose provides the business assistance in avoiding the dilemma again. **For Example**, suppose that a supervisor is asked to provide a reference for a friend who works for her. The supervisor is hesitant because the friend has not been a very good employee. The ethical dilemma the manager believes she faces is whether to lie or tell the truth about the employee. The real ethical dilemma is why the supervisor never provided evaluation or feedback indicating the friend's poor performance. Avoiding the problem in the future is possible through candid evaluations. Resolving the problem requires that the supervisor talk to her friend now about the issue of performance and the problem with serving as a reference.



ETHICS & THE LAW

Pumping Up the SAT Scores for a Good Ranking

Since 2005, Claremont McKenna, ranked #9 on *U.S. News & World Report's* best liberal arts colleges in the country, has been lopping on a few points here and there to its entering students' average SAT score before reporting those numbers to *U.S. News & World Report* and rating organizations such as the Princeton Review. For example, in 2010, its combined median score was reported as 1410, rather than its actual 1400. And its 75th percentile was reported at 1510, when it was, in reality, 1480.

Claremont McKenna's vice president and dean of admissions has been removed from his job title on the college Web site. President Pamela B. Gann explained the problem and concluded, "As an institution of higher education with a deep and consistent commitment to the integrity of our

academic activities, and particularly, our reporting of institutional data, we take this situation very seriously."

Robert Franek of the Princeton Review offered, "That is a pretty mild difference in a point score. That said, 10 points, 20 points to a student that isn't getting that score on the SAT could be an important distinction." Is the issue that the difference is mild? Mr. Franek also added, "I feel like so many schools have a very clear obligation to college-bound students to report this information honestly."

Evaluate the issues as well as Mr. Franek's take on the situation from an ethical perspective.

Source: Daniel E. Slotnik and Richard Pérez-Peña, "College Says It Exaggerated SAT Figures for Rating," *New York Times*, Jan. 31, 2012, p. A12.

¹²Janet Lowe, *Warren Buffett Speaks: Wit and Wisdom from the World's Greatest Investor* (1997).

One final aspect of the Nash model that businesspeople find helpful is a question that asks for a perspective on an issue from family and friends. The problem of group-think in business situations is very real. As businesspeople sit together in a room and discuss an ethical dilemma, they can persuade each other to think the same way. The power of consensus can overwhelm each person's concerns and values. There is a certain fear in bringing up a different point of view in a business meeting. Proper perspective is often lost as the discussion centers around numbers. Therefore, bringing in the views of an outsider is often helpful. **For Example**, when McNeil, the manufacturer of Tylenol, faced the cyanide poisonings from contaminated capsules sold in the Chicago area, it had to make a decision about the existing Tylenol inventory. It was clear to both insiders and outsiders that the poison had not been put in the capsules at McNeil but after delivery to the stores. Despite the huge numbers involved in the recall and the destruction of inventory, the McNeil managers made the decision easily because they viewed the risk to their own families, that is, from the outside. From this standpoint, the issue became a question of human life, not of numbers.¹³

Make the Connection

Summary

Business ethics is the application of values and standards to business conduct and decisions. These values originate in various sources from positive (codified) law to natural law to ethical theories and standards and on to stakeholder values. Business ethics is important because trust is a critical component of good business relationships and free enterprise. A business with values will enjoy the additional competitive advantage of a good reputation and, over the long term, better earnings. When businesses make decisions that violate basic ethical standards, they set into motion social forces and cause the area of abuse to be regulated, resulting in additional costs and restrictions for

business. Voluntary value choices by businesses position them for a competitive advantage.

The categories of ethical values in business are truthfulness and integrity, promise keeping, loyalty and avoiding conflicts of interest, fairness, doing no harm, and maintaining confidentiality.

Resolution of ethical dilemmas is possible through the use of various models that require a businessperson to examine the impact of a decision before it is made. These models include stakeholder analysis, the Blanchard and Peale test, the front-page-of-the-newspaper test, and the Laura Nash model.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

3-1 What Is Business Ethics?

LO.1 Define business ethics

See the discussion of the definition and balancing the goal of profits with the values of individuals and society, page 34.

3-2 Why Is Business Ethics Important?

LO.2 Discuss why ethics are important in business

See "The Importance of Trust," page 39.

See "Business Ethics and Financial Performance," page 39.

See "The Importance of a Good Reputation," page 41.

See Ethics & the Law on market trust, page 43.

See Sports & Entertainment Law, page 47.

¹³"Brief History of Johnson & Johnson" (company pamphlet, 1992).

3-3 How to Recognize and Resolve Ethical Dilemmas

LO.3 Describe how to recognize and resolve ethical dilemmas

- See “Integrity and Truthfulness,” page 45.
- See “Promise Keeping,” page 45.
- See “Loyalty—Avoiding Conflicts of Interest,” page 46.
- See “Doing No Harm,” page 46.

- See Ethics & the Law on the VA, page 40.
- See “Maintaining Confidentiality,” page 47.
- See “Resolving Ethical Dilemmas,” page 47.
- See “Blanchard and Peale Three-Part Test,” page 48.
- See “The Front-Page-of-the-Newspaper Test,” page 48.
- See Ethics & the Law on pumping up SAT scores, page 49.
- See “Laura Nash Model,” page 49.

Key Terms

business ethics
civil disobedience
conflict of interest
entitlement theory
ethical egoism
ethics

integrity
Kant’s categorical imperative
moral relativists
natural law
positive law
primum non nocere

rights theory
social contract
stakeholder analysis
stakeholders
theory of justice
utilitarians

Questions and Case Problems

1. Marty Mankamyer, the president of the United States Olympic Committee (USOC), resigned in early February 2003 following reports in *The Denver Post* that indicated she had demanded a commission from a fellow real estate broker in the Colorado Springs area, the home of the USOC, who had sold property to Lloyd Ward, the CEO of the USOC. Mr. Ward had purchased a 1.3-acre lot in Colorado Springs for \$475,000 and had paid the listing broker, Brigitte Ruskin, a commission.

Ms. Mankamyer allegedly demanded a portion of the commission from Ms. Ruskin, and Ms. Ruskin sent her a check. Ms. Mankamyer had shown Mr. Ward and his wife properties in the area when they were being considered for the job and when he was considering taking the job. However, Mrs. Ward indicated that Ms. Mankamyer did not identify herself as a real estate agent and that she assumed that Ms. Mankamyer was showing the properties as a “goodwill gesture.”¹⁴ What conflicts of interest do you see here?

2. During the inauguration for President Obama in January 2013, Beyoncé was scheduled to sing the national anthem. The question arose: Did she lip-sync during her performance? No answer was forthcoming from the singer’s representatives, but it was clear from those attending that the National Marine Band was not playing during her performance. Those in charge of the event felt that since she had not had

an opportunity to rehearse with the band that it was best to use a tape. Are there any ethical issues involved in this choice for the performance? Was there an obligation of disclosure?

3. Fred Sanguine is a New York City produce broker. Ned Santini is a 19-year-old college student who works for Sanguine from 4:00 A.M. until 7:00 A.M. each weekday before he attends classes at Pace University. Fred has instructed Ned on the proper packing of produce as follows: “Look, put the bad and small cherries at the bottom. Do the same with the strawberries and blueberries. Put the best fruit on top and hide the bad stuff at the bottom. This way I get top dollar on all that I sell.” Ned is uncomfortable about the instructions, but, as he explains to his roommate, “It’s not me doing it. I’m just following orders. Besides, I need the job.”

Should Ned just follow instructions? Is the manner in which the fruit is packed unethical? Would you do it? Why or why not? Is anyone really harmed by the practice?

4. Alan Gellen is the facilities manager for the city of Milwaukee and makes all final decisions on purchasing items such as chairs, lights, and other supplies and materials. Alan also makes the final decisions for the award of contracts to food vendors at event sites. Grand Beef Franks has submitted a bid to be one of the city’s vendors. Alan went to school with Grand Beef’s owner, Steve Grand, who phones Alan and explains that Grand Beef owns a condominium in Maui that Alan could use. Steve’s offer to Alan is: “All

¹⁴Richard Sandomir, “U.S. Olympic Chief Resigns in a Furor Over Ethics Issues,” *New York Times*, February 5, 2003, A1, C17; Bill Briggs, *Realtor Waving Red Flag*, <http://www.denverpost.com>, February 4, 2003.

it would cost you for a vacation is your airfare. The condo is fully stocked with food. Just let me know.”

Should Alan take the offer? Would you? Be sure to determine which category of ethical values this situation involves and to apply several models as you resolve the question of whether Alan should accept the invitation.

5. A Dillard’s customer brought in a pair of moderately expensive dress shoes, expressing a desire to return them because they just weren’t quite right. As the manager processed the order she checked inside the box to be sure that the shoes in the box were the shoes that matched the box—past experience dictated that follow-up on returns. The shoes were the correct ones for the box, but there was another issue. The shoes had masking tape on the bottom—masking tape that was dirty. When the manager returned to the customer she said, “You forgot to remove the masking tape from your shoes.” The customer responded, “I only wore them once. That’s all I needed them for.”

From Neiman Marcus to Saks to Dillard’s, managers have to stay one step ahead of customers, or lessees, who buy, or lease for free, dresses and now shoes for one use with premeditated intent to return the merchandise. Stores now place tags strategically so that the dresses cannot be worn without cutting them off and there are no returns if the tags are cut off on formal wear.

Ace Hardware and Home Depot have customers who “buy” a special tool, try to use it once, and then return it. The hardware/home improvement stores are left with opened packaging and used goods by buy-it-temporarily customers.

List some consequences for this behavior by customers.

6. Adam Smith wrote the following in *The Theory of Moral Sentiments*:

*In the practice of the other virtues, our conduct should rather be directed by a certain idea of propriety, by a certain taste for a particular tenor of conduct, than by any regard to a precise maxim or rule; and we should consider the end and foundation of the rule, more than the rule itself.*¹⁵

Do you think Adam Smith adhered to positive law as his ethical standard? Was he a moral relativist? Does his quote match stakeholder analysis? What would his ethical posture be on violating the law?

7. A new phenomenon for admissions to MBA programs is hiring consultants to help applicants hone their applications. About 20 percent of those who apply to the top MBA programs have hired consultants at a cost of \$150 to \$200 per hour to help them say and do the right things to be admitted. The total cost for most who use a consultant is \$5,000. The consultants help with personal essays and applications. One admissions officer points out that one function of the consultant is to draw out and emphasize skills that the applicant may not see as important. For example, playing the piano is looked upon favorably because it shows discipline and focus.

However, admissions committees are becoming adept at spotting the applications via consultant because, as the faculty describe it, these essays and applications have a certain “sameness” to them. The Fuqua School at North Carolina suggests that students simply call the admissions office and get comparable advice for free. Is it ethical to use an admissions consultant? When would you cross a line in using the consultant on the essay?

8. “I was very upset that there’s that many dishonest people,” said Andrea Reuland, the owner of Trigs Shell Station in Minocqua, Wisconsin.

She lost \$3 per gallon on 586 gallons of gas sold during a 45-minute period when local residents phoned others to come and get gas because an employee had made a mistake and entered the price at 32.9 cents vs. \$3.299 per gallon.

Eighty-seven percent of the people who responded to a survey about the incident said they would have done the same thing as the Minocqua residents.

Describe who is affected by what buyers did by not paying the correct price for the gas. Describe a simple test for resolving an ethical dilemma such as this where you can get something for free or very little.

9. The state of Arizona mandates emissions testing for cars before drivers can obtain updated registrations. The state hires a contractor to conduct the emissions tests in the various emissions-testing facilities around the state. In October 1999, the Arizona attorney general announced the arrest of 13 workers at one of the emissions-testing facilities for allegedly taking payoffs of between \$50 and \$200 from car owners to pass their cars on the emissions tests when those cars fell below emissions standards and would not have been registered. Nearly half of the staff at the emissions facility were arrested.

Why is it a crime for someone working in a government-sponsored facility to accept a payment

¹⁵Adam Smith, *The Theory of Moral Sentiments* (Arlington House, 1969; originally published in 1769).

- for a desired outcome? Do the payoffs to the workers really harm anyone?
10. The president and athletic director at the University of California at Los Angeles (UCLA) fired the school's basketball coach because an expense form he had submitted for reimbursement had the names of two students he said had joined him for a recruiting dinner. The students had not been to the dinner. The coach was stunned because he had been at UCLA for eight years and had established a winning program. He said, "And to throw it all away on a meal?" Do you agree with the coach's assessment? Was it too harsh to fire him for one inaccurate expense form? Did the coach commit an ethical breach?
 11. When some runners in the New York City Marathon hit the Queensboro Bridge, temptation sets in and, rather than finishing the last 10 miles through Harlem and the Bronx, they hop a ride on the subway and head toward the finish line at Central Park. A total of 46 runners used the subway solution to finish the race in the 2008 NYC Marathon. When one runner was questioned about his unusual time, he admitted to using the subway and said, "So I skipped a few boroughs. I didn't do anything illegal." How would you respond to his point that he did not break the law? Why should we worry about some runners?
 12. David A. Vise, a Pulitzer Prize winner and a reporter for the *Washington Post*, wrote the book *The Bureau and the Mole*. When the book hit the market, Mr. Vise purchased 20,000 copies via Barnes & Noble.com, taking advantage of both free shipping offered by the publisher and a discounted initial price. Mr. Vise's book had already hit the *New York Times*' bestseller list in the week before the purchases. He used the books he purchased to conduct online sales of autographed copies of the books, and then returned 17,500 books and asked for his money back. However, that return of 17,500 books represented more books than a publisher generally runs for a book. Mr. Vise said that he did not intend to manipulate the market or profit from the transactions. He said his only intent was to "increase awareness of *The Bureau and the Mole*."

Mr. Vise's editor offered to pay Barnes & Noble for any expenses it incurred. Was it ethical to do what Mr. Vise did? Was he within his rights to return the books? What are his remedies? Does Barnes & Noble have any rights?
 13. Former Enron Chief Financial Officer Andrew Fastow, in his testimony against his former bosses at their criminal trial for fraud, said, "I thought I was being a hero for Enron. At the time, I thought I was helping myself and helping Enron to make its numbers." Mr. Fastow also added, however, "I lost my moral compass."

Are you able to classify Mr. Fastow into a particular ethical standard or principle?
 14. Piper High School in Piper, Kansas, a town located about 20 miles west of Kansas City, experienced national attention because of questions about students and their term papers for a botany class. Christine Pelton, a high school science teacher, had warned students in her sophomore class not to use papers posted on the Internet for their projects. When their projects were turned in, Ms. Pelton noticed that the writing in some of the papers was well above the students' usual quality and ability. She found that 28 of her 118 students had taken substantial portions of their papers from the Internet. She gave these students a zero grade on their term paper projects with the result that many of the students were going to fail the course for that semester. The students' parents protested, and the school board ordered Ms. Pelton to raise the grades.

She resigned in protest. She received a substantial number of job offers from around the country following her resignation. Nearly half of the high school faculty as well as its principal announced their plans to resign at the end of the year. Several of the parents pointed to the fact that there was no explanation in the Piper High School handbook on plagiarism. They also said that the students were unclear about what could be used, when they had to reword, and when quotations marks were necessary.

The annual Rutgers University survey on academic cheating has revealed that 15 percent of college papers turned in for grades are completely copied from the Internet.

Do you think such copying is unethical? Why do we worry about such conduct? Isn't this conduct just a function of the Internet? Isn't it accepted behavior?
 15. Heinz Ketchup holds 54 percent of the ketchup market in the United States. Nine of every 10 restaurants feature Heinz ketchup. However, Heinz has learned that many restaurant owners are simply refilling Heinz Ketchup bottles with other ketchup to capture Heinz prestige without actually buying Heinz. There are no specific regulations that apply to the practice. Discuss the ethical issues. One restaurant owner has said that customers do not notice and that it is not a big deal. Evaluate the ethical issues in his comment.

The Constitution as the Foundation of the Legal Environment

>>> Learning Outcomes

After studying this chapter, you should be able to

- LO.1** Describe the U.S. Constitution and the federal system
- LO.2** Explain the relationship between the U.S. Constitution and the states
- LO.3** Discuss interpreting and amending the Constitution
- LO.4** List and describe the significant federal powers
- LO.5** Discuss constitutional limitations on governmental power

4-1 The U.S. Constitution and the Federal System

- 4-1a What a Constitution Is
- 4-1b The Branches of Government

4-2 The U.S. Constitution and the States

- 4-2a Delegated and Shared Powers
- 4-2b Other Powers
- 4-2c Federal Supremacy

4-3 Interpreting and Amending the Constitution

- 4-3a Conflicting Theories
- 4-3b Amending the Constitution
- 4-3c The Living Constitution

4-4 Federal Powers

- 4-4a The Power to Regulate Commerce
- 4-4b The Financial Powers

4-5 Constitutional Limitations on Government

- 4-5a Due Process
- 4-5b Equal Protection of the Law
- 4-5c Privileges and Immunities
- 4-5d Protection of the Person
- 4-5e The Bill of Rights and Businesses as Persons

4-1 The U.S. Constitution and the Federal System

federal system—the system of government in which a central government is given power to administer to national concerns while individual states retain the power to administer to local concerns.

constitution—a body of principles that establishes the structure of a government and the relationship of the government to the people who are governed.

tripartite—three-part division (of government).

legislative branch—the branch of government (e.g., Congress) formed to make the laws.

executive branch—the branch of government (e.g., the president) formed to execute the laws.

judicial branch—the branch of government (e.g., the courts) formed to interpret the laws.

bicameral—a two-house form of the legislative branch of government.

delegated powers—powers expressly granted the national government by the Constitution.

The Constitution of the United States establishes the structure and powers of government but also the limitations on those powers. This Constitution forms the foundation of our legal environment. By establishing a central government to coexist with the governments of the individual states, the U.S. Constitution created a federal system. In a **federal system**, a central government has power to address national concerns while the individual states retain the power to handle local concerns.

4-1a What a Constitution Is

A **constitution** is the written document that establishes the structure of the government and its relationship to the people. The U.S. Constitution was adopted in 1789 by the 13 colonies that had won their independence from King George.¹

4-1b The Branches of Government

The U.S. Constitution establishes a **tripartite** (three-part) government: a **legislative branch** (Congress) to make the laws, an **executive branch** (the president) to execute or enforce the laws, and a **judicial branch** (courts) to interpret the laws.² The national legislature or Congress is a **bicameral** (two-house) body consisting of the Senate and the House of Representatives. Members of the Senate are popularly elected for a term of six years. Members of the House of Representatives are popularly elected for a term of two years. The president is elected by an electoral college whose membership is popularly elected. The president serves for a term of four years and is eligible for reelection for a second term. Judges of the United States are appointed by the president with the approval of the Senate and serve for life, subject to removal only by impeachment because of misconduct. (See Chapter 2 for a discussion of the federal court system.)

4-2 The U.S. Constitution and the States

The Constitution created certain powers within the national government that would have been exercised by the individual states, which are given their powers by the people of the state. Figure 4-1 illustrates the delegation of powers. Likewise, the states, as the power-granting authorities, reserved certain powers for themselves.

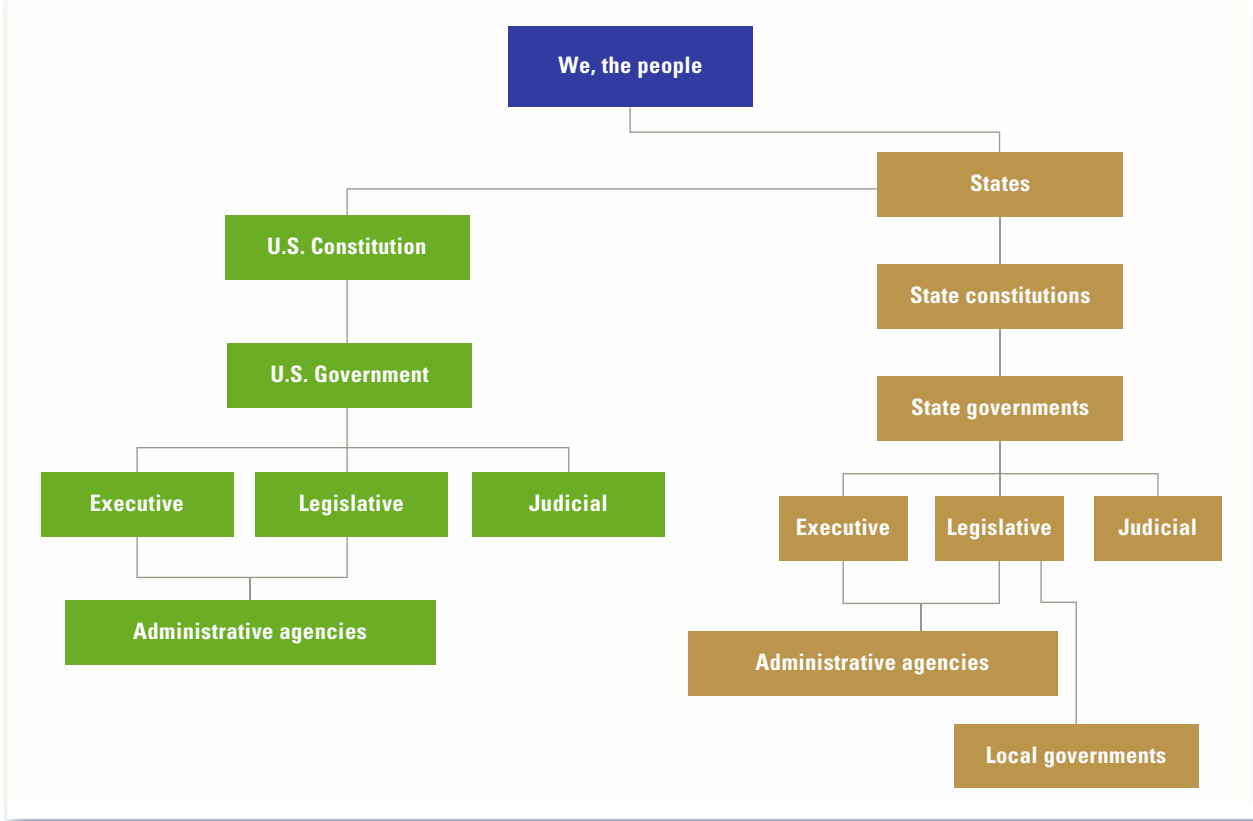
4-2a Delegated and Shared Powers

Delegated Powers

The powers given by the states to the national government are described as *delegated powers*. Some of these **delegated powers** are given exclusively to the national government. **For Example**, the national government alone may declare war or establish a currency.

¹ U.S. Const., Art 1, §8, cl 1. To read more of the U.S. Constitution, refer to Appendix 2, or go to <http://www.constitution.org> and click on “Founding Documents.”

² *Free Enterprise Fund v. Public Company Accounting Oversight Board*, 561 U.S. 477 (2010).

FIGURE 4-1 Governments of the United States

Shared Powers

shared powers—powers that are held by both state and national governments.

The powers delegated to the national government that may still be exercised by the states are **shared powers**. **For Example**, the grant of power to the national government to impose taxes did not destroy the state power to tax. In other cases, a state may provide regulation along with, but subject to the supremacy of, federal law. **For Example**, regulation of the use of navigable waterways within a state is an example of joint state and federal regulation.

police power—the power to govern; the power to adopt laws for the protection of the public health, welfare, safety, and morals.

4-2b Other Powers

Police Power of the States

The states possess the power to adopt laws to protect the general welfare, health, safety, and morals of the people. This authority is called the **police power**. **For Example**, states may require that businesses be licensed with state agencies to protect persons dealing with the business. State exercise of the police power may not unreasonably interfere with federal powers.

ex post facto law—a law making criminal an act that was lawful when done or that increases the penalty when done. Such laws are generally prohibited by constitutional provisions.

Prohibited Powers

The Constitution also prohibits both states and the federal government from doing certain things. **For Example**, neither states nor the national government may adopt **ex post facto laws**, which make criminal an act that has already been committed

but was not criminal when it was committed. Laws that increase the penalty for an act already committed above the penalty in force when the act was committed are also *ex post facto* laws.

4-2c Federal Supremacy

States cannot enact conflicting state regulation if the congressional intent to regulate exclusively can be inferred from the details of congressional regulation. **Preemption** means that the federal regulatory scheme is controlling.

preemption—the federal government’s superior regulatory position over state laws on the same subject area.

Express Federal Regulation

The Constitution and statutes passed by Congress are the supreme law of the land. They cancel out any conflicting state law.³ When a direct conflict exists between federal and state statutes, federal law prevails.

In some cases, however, no obvious conflict occurs because the federal statute covers only part of the subject matter. In such cases, the question becomes whether a state law can regulate the areas not regulated by Congress or whether the partial regulation made by Congress preempts, or takes over, the field so as to preclude state legislation.

CASE SUMMARY

Generic Preemption: Controlling Who Recovers for Pharma Injuries

FACTS: In 1978, the FDA approved an anti-inflammatory pain reliever called “sulindac” under the brand name of “Clinoril.” When the patent expired, the FDA approved several generic versions of sulindac for sale, including one developed by Mutual Pharmaceutical (Petitioner). The warnings for Clinoril included the possibility of developing toxic epidermal necrolysis. Karen Bartlett (Respondent) took a generic form of sulindac in December 2004 and developed an acute case of toxic epidermal necrolysis. Sixty to sixty-five percent of Ms. Bartlett’s body deteriorated, was burned off, or turned into an open wound. She spent months in a medically induced coma, underwent 12 eye surgeries, and was tube-fed for a year. She is now severely disfigured, has a number of physical disabilities, and is nearly blind.

At the time Ms. Bartlett got her sulindac prescription, the label did not refer to toxic epidermal necrolysis but warned that the drug could cause “severe skin reactions” and “fatalities.” Toxic epidermal necrolysis was listed as a side effect in the package insert. After Ms. Bartlett was suffering from toxic epidermal necrolysis, the FDA did a comprehensive study and recommended that the product label include more explicit warnings about toxic epidermal necrolysis.

Ms. Bartlett sued Mutual in New Hampshire state court, and Mutual removed the case to federal court. Ms. Bartlett initially asserted both failure-to-warn and design-defect claims, but the District Court dismissed her failure-to-warn claim based on her doctor’s “admission” that he had not read the box label or insert.”

After a two-week trial on a design-defect claim, a jury found Mutual liable and awarded Ms. Bartlett over \$21 million in damages. The Court of Appeals affirmed, and Mutual appealed. The U.S. Supreme Court granted *certiorari*.

DECISION: The court held that the federal law was clear that a generic manufacturer could not change the label, and it was the purpose of the law to provide a cheap way to get the drugs out there once the patent was expired. Generic manufacturers were to just use the same warnings provided by the brand name pharmaceutical company, without variation. Until there was a change in the label under FDA processes and standards, the generic manufacturer could not make additions or changes, and federal law preempted state laws on product liability recovery. [*Mutual Pharmaceutical Co., Inc. v. Bartlett*, 133 S. Ct. 2466 (2013)]

³U.S. Const., Art VI, cl 2 *PLIVA, Inc. v. Mensing*, 131 S. Ct. 2567 (2013).

Silence of Congress

In some situations, the silence of Congress in failing to cover a particular subject area indicates that Congress does not want any law on the matter. However, when national uniformity is essential, the silence of Congress generally means that the subject has been preempted for practical reasons by Congress and that no state law on the subject may be adopted.

Effect of Federal Deregulation

The fact that the federal government removes the regulations from a regulated industry does not automatically give the states the power to regulate that industry. If under the silence-of-Congress doctrine the states cannot regulate, they are still barred from regulating after deregulation. **For Example**, deregulation of banks in the 1980s did not mean that the states could step in and regulate those banks.⁴

4-3 Interpreting and Amending the Constitution

The Constitution as it is interpreted today has changed greatly from the Constitution as originally written. The change has been brought about by interpretation, amendment, and practice.

4-3a Conflicting Theories

Shortly after the Constitution was adopted, conflict arose over whether it was to be interpreted strictly, so as to give the federal government the least power possible, or broadly, so as to give the federal government the greatest power that the words would permit. These two views may be called the *bedrock view* and the *living-document view*, respectively.

In the **bedrock view**, or strict constructionist or originalist view, the purpose of a constitution is to state certain fundamental principles for all time. In the **living-document view**, a constitution is merely a statement of goals and objectives and is intended to grow and change with time.

Whether the Constitution is to be liberally interpreted under the living-document view or narrowly interpreted under the bedrock view has a direct effect on the Constitution. For the last century, the Supreme Court has followed the living-document view. This view has resulted in strengthening the power of the federal government, permitting the rise of administrative agencies, and expanding the protection of human rights.

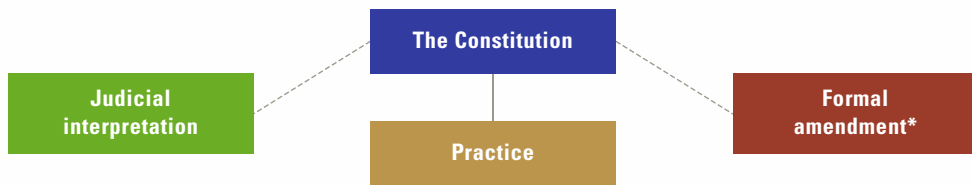
One view is not selected to the exclusion of the other. As contradictory as these two views sound, the Constitution remains durable. We do not want a set of New Year's resolutions that will soon be forgotten. At the same time, we know that the world changes, and, therefore, we do not want a constitution that will hold us tied in a strait-jacket of the past.

In terms of social forces that make the law, we are torn between our desire for stability and our desire for flexibility. We want a constitution that is stable. At the same time, we want one that is flexible.

bedrock view—a strict constructionist interpretation of a constitution.

living-document view—the term used when a constitution is interpreted according to changes in conditions.

⁴For a discussion of preemption of state regulation of airline advertising when federal regulation of air travel is so pervasive, see *New York v. Trans World Airlines*, 556 N.Y.S.2d 803 (1990) and *Pan American World Airways, Inc. v. Abrams*, 764 F. Supp. 864 (S.D.N.Y. 1991). See also footnote 3 for another case on pharmaceutical preemption and *People ex rel. Cuomo v. Greenberg*, 95 A.D.3d 474, 946 N.Y.S.2d 1 (N.Y.A.D. 2012).

FIGURE 4-2 Amending the U.S. Constitution

*Article V of the U.S. Constitution specifies the procedure for adopting amendments.

4-3b Amending the Constitution

The Constitution has been amended in three ways: (1) expressly, (2) by interpretation, and (3) by practice. Figure 4-2 illustrates these three methods of amendment.

Constitutional Method of Amending

Article V of the Constitution gives the procedure to be followed for amending the Constitution. Relatively few changes have been made to the Constitution by this formal process, although thousands of proposals have been made. Since the time of its adoption, there have been only 27 amendments to the Constitution.⁵

Amendment by Judicial Interpretation

The U.S. Supreme Court has made the greatest changes to the written Constitution by interpreting it. Generally, interpretation is used to apply the Constitution to a new situation that could not have been foreseen when the written Constitution was adopted.

Amendment by Practice

In practice, the letter of the Constitution is not always followed. Departure from the written Constitution began as early as 1793 when George Washington refused to make treaties as required by the Constitution, by and with the consent of the Senate. Washington began the practice of the president's negotiating a treaty with a foreign country and then submitting it to the Senate for approval. This practice has been followed since that time. Similarly, the electoral college was originally intended to exercise independent judgment in selecting the president, but it now automatically elects the official candidate of the party that elected the majority of the members of the electoral college.

4-3c The Living Constitution

The living Constitution has the following characteristics.

Strong Government

One of the characteristics of the new Constitution is strong government. Business enterprises are highly regulated and the economy is controlled through monetary policy.

⁵Gregory Watson, a University of Texas at Austin student who was doing research for a paper for a class on the U.S. Constitution, ran across a 1789 proposed amendment to the Constitution that had never been ratified by the states. Watson wrote a paper and got a "C" but through a successful letter-writing campaign was able to get the 27th Amendment passed. The amendment reads, "No law, varying the compensation for the services of the Senators and Representatives, shall take effect, until an election of Representatives shall have intervened."

Strong President

Instead of being merely an officer who carries out the laws, the president has become the political leader of a party, exerting strong influence on the lawmaking process.

Eclipse of the States

Under constitutional interpretations, all levels of government have powers that they never possessed before, but the center of gravity has shifted from the states to the nation. When the Constitution was adopted in 1789, the federal government was to have only the very limited powers specified in Article I, Section 8, of the Constitution. Whatever regulation of business was permissible was to be imposed by the states. Today, the great bulk of the regulation of business is adopted by the federal government through Congress or its administrative agencies. As the U.S. economy moved from the local community stage to the nationwide and then international stages, individual states could no longer provide effective regulation of business. Regulation migrated to the central government.

Administrative Agencies

These units of government were virtually unheard of in 1789, and the Constitution made no mention of them. The vast powers of the new Constitution are exercised to a very large degree by administrative agencies. They are in effect a fourth branch of the government, not provided for in the written Constitution. More importantly, the administrative agencies are the ones that come in contact with the majority of businesspersons and citizens.

Agencies have had a significant amount of power delegated to them. The members and heads of the agencies, boards, or commissions are not elected by the voters (see Chapter 6). They are appointed by the president and, at certain levels of appointment in the agency, must be approved by Congress.

4-4 Federal Powers

The federal government possesses powers necessary to administer matters of national concern.

4-4a The Power to Regulate Commerce

The desire to protect commerce from restrictions and barriers set up by the individual states was a prime factor leading to the adoption of the Constitution of 1789. To protect commerce, Congress was given Article I, Section 8, Clause 3—now known as the **commerce clause**—the power “to regulate commerce with foreign nations, and among the several states, and with the Indian tribes.”⁶

Until 1937, the Supreme Court held that this provision gave Congress the power to control or regulate only that commerce crossing a state line, such as an interstate railway train or an interstate telegraph message.

The Commerce Power Becomes a General Welfare Power

In 1937, the Supreme Court began expanding the concept of interstate commerce. By 1946, the power to regulate interstate commerce had become very broad. By that year, the power had expanded to the point that it gave authority to Congress to adopt regulatory laws that were “as broad as the economic needs of the nation.”⁷ By virtue of this broad interpretation, Congress can regulate manufacturing, agriculture, mining, stock

commerce clause—that section of the U.S. Constitution allocating business regulation between federal and state governments.

⁶U.S. Const., Art 1, §8, cl 1. To read more of the U.S. Constitution, refer to Appendix 2, or go to <http://www.constitution.org> and click on “Founding Documents.”

⁷*American Power & Light Co. v. Securities and Exchange Commission*, 329 U.S. 90 (1946).

exchanges, insurance, loan sharking, monopolies, and conspiracies in restraint of trade. The far reach of the interstate commerce power is seen in the Freedom of Access to Clinic Entrances Act,⁸ which prohibits obstruction of entrances to clinics, as well as in the commerce clause challenges to the Affordable Health Care Act, also known as Obama Care.⁹

The case that was the beginning point in the transition of the commerce clause was *NLRB v. Jones & Laughlin Steel*, 301 U.S. 1 (1937). The “affectation” doctrine expanded the authority of the federal government under the commerce clause. At that time, the Court concluded, “If it is interstate commerce that feels the pinch, it does not matter how local the squeeze.”

The Commerce Clause Today

Today, judicial review of the commerce clause typically finds some connection between the legislation and congressional authority. However, the U.S. Supreme Court has found some areas Congress may not regulate and has placed some limitations on the commerce clause. These constraints on the commerce clause focus on the nature of the underlying activity being regulated. So long as the federal regulation relates to economic/commercial activity, it is constitutional. If, however, the underlying activity is not economic and only may have an economic impact, the Supreme Court has imposed restrictions on congressional authority under the commerce clause. **For Example**, in *U.S. v. Morrison*, 529 U.S. 598 (2000), the Supreme Court held that the Violence Against Women Act was unconstitutional because the underlying activity being regulated was violence, an activity that was not economic. Regulation of economic activity is required in order to survive constitutional scrutiny under the commerce clause.

CASE SUMMARY

Mandating Health Insurance under the Commerce Clause

FACTS: Congress passed the Patient Protection and Affordable Care Act (also known as Obama Care) in order to increase the number of Americans covered by health insurance and decrease the cost of health care. One key provision in the law is the individual mandate, which requires most Americans to maintain “minimum essential” health insurance coverage. Attorneys general from several states, along with businesses, challenged this requirement (and other provisions of the law) as being unconstitutional under the commerce clause. From a series of federal court decisions below, some finding the law constitutional and others not, the affected parties appealed and the Supreme Court granted *certiorari*. Their cases were consolidated for the court’s review.

DECISION: The court faced a new commerce clause issue of whether the federal government could require citizens to purchase a good or service because the lack of health insurance affected commerce. In the 5-4 decision, the court

concluded, “The individual mandate, however, does not regulate existing commercial activity. It instead compels individuals to *become* active in commerce by purchasing a product, on the ground that their failure to do so affects interstate commerce. Construing the Commerce Clause to permit Congress to regulate individuals precisely *because* they are doing nothing would open a new and potentially vast domain to congressional authority. Every day individuals do not do an infinite number of things. In some cases they decide not to do something; in others they simply fail to do it. Allowing Congress to justify federal regulation by pointing to the effect of inaction on commerce would bring countless decisions an individual could *potentially* make within the scope of federal regulation, and—under the Government’s theory—empower Congress to make those decisions for him.” [*National Federation of Independent Business v. Sebelius*, 132 S. Ct. 2566 (2012)] (**Note: The law was still upheld.**)

⁸ 18 U.S.C. §248.

⁹ *United States v. Wilson*, 73 F.3d 675 (7th Cir. 1995), *cert. denied*, 519 U.S. 806 (1996), *Florida ex rel. National Federation of Independent Business v. Sebelius*, 132 S. Ct. 2566 (2012).

The Commerce Power as a Limitation on States

The federal power to regulate commerce not only gives Congress the power to act but also prevents states from acting in any way that interferes with federal regulation or burdens interstate commerce. **For Example**, if the federal government establishes safety device regulations for interstate carriers, a state cannot require different devices.

CASE SUMMARY

Minors in Maine and a Major Commerce Clause Decision

FACTS: Maine passed a law that prohibited anyone other than a Maine-licensed tobacco retailer from accepting an order for delivery of tobacco. The law required the retailer to arrange for delivery with a special receipt showing that someone over the age of 18 had received and signed for the tobacco products delivered. Out-of-state shippers and tobacco sellers challenged the law as one that favored Maine tobacco retailers. The state of Maine argued that its law was passed to prevent the public health hazard of minors becoming addicted to tobacco. The federal district court

granted summary judgment for the shippers, and the court of appeals affirmed. The state of Maine appealed.

DECISION: In a 9 to 0 decision, the Court held that the Maine law may have been passed with health benefits in mind, but it clearly gave Maine businesses an economic benefit. In addition, other states had managed to fight teen smoking using programs other than discrimination between in-state and out-of-state tobacco retailers. [*Rowe v. New Hampshire Motor Transport Association*, 552 U.S. 364 (2008)]

States may not use their tax power for the purpose of discriminating against interstate commerce. **For Example**, a state cannot impose a higher tax on goods imported from another state than it imposes on the same kind of goods produced in its own territory.

State regulations designed to advance local interests may conflict with the commerce clause. Such regulations are invalid. For example, suppose a state has a health concern about having milk properly processed. One way to address the concern is to require all milk to be processed in-state. Such a regulation clearly favors that state's businesses and imposes a great burden on out-of-state milk producers. Such a regulation would be an unconstitutional exercise of state power because the state could simply require all milk sellers to be licensed. Licensing would allow the state to check the milk-processing procedures of all firms and accomplish the safety goal without imposing such a burden on out-of-state firms.¹⁰ For example, in *Granholm v. Heald*, 544 U.S. 460 (2005), both New York and Michigan statutes prohibited out-of-state wine producers from selling their wines directly to consumers there. In-state wineries could sell directly to consumers. The impact of the prohibition on the out-of-state wine producers was that they were required to pay wholesaler fees and thus could not compete with in-state wine producers on direct-to-consumer sales.

The court held that state laws violated the commerce clause because they treated in-state and out-of-state economic interests differently with the result being that one benefits and the other is burdened. The mere fact that a wine producer is not a resident of the state should not foreclose access to markets there.¹¹

¹⁰ *Minnesota v. Clover Leaf Creamery*, 449 U.S. 456 (1981).

¹¹ *Missouri v. Harris*, 58 F. Supp. 3d 1059 (E.D. Cal. 2014) – in this case a federal judge dismissed a complaint brought by egg farmers in six states who are prohibited from selling their eggs in California unless they meet the nonconfinement standards of California's Proposition 2, which requires that chickens be able to lie down, stand up, and fully extend their limbs.

4-4b The Financial Powers

The financial powers of the federal government include the powers to tax and to borrow, spend, and coin money.

The Taxing Power

The federal Constitution provides that “Congress shall have power to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defence and general welfare of the United States.”¹² Subject to the express and implied limitations arising from the Constitution, the states may impose such taxes as they desire and as their own individual constitutions and statutes permit. In addition to express constitutional limitations, both national and local taxes are subject to the unwritten limitation that they be imposed for a public purpose. Taxes must also be apportioned. A business cannot be taxed for all of its revenues in all 50 states. There must be apportionment of taxes, and there must be sufficient connection with the state.¹³ **For Example,** in *Quill v. North Dakota*, 504 U.S. 298 (1992), Quill, an office equipment and supplies seller, did business in North Dakota through catalogs and flyers, advertisements in national periodicals, and telephone calls. Quill delivered all of its merchandise to its North Dakota customers by mail or common carriers from out-of-state locations. North Dakota imposed sales tax requirements on Quill. The U.S. Supreme Court held that the exercise of the taxing authority placed an undue burden on commerce and retailers such as Quill and that the standard of a company’s presence in the state through property or personnel was required to impose taxes.



CASE SUMMARY

Booking Sales Tax Revenue Against BarnesandNoble.com

FACTS: The facts of this case are not in dispute. Barnesandnoble.com LLC (Bn.com) is a Delaware corporation that sells books, movies, and other media over the Internet. In 2006, the New Mexico Taxation and Revenue Department (the Department) assessed gross receipts tax against bn.com on its sales to New Mexico residents during a period from January 1998 through July 2005. Bn.com protested the assessment, and a hearing officer granted summary judgment to bn.com, finding that it lacked a substantial nexus with the state of New Mexico, and, therefore, it could not constitutionally be required to pay the tax. The Department appealed, and the Court of Appeals held that bn.com had a substantial nexus with the state. bn.com appealed.

DECISION: The court found the following interconnected activities of the stores (Booksellers): (1) Booksellers’

promotion of bn.com through sales of gift cards redeemable at bn.com and bearing bn.com’s name, (2) Booksellers’ policy of sharing customers’ e-mail addresses with bn.com, (3) Booksellers’ implicit endorsement of bn.com through the companies’ shared loyalty program and Booksellers’ return policy, and (4) Booksellers’ in-state use of Barnes & Noble logos and trademarks, which bn.com also used. Because Booksellers’ activities in New Mexico were significantly associated with bn.com’s ability to establish and maintain a market here, bn.com had a substantial nexus with the state of New Mexico. Therefore, New Mexico may collect gross receipts tax on bn.com’s sales in the state without offending the commerce clause of the United States Constitution. Affirmed and remanded. [*New Mexico Taxation and Revenue Department v. BarnesandNoble.com LLC*, 303 P.3d 824 (N.M. 2014)]

¹² U.S. Const., Art 1, §8, cl 1. To read more of the U.S. Constitution, refer to Appendix 2, or go to <http://www.constitution.org> and click on “Founding Documents.”

¹³ *Polar Tankers, Inc. v. City of Valdez, Alaska*, 557 U.S. 1 (2009).



E-COMMERCE & CYBERLAW

Internet and Interstate

Collection of sales tax from Internet stores has been a stickler of an issue for businesses, state revenue officials, and the U.S. Supreme Court. All three were grappling with how to collect, what to collect, and whether anybody had any authority to collect. Internet sales represent a large, untapped source of revenue. A study from the Center for Business and Economic Research at the University of Tennessee estimated the lost tax revenue from untaxed Internet sales as \$30 billion in 2011.

The merchants involved fell into different legal groups in terms of their theories on whether tax was owed and whether they should just pay it, with or without the states having the authority to tax:

1. Those stores with physical presences in states (Walmart and J.C. Penney) that just collected sales tax as if they were collecting it in a store in that state where the Internet purchaser was located
2. Those stores without a physical presence (Amazon) that did collect taxes, particularly in those states known for taking a hard-line approach
3. Those stores without a physical presence that do not collect taxes and maintain that it is unconstitutional to do so
4. Those stores with or without a physical presence that have collected taxes but held them until everyone could figure out the legal status of the companies

What are the constitutional issues in this taxation question?

Amazon has negotiated with most states on sales tax issues and you can notice as a buyer that you pay some form of tax on your Amazon purchases now.

Source: Stu Woo, "Amazon Battles States Over Sales Tax," *Wall Street Journal*, August 3, 2011, p. A1.

The Spending Power

The federal government may use tax money and borrowed money "to pay the debts and provide for the common defence and general welfare of the United States."¹⁴

4-5 Constitutional Limitations on Government

The constitutional limitations discussed in the following sections afford protections of rights for both persons and businesses.

4-5a Due Process

The power of government is limited by both the Fifth and Fourteenth Amendments to the Constitution. Those amendments, respectively, prohibit the national government and state governments from depriving any person "of life, liberty, or property without due process of law."¹⁵

When Due Process Rights Arise

As a result of liberal interpretation of the Constitution, the **due process clause** now provides a guarantee of protection against the loss of property or rights without the chance to be heard. These amendments also guarantee that all citizens are given the same protections. **For Example**, the Supreme Court has extended the due process clause to protect

due process clause—a guarantee of protection against the loss of property or rights without the chance to be heard.

¹⁴U.S. Const., Art 1, §8, cl 1. To read more of the U.S. Constitution, refer to Appendix 2, or go to <http://www.constitution.org> and click on "Founding Documents."

¹⁵U.S. Const., Art 1, §8, cl 1. To read more of the U.S. Constitution, refer to Appendix 2, or go to <http://www.constitution.org> and click on "Founding Documents."

quasi-judicial proceedings—forms of hearings in which the rules of evidence and procedure are more relaxed but each side still has a chance to be heard.

the record or standing of a student.¹⁶ A student cannot lose credit in a course or be suspended or expelled without some form of a hearing.

Because there are so many areas in which due process rights exist and require a chance to be heard, speeding up due process has resulted in the creation of **quasi-judicial proceedings**. In these types of proceedings, the parties need not go through the complex, lengthy, and formal procedures of a trial (described in Chapter 2). Rather, these proceedings have a hearing officer or administrative law judge (see Chapter 6) who conducts an informal hearing in which the rules of evidence and procedure are relaxed.

For Example, a student taking a grade grievance beyond a faculty member's decision will generally have his case heard by a panel of faculty and students as established by college or university rules. An employer appealing its unemployment tax rate will have the appeal heard by an administrative law judge.

What Constitutes Due Process?

Due process does not require a trial on every issue of rights. Shortcut procedures, such as grade grievance panels, have resulted as a compromise for providing the right to be heard along with a legitimate desire to be expeditious in resolving these issues. In *Horne v. U.S. Department of Agriculture*, 132 S. Ct. 2566 (2015), raisin farmers challenged the taking of their raisin crops by the Department of Agriculture in its efforts to stabilize the raisin market. The farmers' challenge was based on their lack of a hearing for the taking as well as compensation for the loss of their raisin crops and the imposition of penalties if they sold the raisins prohibited by the Department of Agriculture. The court held that the Fifth Amendment requires that the government pay just compensation when it takes personal property, just as when it takes real property. The government cannot make raisin growers relinquish their raisins without just compensation.

4-5b Equal Protection of the Law

The Constitution prohibits the states and the national government from denying any person the equal protection of the law.¹⁷ This guarantee prohibits a government from treating one person differently from another when there is no reasonable ground for classifying them differently.

For Example, laws that make distinctions in the regulation of business, the right to work, and the right to use or enjoy property on the basis of race, national origin, or religion are invalid. Also invalid are laws that impose restrictions on some, but not all, persons without any justification for the distinction.¹⁸ **For Example**, a state statute taxing out-of-state insurance companies at a higher rate than in-state insurance companies violates the equal protection clause.¹⁹

privileges and immunities clause—a clause that entitles a person going into another state to make contracts, own property, and engage in business to the same extent as citizens of that state.

4-5c Privileges and Immunities

The U.S. Constitution declares that “the citizens of each state shall be entitled to all privileges and immunities of citizens in the several states.”²⁰ The so-called **privileges and immunities clause** means that a person going into another state is entitled to make

¹⁶That is, a student cannot be expelled without a chance to have his or her side of the story reviewed.

¹⁷U.S. Constitution, Fourteenth Amendment as to the states; modern interpretation of due process clause of the Fifth Amendment as to national government. Congress adopted the Civil Rights Act to implement the concept of equal protection.

¹⁸*Associated Industries of Missouri v. Lohman*, 511 U.S. 641 (1994).

¹⁹*Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869 (1985). But see a differing view on distinctive treatment of temporary bridge contractors vs. permanent bridge contractors, *Mabey Bridge & Shore, Inc. v. Schoch*, 666 F.3d 862 (3rd Cir. 2012).

²⁰U.S. Const., Art 1, §8, cl 1. To read more of the U.S. Constitution, refer to Appendix 2, or go to <http://www.constitution.org> and click on “Founding Documents.”

contracts, own property, and engage in business to the same extent as the citizens of that state. **For Example**, a state cannot bar someone who comes from another state from engaging in local business or from obtaining a hunting or fishing license merely because the person is not a resident of that state.

4-5d Protection of the Person

The Constitution has no general provision declaring that the government shall not impair rights of persons. The Constitution does not mention the phrase *unalienable right* that was part of the Declaration of Independence.²¹ However, the Bill of Rights, the first 10 amendments to the Constitution, does provide protections for freedom of speech, jury trials, and freedom of religion and association.²² The Bill of Rights provides for the due process protections discussed earlier as well as those that prohibit unlawful searches and seizures. The Second Amendment provides for the right to keep and bear arms, an issue that has resulted in some conflicting decisions that the U.S. Supreme Court has begun to address.²³

During the last six decades, the Supreme Court has been interpreting the rights in these amendments and has been finding constitutional protection for a wide array of rights of the person that are not expressly protected by the Constitution. **For Example**, judicial interpretations have concluded that the Constitution provides for the right of privacy, the rights related to marriage,²⁴ protection from unreasonable zoning, protection of parental control, protection from discrimination because of poverty, and protection from gender discrimination.²⁵

4-5e The Bill of Rights and Businesses as Persons

The Bill of Rights provides protections for individuals and also for corporations. **For Example**, the Fourth Amendment (see Chapter 7) provides protections against unreasonable searches. Individuals enjoy that protection in their homes, and corporations enjoy that protection with their files, offices, and business records. Businesses also enjoy freedom of speech protections under the First Amendment. The First Amendment provides that “Congress shall make no law ... abridging the freedom of speech ...”²⁶

The U.S. Supreme Court has clarified the free speech rights of business through classification of the types of business speech. One form of business or commercial speech is advertising. This form of speech in which businesses tout their products is subject to regulation and restriction on form, content, and placement, and such regulation has been deemed constitutional. (See Chapters 24 and 32 for more information on the regulation of advertising.) However, there are other forms of commercial speech. Businesses do have the right to participate in political processes, such as creating

²¹The term *unalienable right* is employed in reference to natural right, fundamental right, or basic right. Apart from the question of scope of coverage, the adjective *unalienable* emphasizes the fact that the people still possess the right rather than having surrendered or subordinated it to the will of society. The word *alien* is the term of the old common law for transferring title or ownership. Today, we would say *transfer* and, instead of saying *unalienable* rights, would say *nontransferable* rights. Unalienable rights of the people were therefore rights that the people not only possessed but also could not give up even if they wanted to. Thus, these rights are still owned by everyone. It is important to note that the Declaration of Independence actually uses the word *unalienable* when describing the rights eventually placed in the Constitution as Amendments I–X, the Bill of Rights, not *inalienable*.

²²*North Coast Women’s Care Medical Group, Inc. v. San Diego County Superior Court*, 189 P.3d 959 (Ca. 2008).

²³*District of Columbia v. Heller*, 554 U.S. 570 (2008).

²⁴*U.S. v. Windsor*, 133 S. Ct. 2675 (2013).

²⁵In some cases, the courts have given the due process and equal protection clauses a liberal interpretation in order to find a protection of the person; *Fisher v. University of Texas at Austin*, 133 S. Ct. 2411 (2013). *Certiorari* granted following a remand. 2015 WL 629286 (2015).

²⁶For more on commercial speech, see *Greater New Orleans Broadcasting Association, Inc., v. U.S.*, 527 U.S. 173 (1999) and *U.S. v. Philip Morris USA Inc.*, 566 F.3d 1095 (D.C. Cir. 2009). To read the full language of the First Amendment, go to Appendix 2, or to <http://www.constitution.org> and click on “Founding Documents.”

political action committees and supporting or opposing ballot initiatives. Businesses often take positions and launch campaigns on ballot initiatives that will affect the taxes they will be required to pay. The courts are often balancing the power of corporate political speech, regulation of ads, and the right of corporations as citizens to speak.

CASE SUMMARY

The Case That Caused a Dust-Up between the President and a Justice

FACTS: In January 2008, Citizens United released a film entitled *Hillary: The Movie (Hillary)*, a 90-minute documentary about then-senator Hillary Clinton, who was a candidate in the Democratic Party's 2008 presidential primary elections. Most of the commentators in the film were quite critical of Senator Clinton. *Hillary* was released in theaters and on DVD, but Citizens United wanted to increase distribution by making it available through video-on-demand.

Citizens United produced two 10-second ads and one 30-second ad for *Hillary*. Each ad included a short, pejorative statement about Senator Clinton, followed by the name of the movie and the movie's Web site address. Citizens United wanted to run the advertisements on broadcast and cable television. The Federal Election Commission (FEC) wanted to stop Citizens United from running the ads and Citizens United brought suit, seeking a preliminary injunction against

the FEC. The District Court denied Citizens United a preliminary injunction and granted the FEC summary judgment. Citizens United requested and was granted *certiorari*.

DECISION: The court held that the restrictions on running ads were unconstitutional as a prior restraint on speech as well as discrimination between and among speakers. The court held that requirements on disclosure of funding for ads was constitutional, an alternative to a ban on speech that was reasonable and allowed citizens to make their own determinations about the quality/bias of the speech (ads). President Obama spoke harshly of the decision in his State of the Union address in 2011, and Justice Samuel Alito mouthed, "Not true," in response to the president's remarks. [*Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010)]



THINKING THINGS THROUGH

Freedom of Speech and Our Headlights

Fed up with the warning signals and being outnumbered on the highways by drivers looking out for one another, police officers and state troopers began issuing tickets to those who send signals and warnings to drivers so that they can slow down and avoid being caught going above the speed limit. On November 17, 2012, a police officer pulled Michael Elli over and issued a citation for "[f]lashing lights on certain vehicles prohibited; warning of RADAR ahead."

In the case, *Elli v. City of Ellisville*, No. 4:13-CV-711 HEA (E.D. Mo. 2014), Mr. Elli was advised by the municipal judge that the standard punishment imposed in the City of Ellisville for using headlamps to communicate the presence of a speed

trap is a \$1,000 fine. Mr. Elli told the judge that he wanted to plead not guilty because he did not believe flashing headlamps violated §375.100 of the Ellisville city code. The judge became agitated and asked Mr. Elli if he had ever heard of "obstruction of justice." Mr. Elli then entered a plea of not guilty, and he was ordered to return to court on February 21, 2013. However, the prosecution terminated the case by dismissing the charge prior to the hearing date. Mr. Elli, with the help of the ACLU, filed a civil rights action in federal court.

Have Mr. Elli's rights been violated? Is flashing your headlights a form of speech? What do you think the courts decided?

Make the Connection

Summary

The U.S. Constitution created the structure of our national government and gave it certain powers. It also placed limitations on those powers. It created a federal system with a tripartite division of government and a bicameral national legislature.

The national government possesses some governmental powers exclusively while both the states and the federal government share other powers. In areas of conflict, federal law is supreme.

The U.S. Constitution is not a detailed document. It takes its meaning from the way it is interpreted. In recent years, liberal interpretation has expanded the powers of the federal government. Among the powers of the federal

government that directly affect business are the power to regulate commerce; the power to tax and to borrow, spend, and coin money; and the power to own and operate businesses.

Among the limitations on government that are most important to business are the requirements of due process and the requirement of equal protection of the law. In addition, government is limited by the rights given to individuals such as freedom of speech, freedom of religion, and equal protection. The equal protection concept of the U.S. Constitution prohibits both the federal government and the state governments from treating one person differently from another unless there is a legitimate reason for doing so and unless the basis of classification is reasonable.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

4-1 The U.S. Constitution and the Federal System

LO.1 Describe the U.S. Constitution and the federal system

See the discussion of the tripartite (three-part) government, page 55.

4-2 The U.S. Constitution and the States

LO.2 Explain the relationship between the U.S. Constitution and the states

See the discussion of the federal system, page 55.

See Figure 4-1 for an illustration of the delegation of powers, page 56.

4-3 Interpreting and Amending the Constitution

LO.3 Discuss interpreting and amending the Constitution

See the discussion of the bedrock and living-document views, page 58.

4-4 Federal Powers

LO.4 List and describe the significant federal powers

See the *Bartlett* case, page 57.

See the discussion of the commerce power. See the *Sebelius* case, page 61.

See the discussion of the taxing power and the *Barnes & Noble* case, page 63.

4-5 Constitutional Limitations on Government

LO.5 Discuss constitutional limitations on governmental power

See the discussion of the Bill of Rights, page 66.

See the *Citizens United* case to understand First Amendment issues, page 67.

See the discussion of the Fourth Amendment, page 66.

See the discussion of due process, pages 64–65.

See the *For Example* discussion of a student taking a grade grievance beyond a faculty member's decision, page 65.

Key Terms

bedrock view

bicameral

commerce clause

constitution

delegated powers

due process clause

executive branch

ex post facto laws

federal system

judicial branch

legislative branch

living-document view

police power

preemption

privileges and immunities clause

quasi-judicial proceedings

shared powers

tripartite

Questions and Case Problems

1. Federal law requires most interstate truckers to obtain a permit that reflects compliance with certain federal requirements. The 1965 version of the law authorized states to require proof that a truck operator had such a permit. By 1991, 39 states had demanded such proof, requiring a \$10 per truck registration fee and giving each trucker a stamp to affix to a multistate “bingo card” carried in the vehicle. Finding this scheme inefficient and burdensome, Congress created the current Single State Registration System (SSRS), which allows a trucking company to fill out one set of forms in one state, thereby registering in every participating state through which its trucks travel.

A subsection of Michigan’s Motor Carrier Act imposes on truck companies operating in interstate commerce an annual fee of \$100 for each self-propelled motor vehicle operated by or on behalf of the motor carrier. The American Truckers Association (ATA) and others challenged the \$100 fee as preempted by the extensive federal regulation of interstate trucking and trucking companies. The ATA and others appealed to the U.S. Supreme Court. What should the U.S. Supreme Court do? Be sure to discuss what portion of the Constitution applies to this issue. [*American Trucking Associations, Inc. v. Michigan Public Service Com’n*, 545 U.S. 429]

2. J.C. Penney, a retail merchandiser, has its principal place of business in Plano, Texas. It operates retail stores in all 50 states, including 10 stores in Massachusetts, and a direct mail catalog business. The catalogs illustrated merchandise available for purchase by mail order. The planning, artwork, design, and layout for these catalogs were completed and paid for outside of Massachusetts, primarily in Texas, and Penney contracted with independent printing companies located outside Massachusetts to produce the catalogs. The three major catalogs were generally printed in Indiana, while the specialty catalogs were printed in South Carolina and Wisconsin. Penney supplied the printers with paper, shipping wrappers, and address labels for the catalogs; the printers supplied the ink, binding materials, and labor. None of these materials was purchased in Massachusetts. Printed catalogs, with address labels and postage affixed, were transported by a common carrier from the printer to a U.S. Postal Service office located

outside Massachusetts, where they were sent to Massachusetts addressees via third- or fourth-class mail. Any undeliverable catalogs were returned to Penney’s distribution center in Connecticut.

Purchases of catalog merchandise were made by telephoning or returning an order form to Penney at a location outside Massachusetts, and the merchandise was shipped to customers from a Connecticut distribution center. The Massachusetts Department of Revenue audited Penney in 1995 and assessed a use tax, penalty, and interest on the catalogs that had been shipped into Massachusetts. The position of the department was that there was a tax due of \$314,674.62 on the catalogs that were used by Penney’s Massachusetts customers. Penney said such a tax was unconstitutional in that it had no control or contact with the catalogs in the state. Can the state impose the tax? Why or why not? [*Commissioner of Revenue v. J.C. Penney Co., Inc.*, 730 N.E.2d 266 (Mass)]

3. Alfonso Lopez, Jr., a 12th-grade student at Edison High School in San Antonio, Texas, went to school carrying a concealed .38-caliber handgun and five bullets. School officials, acting on an anonymous tip, confronted Lopez. Lopez admitted that he had the gun. He was arrested and charged with violation of federal law, the Gun-Free School Zones Act of 1990. Lopez moved to dismiss his indictment on the grounds that the provision of the Gun-Free School Zones Act with which he was charged was unconstitutional in that it was beyond the power of Congress to legislate controls over public schools. The district court found the statute to be a constitutional exercise of congressional authority.

Lopez was found guilty and sentenced to two years in prison. He appealed and challenged his conviction on the basis of the commerce clause. The Court of Appeals agreed with Lopez, found the Gun-Free School Zones Act an unconstitutional exercise of congressional authority, and reversed the conviction. The U.S. Attorney appealed. Who should win at the U.S. Supreme Court and why? [*United States v. Lopez*, 514 U.S. 549]

4. The University of Wisconsin requires all of its students to pay, as part of their tuition, a student activity fee. Those fees are used to support campus clubs and activities. Some students who objected to

- the philosophies and activities of some of the student clubs filed suit to have the fees halted. What constitutional basis do you think they could use for the suit? [*Board of Regents of Wisconsin System v. Southworth*, 529 U.S. 217]
5. The Crafts' home was supplied with gas by the city gas company. Because of some misunderstanding, the gas company believed that the Crafts were delinquent in paying their gas bill. The gas company had an informal complaint procedure for discussing such matters, but the Crafts had never been informed that such a procedure was available. The gas company notified the Crafts that they were delinquent and that the company was shutting off the gas. The Crafts brought an action to enjoin the gas company from doing so on the theory that a termination without any hearing was a denial of due process. The lower courts held that the interest of the Crafts in receiving gas was not a property interest protected by the due process clause and that the procedures the gas company followed satisfied the requirements of due process. The Crafts appealed. Were they correct in contending that they had been denied due process of law? Why or why not? [*Memphis Light, Gas and Water Division v. Craft*, 436 U.S. 1]
 6. In 2002, the Williamson family, riding in their 1993 Mazda minivan, was struck head-on by another vehicle. Thanh Williamson was sitting in a rear aisle seat, wearing a lap belt; she died in the accident. Delbert and Alexa Williamson were wearing lap-and-shoulder belts; they survived. Thanh's estate brought suit in a California state court to recover from Mazda for her wrongful death. The basis of the suit was that Mazda should have installed lap-and-shoulder belts on all seats, including the rear aisle seats, and that Thanh died because Mazda equipped her seat with only a lap belt instead. Federal safety requirements do not require lap-and-shoulder belts except for seats located next to doors and windows. Middle seats (aisle) can have a lap belt only. Mazda asked for a dismissal on the grounds that allowing Thanh's estate to recover would contradict federal law and that federal law preempts state tort laws on product liability. The trial court dismissed the suit as preempted by federal law, and the Court of Appeal affirmed. The U.S. Supreme Court granted *certiorari*. What should the court decide and why? [*Williamson v. Mazda Motor of America, Inc.*, 562 U.S. 323]
 7. Montana imposed a severance tax on every ton of coal mined within the state. The tax varied depending on the value of the coal and the cost of production. It could be as high as 30 percent of the price at which the coal was sold. Montana mine operators and some out-of-state customers claimed that this tax was unconstitutional as an improper burden on interstate commerce. Decide. [*Commonwealth Edison Co. v. Montana*, 453 U.S. 609]
 8. Ollie's Barbecue is a family-owned restaurant in Birmingham, Alabama, specializing in barbecued meats and homemade pies, with a seating capacity of 220 customers. It is located on a state highway 11 blocks from an interstate highway and a somewhat greater distance from railroad and bus stations. The restaurant caters to a family and white-collar trade, with a take-out service for "Negroes." (Note: This term is used by the Court in its opinion in the case.) In the 12 months preceding the passage of the Civil Rights Act, the restaurant purchased locally approximately \$150,000 worth of food, \$69,683 or 46 percent of which was meat that it bought from a local supplier who had procured it from outside the state. Ollie's has refused to serve Negroes in its dining accommodations since opening in 1927, and since July 2, 1964, it has been operating in violation of the Civil Rights Act. A lower court concluded that if it were required to serve Negroes, it would lose a substantial amount of business. The lower court found that the Civil Rights Act did not apply because Ollie's was not involved in "interstate commerce." Will the commerce clause permit application of the Civil Rights Act to Ollie's? [*Katzenbach v. McClung*, 379 U.S. 294]
 9. Ellis was employed by the city of Lakewood. By the terms of his contract, he could be discharged only for cause. After working for six years, he was told that he was going to be discharged because of his inability to generate safety and self-insurance programs, because of his failure to win the confidence of employees, and because of his poor attendance. He was not informed of the facts in support of these conclusions and was given the option to resign. He claimed that he was entitled to a hearing. Is he entitled to one? Why or why not? [*Ellis v. City of Lakewood*, 789 P.2d 449 (Colo. App.)]
 10. The Federal Food Stamp Act provided for the distribution of food stamps to needy households. In 1971, section 3(e) of the statute was amended to define households as limited to groups whose

- members were all related to each other. This was done because of congressional dislike for the lifestyles of unrelated hippies who were living together in hippie communes. Moreno and others applied for food stamps but were refused them because the relationship requirement was not satisfied. An action was brought to have the relationship requirement declared unconstitutional. Is it constitutional? Discuss why or why not. [*USDA v. Moreno*, 413 U.S. 528]
11. New Hampshire adopted a tax law that in effect taxed the income of nonresidents working in New Hampshire only. Austin, a nonresident who worked in New Hampshire, claimed that the tax law was invalid. Was he correct? Explain. [*Austin v. New Hampshire*, 420 U.S. 656]
 12. California passed a law that prohibited the sale or rental of “violent video games.” The act defined violent video games as games “in which the range of options available to a player includes killing, maiming, dismembering, or sexually assaulting an image of a human being, if those acts are depicted” in a manner that “[a] reasonable person, considering the game as a whole, would find appeals to a deviant or morbid interest of minors.” The association of video game manufacturers and developers brought suit, challenging the California statute as an unconstitutional violation of their First Amendment right and a violation of their due process rights because it is so vague. What should the U.S. Supreme Court hold on the constitutionality of the statute and why? [*Brown v. Entertainment Merchants Ass’n*, 131 S. Ct. 2729]

Government Regulation of Competition and Prices

>>> Learning Outcomes

After studying this chapter, you should be able to

- LO.1** Explain the powers the government has to be sure free markets are working efficiently
- LO.2** List the federal statutes that regulate horizontal markets and competition and give examples of each
- LO.3** Describe the federal statutes that regulate the supply chain and vertical markets
- LO.4** Discuss the remedies available to protect business competition

5-1 Power to Regulate Business

- 5-1a Regulation, Free Enterprise, and Deregulation
- 5-1b Regulation of Unfair Competition

5-2 Regulation of Horizontal Markets and Competitors

- 5-2a Regulation of Prices
- 5-2b Monopolization
- 5-2c Boycotts and Refusals to Deal
- 5-2d Mergers among Competitors

5-3 Regulation of the Supply Chain and Vertical Trade Restraints

- 5-3a Price Discrimination
- 5-3b Exclusive Dealings and Territories
- 5-3c Resale Price Maintenance
- 5-3d Tying
- 5-3e Mergers along the Supply Chain

5-4 Remedies for Anticompetitive Behavior

- 5-4a Criminal Penalties
- 5-4b Civil Remedies

5-1 Power to Regulate Business

The federal government may regulate any area of business to advance the nation's national economic needs. Under the police power, states may regulate all aspects of business so long as they do not impose an unreasonable burden on interstate commerce or any activity of the federal government. (See Chapter 4 for a discussion of the protections and limits of the commerce clause.)

5-1a Regulation, Free Enterprise, and Deregulation

Milton Friedman, the Nobel economist, has written that government regulation of business interferes with the free enterprise system. Under a true free enterprise system, market forces would provide the necessary protections through the forces of demand and supply. Sometimes, however, the demand response, or market reaction, to problems or services is not rapid enough to prevent harm, and government regulation steps in to stop abuses. The antitrust laws step in when competitors create barriers to market entry or collude on prices or production in order to control prices.

5-1b Regulation of Unfair Competition

Each of the states and the federal government have statutes and regulations that prohibit unfair methods of competition. Unfair competition is controlled by both statutes and administrative agencies and regulations. The statutes that curb unfair competition are the Sherman Act, the Clayton Act, the Robinson-Patman Act, and the Federal Trade Commission Act.¹ Each of these statutes covers different types of anticompetitive behavior by competitors. There are horizontal restraints (those among competitors) and vertical restraints of trade (throughout the supply chain) and each is listed in Figure 5-1 and discussed in the sections that follow.

5-2 Regulation of Horizontal Markets and Competitors

Certain of the antitrust laws regulate the relationships between and among competitors, known as horizontal restraints. The goal of these laws is to be sure that firms that are

FIGURE 5-1 Types of Anticompetitive Behavior

HORIZONTAL RESTRAINTS	VERTICAL RESTRAINTS
Price-Fixing (Sherman Act)	Price Discrimination (Robinson-Patman Act)
Monopolization (Sherman Act)	Exclusive Dealings and Territories (Sherman Act)
Mergers among Competitors (Clayton Act)	Mergers along the Supply Chain (Clayton Act)
	Resale Price Maintenance (Sherman Act)
	Tying (Clayton Act)

¹ 15 U.S.C. §41 *et seq.* To review the Federal Trade Commission Act, go to <http://www.ftc.gov>.

gaining customers are doing so because they offer better products and better customer service and not because they are manipulating the markets or their prices.

CPA 5-2a Regulation of Prices

Governments, both national and state, may regulate prices. Prices in various forms are regulated, including not only what a buyer pays for goods but also through credit terms and other charges. The Sherman Act is the federal law that regulates this form of anticompetitive behavior among horizontal competitors.

CPA Prohibition on Price-Fixing

Agreements among competitors, as well as “every contract, combination ... or conspiracy” to fix prices, violate Section 1 of the Sherman Act.² Known as *horizontal price-fixing*, any agreement to charge an agreed-upon price or to set maximum or minimum prices between or among competitors are *per se*—in, through, or by themselves—is a violation of the Sherman Act. Price-fixing can involve competitors agreeing to not sell below a certain price, agreeing on commission rates, agreeing on credit terms, or exchanging cost information. Price is treated as a sensitive element of competition, and discussion among competitors has also been deemed to be an attempt to monopolize. An agreement among real estate brokers to never charge below a 6 percent commission is price-fixing.³ **For Example**, in 2014, the Justice Department filed a civil antitrust suit against Apple and various e-book publishers for conspiracy to fix e-book prices. The publishers and Apple joined forces with the hope that they could prevent Amazon from taking hold of the e-book market with what one of the CEOs of a publishing firm called “the wretched \$9.99 price point.”⁴ The CEOs met together and discussed prices in New York City. Apple had what was called “most favored nation” clauses in its contracts with the publishers; Apple had to be given the publishers’ lowest price, thus preventing the publishers from dealing with Amazon. Three publishers settled their cases. Apple went to trial and was found guilty of a conspiracy to fix prices in the e-book market.



5-2b Monopolization

Monopolies and combinations that restrain trade are prohibited under the federal antitrust laws.

The Sherman Act

The **Sherman Antitrust Act** includes two very short sections that control monopolistic behavior. They provide:

[§1] Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations, is declared to be illegal.

[§2] Every person who shall monopolize or attempt to monopolize, or combine or conspire with any other person or persons to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a felony.⁵

²To view the full language of Section 1 of the Sherman Act, see 15 U.S.C. §1.

³*McClain v. Real Estate Board of New Orleans, Inc.*, 441 U.S. 942 (1980).

⁴*U.S. v. Apple, Inc.*, 12-CV-2826 (2012). <http://online.wsj.com/news/interactive/docid=120411161455-413f968a5c71466491205e6292975605%7Cfile=ebookssettle041112?ref=SB10001424052702304444604577337573054615152>. The other publishers also sued were Hachette Book Group, Inc., HarperCollins Publishers, The Penguin Group, and Simon & Schuster. *United States v. Apple Inc.*, 889 F. Supp. 2d 623 (S.D.N.Y. 2012), *U.S. v. Apple*, 791 F.3d 290 (2nd Cir. 2015).

⁵15 U.S.C. §1. Free competition has been advanced by the Omnibus Trade and Competitiveness Act of 1988, 19 U.S.C. §2901 *et seq.*

Sherman Antitrust Act—a federal statute prohibiting combinations and contracts in restraint of interstate trade, now generally inapplicable to labor union activity.

CPA

The Sherman Act applies not only to buying and selling activities but also to manufacturing and production activities. Section 1 of the Sherman Act applies to agreements, conduct, or conspiracies to restrain trade, which can consist of price-fixing, tying, and monopolization. Section 2 prohibits monopolizing or attempting to monopolize by companies or individuals.

market power—the ability to control price and exclude competitors.

Monopolization

To determine whether a firm has engaged in monopolization or attempts to monopolize, the courts determine whether the firm has **market power**, which is the ability to control price and exclude competitors. Market power is defined by looking at both the geographic and product markets. **For Example**, a cereal manufacturer may have 65 percent of the nationwide market for its Crispy Clowns cereal (the product market), but it may have only 10 percent of the Albany, New York, market because of a local competitor, Crunchy Characters. Crispy Clowns may have market power nationally, but in Albany, it would not reach monopoly levels.

Having a large percentage of a market is not necessarily a monopoly.⁶ The Sherman Act requires that the monopoly position be gained because of a superior product or consumer preference, not because the company has engaged in purposeful conduct to exclude competitors by other means, such as preventing a competitor from purchasing a factory. **For Example**, perhaps one of the best known monopolization cases involved Microsoft. In the case, the Justice Department alleged that because Microsoft had 90 percent of the market for operating systems, it had and used monopoly power to control and market and did so by refusing to sell its operating system to companies that installed Netscape in lieu of or in addition to the Microsoft Explorer browser.⁷ Microsoft was found guilty of monopolization. Ironically, today, Microsoft has filed antitrust complaints against Google, alleging that Google drives those who use its search engine to its own specialized sites that compete with Microsoft and others.



THINKING THINGS THROUGH

Teeth Whitening and the Antitrust Laws

The market for teeth whitening began in the 1990s. North Carolina dentists grew a market for the application of concentrations of peroxide to teeth to create a chemical reaction that results in whiter teeth. In about 2003, non-dentists also started offering teeth-whitening services, often at a significantly lower price than the dentists. Day spas, chain whitening franchises, and other businesses offered the service. Shortly thereafter, dentists began complaining to the North Carolina State Board of Dental Examiners and sought to have the non-dentist whitening services shut down because allowing such services to be performed by non-dentists created public health, safety, and welfare concerns.

After receiving complaints from dentists, the Board opened an investigation into teeth-whitening services performed by

non-dentists. As a result of the investigations, the Board issued 47 cease-and-desist letters to 29 non-dentist teeth-whitening providers. The letters were issued on official letterhead and noted that the companies were subject to misdemeanor charges for the unauthorized practice of dentistry if they did not cease and desist their operations. The result was that non-dentist teeth whiteners were eliminated from North Carolina.

The FTC filed a complaint against the Board charging it with unfair competition. The Board moved to dismiss the complaint. Who is correct in this situation?

[North Carolina State Bd. of Dental Examiners v. F.T.C., 135 S. Ct. 1101 (2015)]

⁶ *Bell Atlantic v. Twombly*, 550 U.S. 544 (2007).

⁷ *United States v. Microsoft*, 253 F.2d 34 (D.C. Cir. 2001).

5-2c Boycotts and Refusals to Deal

Under the Sherman Act, competitors are not permitted to agree not to deal with certain buyers. Boycotts among competitors are *per se* violations of the Sherman Act, which means that there are no defenses to these kinds of controls by competitors on markets. Sometimes boycotts have the best of intentions, but they are still illegal. **For Example**, defense lawyers who went on strike in order to get a higher hourly rate for public defenders so that the indigent defendants would have quality representation still engaged in an illegal boycott.⁸

5-2d Mergers among Competitors

The Sherman Antitrust Act does not prohibit bigness. However, Section 7 of the Clayton Act provides that “no corporation ... shall acquire the whole or any part of the assets of another corporation ... where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.” If the Clayton Act is violated through ownership or control of competing enterprises, a court may order the violating defendant to dispose of such interests by issuing a decree called a **divestiture order**.⁹ Courts examine market share and relevant markets to determine whether a merger would create a monopoly. **For Example**, the Justice Department filed suit to stop the proposed merger between Anheuser-Busch, InBev NV, the maker of Bud Light, and Modelo, the maker of Corona. The fears expressed in the suit were that the combination of the two companies

divestiture order—a court order to dispose of interests that could lead to a monopoly.



ETHICS & THE LAW

Toys R Us and Horizontal/Vertical Controls on Distribution

Toys R Us (TRU), a company that sells 20 percent of all the toys sold in the United States, coordinated informal agreements among toy manufacturers including Mattel and Hasbro that they would restrict the distribution of their products to warehouse club stores (such as Sam’s and Costco). The toy market breaks out as follows:

TYPE OF RETAIL OUTLET	PRICE MARK-UP
Traditional toy and department stores	40–50%
Specialized discount toy stores (TRU)	30%
General discount (Wal-Mart/ Kmart/Target)	22%
Warehouse/club	9%

To avoid the price competition, the informal TRU agreement was that the toy manufacturers would sell their products

to warehouse clubs only if they were part of a more expensive package deal. For example, a Barbie doll could be purchased individually at Toys R Us for \$10.95, but the same Barbie doll could be purchased only as part of a package deal for \$15.95 at the warehouse clubs. There were also some restrictions on the toys available to warehouse clubs. For example, Hall of Fame GI Joe was never sold at warehouse clubs. Mattel and Hasbro, fearful of losing Toys R Us as a distribution tool, went along with the arrangement.

The Federal Trade Commission (FTC) filed suit against TRU to end the agreements.*

Walk through the antitrust laws and determine whether the conduct of TRU violated any of them. Then think through the ethics of TRU’s actions. What about Mattel and Hasbro agreeing to the informal arrangement? Was their conduct in violation of the antitrust laws? Was it ethical?

**Toys “R” Us, Inc. v. FTC* (7th Cir. 2000). In re *Pool Products Distribution Market Antitrust Litigation*, 988 F.Supp.2d 696 (E.D. La. 2013).

⁸ *FTC v. Superior Court Trial Lawyers Ass’n*, 493 U.S. 411 (1990).

⁹ *California v. American Stores Co.*, 492 U.S. 1301 (1989).



E-COMMERCE & CYBERLAW

Steve Jobs's E-Mails in Apple's Antitrust Litigation

Apple faced its third antitrust trial related to the Internet in 2014, and the most damaging testimony against Apple came from the late Steve Jobs—through his e-mails. This third antitrust suit had been hanging around for 10 years and dealt with the issue of the workaround services that had developed to find a way to get music for the iPods loaded through sources other than Apple's iTunes. For example, in one e-mail, Mr. Jobs wrote, "We need to make sure that when Music Match launches their download music store they cannot use iPod. Is this going to be an issue?"* That would be the kind of language someone defending Apple against the antitrust allegations in this iPod case would not want to exist.

During the antitrust litigation over the e-book pricing wars, one of Mr. Jobs's e-mails read, "Throw in with Apple and see if we can all make a go of this to create a real mainstream e-books market at \$12.99 and \$14.99." The goal was to drive out Amazon from the market because Amazon e-book prices were cheaper.

E-mail is discoverable, admissible as evidence, and definitely not private. Employees should follow the admonition of one executive whose e-mail was used to fuel a million-dollar settlement by his company with a former employee: "If you wouldn't want anyone to read it, don't send it in e-mail."

*Brian X. Chen, "Star Witness In Apple Suit Is Still Jobs," *New York Times*, December 1, 2014, p. B1.

Clayton Act—a federal law that prohibits price discrimination.

Robinson-Patman Act—a federal statute designed to eliminate price discrimination in interstate commerce.

price discrimination—the charging practice by a seller of different prices to different buyers for commodities of similar grade and quality, resulting in reduced competition or a tendency to create a monopoly.

would result in their domination of the distribution chain and would result in price increases. At the time of the proposed merger, AB InBev NV held 39 percent of the beer market, Miller/Coors held 26 percent, Modelo held 7 percent, and Heineken, the last of the big four held 6 percent. Other beer makers combined hold the remaining 22 percent of the U.S. beer market. If Bud and Corona had merged as proposed, they would have held 46 percent of the country's beer market. The case was settled after Bud agreed to divestiture of certain brands that it sold that reduced its post-merger percentage of market share.

When large-size enterprises plan to merge, they must give written notice to the FTC and to the head of the Antitrust Division of the Department of Justice. This advance notice gives the department the opportunity to block the merger and thus avoid the loss that would occur if the enterprises merged and were then required to separate.¹⁰

For Example, AT&T was required to notify the Justice Department when it proposed acquisition of T-Mobile because AT&T's market share was 37 percent and T-Mobile's was 16 percent. A merger (which was not approved) would have resulted in a company with a 51 percent share of the market.¹¹

5-3 Regulation of the Supply Chain and Vertical Trade Restraints

5-3a Price Discrimination

The **Clayton Act** and **Robinson-Patman Act** prohibit price discrimination.¹² **Price discrimination** occurs when a seller charges different prices to different buyers for

¹⁰ Antitrust Improvement Act of 1976, 15 U.S.C. §1311 *et seq.*

¹¹ Thomas Catan and Spencer A. Ante, "U.S. Sues to Stop AT&T Deal," *Wall Street Journal*, September 9, 2011, p. A1.

¹² 15 U.S.C. §§1, 2, 3, 7, 8.

“commodities of like grade and quality,” with the result being reduced competition or a tendency to create a monopoly.¹³

Price discrimination prohibits charging different prices to buyers as related to marginal costs. That is, volume discounts are permissible because the marginal costs are different on the larger volume of goods. However, the Robinson-Patman Act makes it illegal to charge different prices to buyers when the marginal costs of the seller for those goods are the same. Any added incentives or bonuses are also considered part of the price.

For Example, offering one buyer free advertising while not offering it to another as an incentive to buy would be a violation of the Robinson-Patman Act. The Clayton Act makes both the giving and the receiving of any illegal price discrimination a crime.

CPA

Sellers cannot sell below cost to harm competitors or sell to one customer at a secret price that is lower than the price charged other customers when there is no economic justification for the lower price.¹⁴ Some state statutes specifically permit sellers to set prices so that they can match competitive prices, but not to undercut a competitor’s prices.¹⁵

CASE SUMMARY

Getting a Piece of the Pie Market

FACTS: Utah Pie Company is a Utah corporation that for 30 years has been baking pies in its plant in Salt Lake City and selling them in Utah and surrounding states. It entered the frozen pie business in 1957 and was immediately successful with its new line of frozen dessert pies—apple, cherry, boysenberry, peach, pumpkin, and mince.

Continental Baking Company, Pet Milk, and Carnation, all based in California, entered the pie market in Utah. When these companies entered the Utah market, a price war began. In 1958 Utah Pie was selling pies for \$4.15 per dozen. By 1961, as all the pie companies competed, it was selling the same pies for \$2.75 per dozen. Continental’s price went from \$5.00 per dozen in 1958 to \$2.85 in 1961. Pet’s prices went from \$4.92 per dozen to \$3.46, and Carnation’s from \$4.82 per dozen to \$3.30.

Utah Pie filed suit, charging price discrimination. The district court found for Utah Pie. The Court of Appeals reversed, and Utah Pie appealed.

DECISION: There was price discrimination. Pet was selling its pies in Utah through Safeway at prices that were lower than

its prices in other markets and also much lower than its own brand pie in the Salt Lake City market. Pet also introduced a 20-ounce economy pie under the Swiss Miss label and began selling the new pie in the Salt Lake market in August 1960 at prices ranging from \$3.25 to \$3.30 for the remainder of the period. This pie was at times sold at a lower price in the Salt Lake City market than it was sold in other markets. For 7 of the 44 months in question for price discrimination, Pet’s prices in Salt Lake were lower than prices charged in the California markets. This was true even though selling in Salt Lake involved a 30- to 35-cent freight cost.

Also, Pet had predatory intent to injure Utah Pie. Pet admitted that it sent into Utah Pie’s plant an industrial spy to seek information. Pet suffered substantial losses on its frozen pie sales during the greater part of time involved in this suit. Pet had engaged in predatory tactics in waging competitive warfare in the Salt Lake City market. Coupled with the price discrimination, Pet’s behavior lessened competition and violated Robinson-Patman. [*Utah Pie Co. v. Continental Baking Co.*, 386 U.S. 685 (1967)]

¹³ 15 U.S.C. §13a. To read the full Clayton Act, go to <http://www.usdoj.gov> or <http://www.justice.gov> and plug in “Clayton Act” in a site search.

¹⁴ In *Weyerhaeuser v. Ross-Simons*, 549 U.S. 212 (2007), the U.S. Supreme Court ruled that predatory bidding is also a price discrimination issue. In a monopsony, a buyer tries to control a market by overbidding all its competitors and thereby cornering the market for supplies it needs to produce goods. However, if the bidder is actually just in need of the goods and bids higher for them, there is no anticompetitive conduct.

¹⁵ *Home Oil Company, Inc. v. Sam’s East, Inc.*, 252 F. Supp. 2d 1302 (M.D. Ala. 2003).

Price discrimination is expressly permitted when it can be justified on the basis of (1) a difference in grade, quality, or quantity; (2) the cost of transportation involved in performing the contract; (3) a good-faith effort to meet competition; (4) differences in methods or quantities, that is, marginal cost differences; (5) deterioration of goods; or (6) a close-out sale of a particular line of goods. The Robinson-Patman Act¹⁶ reaffirms the right of a seller to select customers and refuse to deal with anyone. The refusal, however, must be in good faith, not for the purpose of restraining trade.

5-3b Exclusive Dealings and Territories

Sometimes manufacturers have sole outlets. Sole outlets are not *per se* violations. For restrictions on territories and outlets to be legal, there must be enough interbrand competition to justify no intrabrand competition. **For Example**, Coca-Cola can have exclusive distributorships in cities because Pepsi will always be there providing consumers with competitive choices in soft drinks.

5-3c Resale Price Maintenance

Resale price maintenance is an attempt by manufacturers to control the prices that retailers can charge for their goods. A “suggested retail price” is just that, a suggestion, and is not a violation of the antitrust laws. However, some manufacturers have policies of terminating retailers when they charge too little or charge too much. For example, many Apple products are the same price wherever you buy them. Minimum prices are justified in a competitive sense because without them, some retailers would cut the price but not offer the customer service the manufacturer wants for its brand. Retailers who charge more can be stopped by manufacturers who do not want to gouge consumers on prices.

CASE SUMMARY

Bagging Customers for Having Sales

FACTS: Leegin Creative Leather Products, Inc., designs, manufactures, and distributes leather goods and accessories under the brand name “Brighton.” The Brighton brand is sold across the United States in over 5,000 retail stores. PSKS, Inc., runs Kay’s Kloset, a Brighton retailer in Lewisville, Texas, that carries about 75 different product lines but was known as the place in that area to go for Brighton.

Leegin’s president, Jerry Kohl, who also has an interest in about 70 stores that sell Brighton products, believes that small retailers treat customers better, provide customers more services, and make their shopping experience more satisfactory than do larger, often impersonal retailers. In 1997, Leegin instituted the “Brighton Retail Pricing and Promotion Policy,” which banished retailers that discounted Brighton goods below suggested prices.

In December 2002, Leegin discovered that Kay’s Kloset had been marking down Brighton’s entire line by 20 percent. When Kay’s would not stop marking the

Brighton products prices down, Leegin stopped selling to the store.

PSKS sued Leegin for violation of the antitrust laws. The jury awarded PSKS \$1.2 million in damages and the judge trebled the damages and reimbursed PSKS for its attorney’s fees and costs—for a judgment against Leegin of \$3,975,000.80. The Court of Appeals affirmed. Leegin appealed.

DECISION: The Court held that the goal of providing customers with information and service through the smaller boutiques was a competitive strategy that offered consumers choices. It was not a *per se* violation for Leegin to require minimum prices. Resale price maintenance increases the choices consumers have by providing them with a full-service retailer. Each case on resale price maintenance requires examination of the market and the effect on competition, but it is not automatically anticompetitive. The decision was reversed. [*Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007)]

¹⁶ 15 U.S.C. §§13, 21.

CASE SUMMARY

Fill It Up: The Price Is Right and Fixed

FACTS: Barkat U. Khan and his corporation entered into an agreement with State Oil to lease and operate a gas station and convenience store owned by State Oil. The agreement provided that Khan would obtain the gasoline supply for the station from State Oil at a price equal to a suggested retail price set by State Oil, less a margin of \$3.25 per gallon. Khan could charge any price he wanted, but if he charged more than State Oil's suggested retail price, the excess went to State Oil. Khan could sell the gasoline for less than State Oil's suggested retail price, but the difference would come out of his allowed margin.

After a year, Khan fell behind on his lease payments, and State Oil gave notice of, and began, eviction proceedings. The court had Khan removed and appointed a receiver to operate the station. The receiver did so without the price constraints and received an overall profit margin above the \$3.25 imposed on Khan.

Khan filed suit, alleging that the State Oil agreement was a violation of Section 1 of the Sherman Act because State Oil was controlling price. The district court held that

there was no *per se* violation and that Khan had failed to demonstrate antitrust injury. The Court of Appeals reversed, and State Oil appealed.

DECISION: In what was a reversal of prior decisions, the Court held that vertical maximum prices (as in this case in which a retailer was prohibited from charging above a certain amount) are not a *per se* violation of the Sherman Act. The Court noted that benefits can come from retailers' not being able to charge above a certain amount. At a minimum, such controls on maximum prices were not an automatic violation of the Sherman Act and need to be examined in light of what happens to competition. In determining whether such prices might affect competition, the Court noted that maximum prices might have an impact on the survival of inefficient dealers, as was the case here. However, encouraging inefficiency is not the purpose of either the market or the laws on anticompetitive behavior. [*State Oil v. Khan*, 522 U.S. 3 (1997)]

5-3d Tying

tying—the anticompetitive practice of requiring buyers to purchase one product in order to get another.

It is a violation of the Sherman Act to force “tying” sales on buyers. **Tying** occurs when the seller makes a buyer who wants to purchase one product buy an additional product that he or she does not want.

The essential characteristic of a tying arrangement that violates Section 1 of the Sherman Act is the use of control over the tying product within the relevant market to compel the buyer to purchase the tied article that either is not wanted or could be purchased elsewhere on better terms.

CASE SUMMARY

If You Want Our Cartridges, You Have to Use Our Ink

FACTS: Trident, Inc., and its parent, Illinois Tool Works Inc. (petitioners), manufacture and market printing systems that include: (1) a patented piezoelectric impulse ink jet printhead, (2) a patented ink container, consisting of a bottle and valve cap, which attaches to the printhead, and (3) specially designed, but unpatented, ink. These products are sold to original equipment manufacturers (OEMs) who are licensed to incorporate the printheads and containers into printers that are in turn sold to companies for use in printing barcodes on cartons and packaging materials. The OEMs agree that they

will purchase their ink exclusively from Illinois, and that neither they nor their customers will refill the patented containers with ink of any kind.

Independent Ink, Inc., has developed an ink with the same chemical composition as the ink sold by Illinois. Independent Ink filed suit, alleging that Illinois's agreements with customers constituted an illegal tying and monopolization in violation of §§ 1 and 2 of the Sherman Act. 15 U.S.C. §§1, 2.

If You Want Our Cartridges, You Have to Use Our Ink continued

The federal district court granted summary judgment for Illinois, and Independent appealed. The appellate court reversed the decision and Illinois appealed.

DECISION: The court held that tying an unpatented product to a patented one was not a *per se* violation because there needed to be proof of market power in the patented product first. On remand, to establish tying, there must be proof that

Illinois Tool has market power in the sale of its cartridges—such as a percentage of market share. You can only engage in tying through a tie of an unsuccessful product to a successful one—the more successful your product and the higher the demand, the more you lose the defense to tying. [*Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28 (2006)]

5-3e Mergers along the Supply Chain

Vertical mergers occur between firms that have buyer and seller relationships. The Clayton Act also applies to vertical mergers. The test is whether the vertical merger will foreclose or lessen competition. **For Example,** Amazon is a retailer of both books and e-books, but it has begun its own publishing firm and has been recruiting authors. Other book publishers are watching closely as Amazon begins to obtain more power in the publishing part of the chain because of its dominance in the retail sales of books. During 2014, Amazon had a dust-up with Hachette Books because there were accusations that Amazon was holding up shipment of non-Amazon author books in order to affect sales and encourage more authors to sign with Amazon's publishing arm.

In addition to controlling business combinations, the federal government protects others. By statute or decision, associations of exporters, marine insurance associations, farmers' cooperatives, and labor unions are exempt from the Sherman Act with respect to agreements between their members. Certain pooling and revenue-dividing agreements between carriers are exempt from the antitrust law when approved by the appropriate federal agency. The Newspaper Preservation Act of 1970 grants an antitrust exemption to operating agreements entered into by newspapers to prevent financial collapse. The Soft Drink Interbrand Competition Act¹⁷ grants the soft drink industry an exemption when it is shown that, in fact, substantial competition exists in spite of the agreements.

The general approach of the U.S. Supreme Court has been that these types of agreements should not be automatically, or *per se*, condemned as a restraint of interstate commerce merely because they create the power or potential to monopolize interstate commerce. It is only when the restraint imposed is unreasonable that the practice is unlawful. The Court applies the rule of reason in certain cases because the practice may not always harm competition.



SPORTS & ENTERTAINMENT LAW

Ticket Issues and Antitrust

The Justice Department took a very close look at whether the merger between Live Nation and Ticketmaster would be anti-competitive because the largest U.S. event promoter was

proposing a merger with the largest primary and secondary ticket seller in the world. The merger was eventually approved because there were still thriving smaller ticket sellers.

¹⁷ 15 U.S.C. §3501 *et seq.*

5-4 Remedies for Anticompetitive Behavior

5-4a Criminal Penalties

A violation of either section of the Sherman Act is punishable by fine or imprisonment, or both, at the discretion of the court. The maximum fine for a corporation is \$100 million. A natural person can be fined a maximum of \$1,000,000 or imprisoned for a maximum term of 10 years, or both.

5-4b Civil Remedies

In addition to these criminal penalties, the law provides for an injunction to stop the unlawful practices.

Any individual or company harmed may bring a separate action for **treble damages** (three times the damages actually sustained). In addition to individual suits, there is the possibility that a state could bring a class-action suit if the antitrust violation has resulted in large numbers of buyers paying higher prices. **For Example**, Pilgrim's Pride agreed to pay \$26 million in damages to dozens of poultry growers because of its closure of chicken-processing plants in order to bring down the price of chicken.

The attorney general of a state may bring a class-action suit to recover damages on behalf of those who have paid the higher prices. This action is called a *parens patriae* action on the theory that the state is suing as the parent of its people.

treble damages—three times the damages actually sustained.

Make the Connection

Summary

Regulation by government has occurred primarily to protect one group from the improper conduct of another group. The police power is the basis for government regulation. Regulation is passed when the free enterprise system fails to control abuses, as when companies engage in unfair methods of competition.

There are horizontal and vertical forms of anticompetitive behavior. The Sherman Act focuses on horizontal anticompetitive behavior such as price-fixing, boycotts, refusals to deal, and monopolization achieved through means other than fair competition.

The Sherman Antitrust Act prohibits price-fixing among competitors, monopolies that do not result from superior skill or products, boycotts, and mergers that lessen competition. The Clayton Act prohibits mergers or the acquisition of the assets of another corporation when this conduct would tend to lessen competition or create a monopoly. The Justice Department requires pre-merger notification for proposed mergers. Violation of the

federal antitrust statutes subjects the wrongdoer to criminal prosecution and possible civil liability that can include treble damages.

Vertical trade restraints include price discrimination, some exclusive dealings arrangements, resale price maintenance, and some mergers among companies positioned vertically in the supply chain.

Prices have been regulated both by prohibiting setting the exact price or a maximum price and discrimination in pricing. Price discrimination between buyers is prohibited when the effect of such discrimination could tend to create a monopoly or lessen competition. Price discrimination occurs when the prices charged different buyers are different despite the same marginal costs. Another vertical antitrust issue is resale price maintenance. Resale price maintenance is control by the manufacturer of the price of its goods as they flow through the supply chain. Resale price maintenance is not illegal *per se* if the control is for purposes of providing customer service.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

5-1 Power to Regulate Business

LO.1 Explain the powers the government has to be sure free markets are working efficiently

See the *For Example* about Crispy Clowns Cereal, page 75.

5-2 Regulation of Horizontal Markets and Competitors

LO.2 List the federal statutes that regulate horizontal markets and competition and give examples of each

See the Apple e-book pricing example, page 74.

See the Toys Я Us Ethics & the Law, page 76.

See the Thinking Things Through feature on teeth whitening, page 75.

See the Microsoft monopolization discussion, page 75.

See the Bud Light and Corona example on horizontal mergers, pages 76–77.

5-3 Regulation of the Supply Chain and Vertical Trade Restraints

LO.3 Describe the federal statutes that regulate the supply chain and vertical markets

See the *Utah Pie* case on predatory pricing, page 78.

See the *Khan* oil case on price controls, page 80.

See the *Leegin* case on resale price maintenance, page 79.

See the *Illinois Tool Works* case on tying, pages 80–81.

See the Sports & Entertainment Law feature on the merger in the event ticket market, page 81.

5-4 Remedies for Anticompetitive Behavior

LO.4 Discuss the remedies available to protect business competition

See a list of the penalties and remedies, page 82.

Key Terms

Clayton Act
divestiture order
market power

price discrimination
Robinson-Patman Act
Sherman Antitrust Act

treble damages
tying

Questions and Case Problems

1. American Crystal Sugar Co. was one of several refiners of beet sugar in northern California, and it distributed its product in interstate commerce. American Crystal and the other refiners had a monopoly on the seed supply and were the only practical market for the beets. In 1939, all of the refiners began using identical form contracts that computed the price paid to the sugar beet growers using a “factor” common to all the refiners. As a result, all refiners paid the same price for beets of the same quality. Though there was no hard evidence of an illegal agreement, the growers brought suit under the Sherman Act against the refiners, alleging that they conspired to fix a single uniform price among themselves to hold down the cost of the beets. The growers sued for the treble damages available under the Sherman Act. Can they recover?

[*Mandeville Island Farms v. American Crystal Sugar Co.*, 334 U.S. 219]

2. Penny Stafford, the owner of Belvi Coffee and Tea Exchange, located in Bellevue, Washington, brought an antitrust suit against Starbucks. She alleged that through its exclusive leases, Starbucks bans other

coffee shops from competing. Starbucks has a 73 percent market share, has \$8.4 billion in annual sales in the United States, and owns 7,551 of the 21,400 coffeehouses located in the United States. However, if Dunkin’ Donuts, KrispyKreme, and Tim Hortons are included in the gourmet coffee market, Starbucks holds only 43 percent of the coffee market. Starbucks purchased Seattle’s Best Coffee (SBC) in 2003 and Torrefazione Italia the same year. Starbucks then closed one-half of all SBC stores and all of the Torrefazione outlets. Starbucks runs 59 stores within a two-mile radius of downtown Seattle. Stafford said that Starbucks has exclusive leases with landlords so that the landlords cannot lease space in the same building to another coffee shop. Does such an exclusive lease violate any antitrust laws, or are such clauses permitted under the law?

3. David Ungar holds a Dunkin’ Donuts franchise. The terms of his franchise agreement require him to use only those ingredients furnished by Dunkin’ Donuts. He is also required to buy its napkins, cups, and so on, with the Dunkin’ Donuts trademark on them. Is

- this an illegal tying arrangement? What if Dunkin' Donuts maintains that it needs these requirements to maintain its quality levels on a nationwide basis? [*Ungar v. Dunkin' Donuts of America, Inc.*, 429 U.S. 823]
4. During the 1980s, the NCAA, a voluntary unincorporated association of approximately 1,100 educational institutions, became concerned over the steadily rising costs of maintaining competitive athletic programs. As a way of containing those costs, the association imposed salary caps on college and university athletic coaches. The caps on salaries as well as limits on number and types of coaches were imposed pursuant to NCAA procedures and members' votes. A group of coaches filed suit, challenging the caps on salaries and hiring as being anticompetitive. The NCAA responded that it had a goal of containing athletic program costs as well as ensuring that entry-level coaching positions were available. Are the salary caps legal under the federal antitrust laws? [*Law v. National Collegiate Athletic Ass'n*, 134 F.3d 1010 (10th Cir.)]
 5. Hines Cosmetic Co. sold beauty preparations nationally to beauty shops at a standard or fixed-price schedule. Some of the shops were also supplied with a free demonstrator and free advertising materials. The shops that were not supplied with them claimed that giving the free services and materials constituted unlawful price discrimination. Hines replied that there was no price discrimination because it charged everyone the same. What it was giving free was merely a promotional campaign that was not intended to discriminate against those who were not given anything free. Was Hines guilty of unlawful price discrimination? Explain.
 6. Moore ran a bakery in Santa Rosa, New Mexico. His business was wholly intrastate. Meads Fine Bread Co., his competitor, engaged in an interstate business. Meads cut the price of bread in half in Santa Rosa but made no price cut in any other place in New Mexico or in any other state. This price-cutting drove Moore out of business. Moore then sued Meads for damages for violating the Clayton and Robinson-Patman Acts. Meads claimed that the price-cutting was purely intrastate and, therefore, did not constitute a violation of federal statutes. Was Meads correct? Why or why not? [*Moore v. Meads Fine Bread Co.*, 348 U.S. 115]
 7. A&P Grocery Stores decided to sell its own brand of canned milk (referred to as *private label* milk). A&P asked its longtime supplier, Borden, to submit an offer to produce the private label milk. Bowman Dairy also submitted a bid, which was lower than Borden's. A&P's Chicago buyer then contacted Borden and said, "I have a bid in my pocket. You people are so far out of line it is not even funny. You are not even in the ballpark." The Borden representative asked for more details but was told only that a \$50,000 improvement in Borden's bid "would not be a drop in the bucket." A&P was one of Borden's largest customers in the Chicago area. Furthermore, Borden had just invested more than \$5 million in a new dairy facility in Illinois. The loss of the A&P account would result in underutilization of the plant. Borden lowered its bid by more than \$400,000. The Federal Trade Commission charged Borden with price discrimination, but Borden maintained it was simply meeting the competition. Did Borden violate the Robinson-Patman Act? Does it matter that the milk was a private label milk, not its normal trade name Borden milk? [*Great Atlantic & Pacific Tea Co., Inc. v. FTC*, 440 U.S. 69]
 8. Department 56 is a company that manufactures and sells collectible Christmas village houses and other replica items to allow collectors to create the whimsical "Snow Village" town or "Dickens Christmas." Department 56 has only authorized dealers. Sam's Club, a division of Wal-Mart Stores, Inc., began selling Department 56 pieces from the Heritage Village Collection. Susan Engel, president and CEO of Department 56, refused to sell Department 56 products to Wal-Mart. Does her refusal violate any antitrust laws?
 9. Dr. Edwin G. Hyde, a board-certified anesthesiologist, applied for permission to practice at East Jefferson Hospital in Louisiana. An approval was recommended for his hiring, but the hospital's board denied him employment on grounds that the hospital had a contract with Roux & Associates for Roux to provide all anesthesiological services required by the hospital's patients. Dr. Hyde filed suit for violation of antitrust laws. Had the hospital done anything illegal? [*Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2]
 10. BRG of Georgia, Inc. (BRG), and Harcourt Brace Jovanovich Legal and Professional Publications (HJB) are the nation's two largest providers of bar review materials and lectures. HJB began offering a Georgia bar review course on a limited basis in 1976 and was in direct, and often intense, competition

- with BRG from 1977 to 1979 when the companies were the two main providers of bar review courses in Georgia. In early 1980, they entered into an agreement that gave BRG an exclusive license to market HJB's materials in Georgia and to use its trade name "Bar/Bri." The parties agreed that HJB would not compete with BRG in Georgia and that BRG would not compete with HJB outside of Georgia. Under the agreement, HJB received \$100 per student enrolled by BRG and 40 percent of all revenues over \$350. Immediately after the 1980 agreement, the price of BRG's course was increased from \$150 to more than \$400. Is their conduct illegal under federal antitrust laws? [*Palmer v. BRG of Georgia, Inc.*, 498 U.S. 46]
11. Favorite Foods Corp. sold its food to stores and distributors. It established a quantity discount scale that was publicly published and made available to all buyers. The top of the scale gave the highest discount to buyers purchasing more than 100 freight cars of food in a calendar year. Only two buyers, both national food chains, purchased in such quantities, and, therefore, they alone received the greatest discount. Favorite Foods was prosecuted for price discrimination in violation of the Clayton Act. Was it guilty?
 12. Public Interest Corporation (PIC) owned and operated television station WTMV-TV in Lakeland, Florida. MCA Television Ltd. (MCA) owns and licenses syndicated television programs. In 1990, the two companies entered into a licensing contract for several first-run television shows. With respect to all but one of these shows, MCA exchanged the licenses on a "barter" basis for advertising time on WTMV. However, MCA conditioned this exchange on PIC's agreeing to license the remaining show, *Harry and the Hendersons*, for cash as well as for barter. *Harry and the Hendersons* was what some in the industry would call a "dog," a show that was not very good that attempted to capitalize on a hit movie. PIC agreed to this arrangement, although it did not want *Harry and the Hendersons*. The shows that PIC did want were *List of a Lifetime*, *List of a Lifetime II*, *Magnum P.I.*, and 17 other miscellaneous features. Is this an illegal tying arrangement? [*MCA Television Ltd. v. Public Interest Corp.*, 171 F.3d 1265 (11th Cir.)]
 13. The Quickie brand wheelchair is the most popular customized wheelchair on the market. Its market share is 90 percent. Other manufacturers produce special-use wheelchairs that fold, that are made of mesh and lighter frames, and that are easily transportable. These manufacturers do not compete with Quickie on customized chairs. One manufacturer of the alternative wheelchairs has stated, "Look, it's an expensive market to be in, that Quickie market. We prefer the alternative chairs without the headaches of customizations." Another has said, "It is such a drain on cash flow in that market because insurers take so long to pay. We produce chairs that buyers purchase with their own money, not through insurers. Our sales are just like any other product." Quickie entered the market nearly 40 years ago and is known for its quality and attention to detail. Buying a Quickie custom chair, however, takes time, and the revenue stream from sales is slow but steady because of the time required to produce custom wheelchairs. Has Quickie violated the federal antitrust laws with its 90 percent market share? Discuss.
 14. Gardner-Denver is the largest manufacturer of ratchet wrenches and their replacement parts in the United States. Gardner-Denver had two different lists of prices for its wrenches and parts. Its blue list had parts that, if purchased in quantities of five or more, were available for substantially less than its white list prices. Did Gardner-Denver engage in price discrimination with its two price lists? [*D. E. Rogers Assoc., Inc. v. Gardner-Denver Co.*, 718 F.2d 1431 (6th Cir.)]
 15. The Aspen ski area consisted of four mountain areas. Aspen Highlands, which owned three of those areas, and Aspen Skiing, which owned the fourth, had cooperated for years in issuing a joint, multiple-day, all-area ski ticket. After repeatedly and unsuccessfully demanding an increased share of the proceeds, Aspen Highlands canceled the joint ticket. Aspen Skiing, concerned that skiers would bypass its mountain without some joint offering, tried a variety of increasingly desperate measures to re-create the joint ticket, even to the point of in effect offering to buy Aspen Highland's tickets at retail price. Aspen Highlands refused even that. Aspen Skiing brought suit under the Sherman Act, alleging that the refusal to cooperate was a move by Aspen Highlands to eliminate all competition in the area by freezing it out of business. Is there an antitrust claim here in the refusal to cooperate? What statute and violation do you think Aspen Skiing alleged? What dangers do you see in finding the failure to cooperate to be an antitrust violation? [*Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585]



Administrative Agencies

>>> Learning Outcomes

After studying this chapter, you should be able to

- L0.1** Describe the nature and purpose of administrative agencies
- L0.2** Discuss the legislative or rulemaking power of administrative agencies
- L0.3** Explain the executive or enforcement function of administrative agencies
- L0.4** Discuss the judicial power of administrative agencies including the rule on exhaustion of administrative remedies

6-1 Nature of the Administrative Agency

- 6-1a Purpose of Administrative Agencies
- 6-1b Uniqueness of Administrative Agencies
- 6-1c Open Operation of Administrative Agencies

6-2 Legislative Power of the Agency

- 6-2a Agency's Regulations as Law
- 6-2b Agency Adoption of Regulations

6-3 Executive Power of the Agency

- 6-3a Enforcement or Execution of the Law
- 6-3b Constitutional Limitations on Administrative Investigation

6-4 Judicial Power of the Agency

- 6-4a The Agency as a Specialized Court
- 6-4b Punishment and Enforcement Powers of Agencies
- 6-4c Exhaustion of Administrative Remedies
- 6-4d Appeal from an Administrative Agency Action

6-1 Nature of the Administrative Agency

Late in the nineteenth century, a new type of governmental structure began to develop to meet the highly specialized needs of government regulation of business: the administrative agency. The administrative agency is now typically the instrument through which government makes and carries out its regulations.

administrative agency—government body charged with administering and implementing legislation.

An **administrative agency** is a government body charged with administering and implementing legislation. An agency may be a department, an independent establishment, a commission, an administration, an authority, a board, or a bureau. Agencies exist on the federal and state levels. One example of a federal agency is the Federal Trade Commission (FTC), whose structure is shown in Figure 6-1.

6-1a Purpose of Administrative Agencies

Federal administrative agencies are created to carry out general policies specified by Congress. Federal agencies include the Securities Exchange Commission (SEC), the Consumer Product Safety Commission (CPSC), and the Food and Drug Administration (FDA). The law governing these agencies is known as **administrative law**.

administrative law—law governing administrative agencies.

States also have administrative agencies that may have jurisdiction over areas of law affecting business, such as workers' compensation claims, real estate licensing, and unemployment compensation.

6-1b Uniqueness of Administrative Agencies

Administrative agencies differ from the legislative branch in that those who head up and operate are ordinarily appointed (in the case of federal agencies, by the president of the United States with the consent of the Senate).

In the tripartite structure of legislative, executive, and judicial branches, the judicial branch reviews actions of the executive and legislative branches to ensure that they have

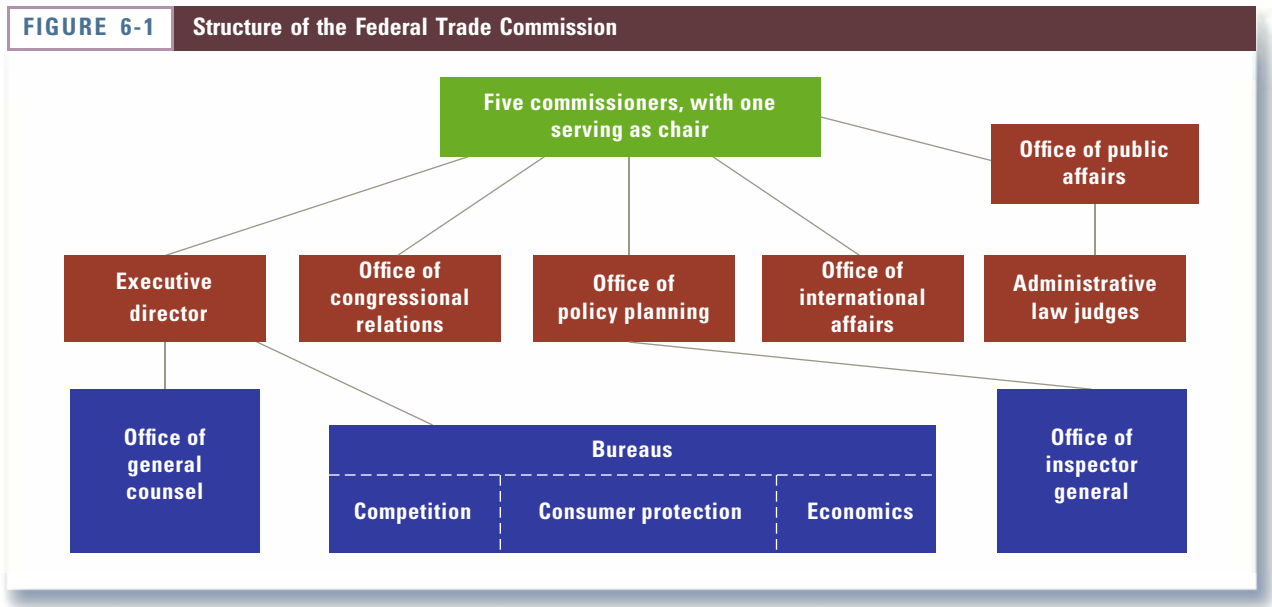
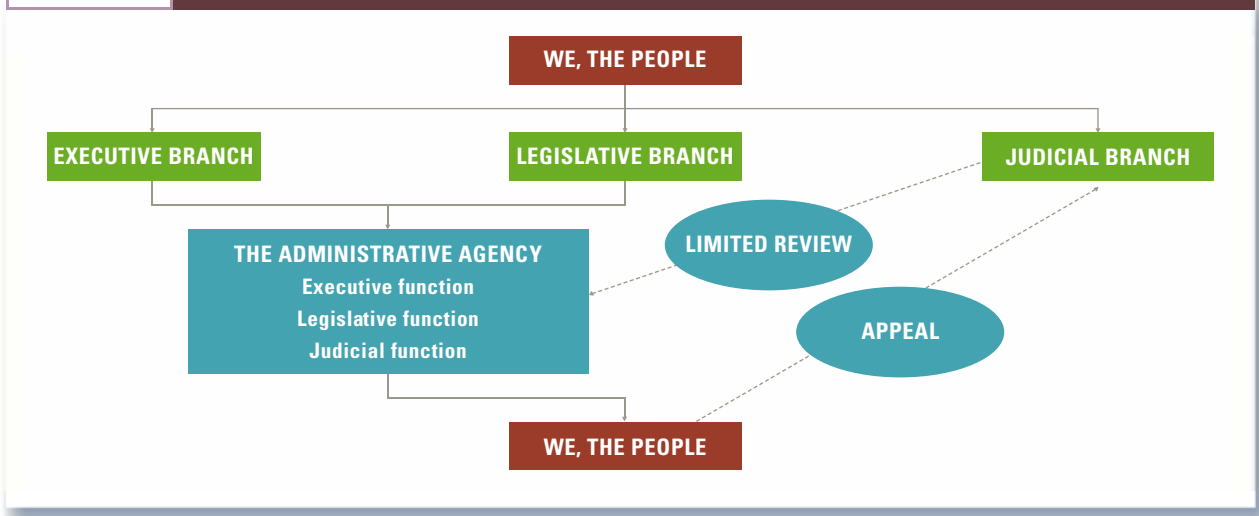


FIGURE 6-2 The Administrative Chain of Command

not exceeded their constitutional powers. However, governmental agencies combine legislative, executive, and judicial powers (Figure 6-2). These agencies make the rules, conduct inspections to see that the rules have been or are being obeyed, and determine whether there have been violations of their rules. Because agencies have such broad powers, they are subject to strict procedural rules as well as disclosure requirements (discussed in the following section).

6-1c Open Operation of Administrative Agencies

The public has ready access to the activity of administrative agencies. That access comes in three ways: (1) open records, (2) open meetings, and (3) public announcement of agency guidelines. The actions and activities of most federal agencies that are not otherwise regulated are controlled by the **Administrative Procedure Act** (APA).¹ Many states have adopted statutes with provisions similar to those of the APA.

Open Records

The **Freedom of Information Act**² (FOIA) provides that information contained in records of federal administrative agencies is available to citizens on proper request. The primary purpose of this statute is “to ensure that government activities be opened to the sharp eye of public scrutiny.”³ Over the past decade there has been an increasing number of FOIA requests by private groups and the media. For example, FOIA requests resulted in the release of information related to political controversies, such as the IRS targeting of certain political groups and the events that led to the death of the U.S. ambassador in Benghazi. Families and citizens also use FOIA requests to obtain information about crimes and investigations.

The Electronic Freedom of Information Act Amendments of 1996 extend the public availability of information to electronically stored data. The area of electronic government

Administrative Procedure Act—federal law that establishes the operating rules for administrative agencies.

Freedom of Information Act—federal law permitting citizens to request documents and records from administrative agencies.

¹Administrative Procedures Act 5 U.S.C. §550 *et seq.*

²5 U.S.C. §552 *et seq.*

³*Brady-Lunny v. Massey*, 185 F. Supp. 2d 928 (C.D. Ill. 2007). See also *Better Government Association v. Blagojevich*, 899 N.E.2d 382 (Ill. App. 2008).

activity has been a focus of FOIA requests. For example, in *Electronic Private Information Center v. Dept. of Homeland Security (DHS)*, 999 F. Supp. 2d 24 (2013), a private organization sought information about the authority of the DHS to shut down wireless network to prevent the detonation of explosive devices.

Because these requests can involve sensitive materials or issues of privacy, there are exceptions to this right of public scrutiny. These exceptions prevent individuals and companies from obtaining information that is not necessary to their legitimate interests and might harm the person or company whose information is being sought.⁴ State statutes typically exempt from disclosure any information that would constitute an invasion of the privacy of others. **For Example**, when Sea World animal trainer, Dawn Brancheau, died as a result of an attack by a killer whale, OSHA conducted the investigation into her death because it was a workplace fatality. OSHA had taken photographs as part of the investigation and there were several FOIA requests for release of the investigation report, including the photos. Ms. Brancheau's family filed a "reverse FOI" suit to stop the disclosure of the information. However, as disturbing as the photos may have been, there is no FOIA exception for death scene materials.⁵

Freedom of information acts are broadly construed, and unless an exemption is clearly given, the information in question is subject to public inspection.⁶ **For Example**, the Department of Justice is required to disclose materials related to an investigation of a member of Congress that has ended with no charges.⁷ Moreover, the person claiming that there is an exemption that prohibits disclosure has the burden of proving that the exemption applies to the particular request made. Exemptions include commercial or financial information not ordinarily made public by the person or company that supplies the information to the agency as part of the agency's enforcement role.⁸

The FOIA's primary purpose is to subject agency action to public scrutiny. Its provisions are liberally interpreted, and agencies must make good-faith efforts to comply with its terms.



ETHICS & THE LAW

IRS Employees Who Snoop

In 1997, the Internal Revenue Service (IRS) disciplined employees who, out of curiosity, were looking up tax returns of famous people to see who made how much income. The IRS fired 23 employees, disciplined 349, and provided counseling for 472. In June 2013, another 349 IRS employees were disciplined, once again, for looking up tax returns of citizens

without any authorization or work purpose for doing so. Is this practice so bad? What is wrong with just looking at data accessible at work?

Why are we concerned about selective research about private citizens? Does it matter that the information was not released to the public?

⁴ Additional protection is provided by the Privacy Act of 1974, 5 U.S.C. §552a(b); *Doe v. U.S. Dept. of Treasury*, 706 F. Supp. 2d 1 (D.D.C. 2009) and protects government employees from disclosures about employer disciplinary actions.

⁵ *Brancheau v. Secretary of Labor*, 2011 WL 4105047 (M.D. Fla.).

⁶ Corporations have limited privacy rights. *FCC v. AT&T Inc.*, 562 U.S. 397 (2011).

⁷ *Citizens for Responsibility and Ethics in Washington v. United States Department of Justice*, 48 F. Supp. 2d 40 (D.D.C. 2014).

⁸ *Ayuda, Inc. v. Federal Trade Commission*, 70 F. Supp. 3d 247 (D.D.C. 2014); for a state law example, see *Oklahoma Public Employees Ass'n v. State ex rel. Oklahoma Office of Personnel Management*, 267 P.3d 838 (Okla. 2011).

open meeting law—law that requires advance notice of agency meeting and public access.

Open Meetings

Under the Sunshine Act of 1976,⁹ called the **open meeting law**, the federal government requires most meetings of major administrative agencies to be open to the public. The Sunshine Act¹⁰ applies to those meetings involving “deliberations” of the agency or those that “result in the joint conduct or disposition of official agency business.” These statutes enable the public to know what actions agencies are taking and prevent administrative misconduct by having open meetings and public scrutiny. Many states also have enacted Sunshine laws.

Public Announcement of Agency Guidelines

To inform the public of the way administrative agencies operate, the APA, with certain exceptions, requires that each federal agency publish the rules, principles, and procedures that it follows.¹¹

6-2 Legislative Power of the Agency

An administrative agency has the power to make laws and does so by promulgating regulations with public input.

6-2a Agency’s Regulations as Law

An agency may adopt regulations within the scope of its authority. The power of an agency to carry out a congressional program “necessarily requires the formulation of policy and the making of rules to fill any gap left by Congress.”¹² If the regulation is not authorized by the law creating the agency, anyone affected by it can challenge the regulation on the basis that the agency has exceeded its authority. (See the section “Beyond the Jurisdiction of the Agency” in this chapter.)

The authority of an agency is not limited to the technology in existence at the time the agency was created or assigned jurisdiction for enforcement of laws. The sphere in which an agency may act expands with new scientific developments.¹³

CASE SUMMARY

Can an Agency Regulate Hot Air?

FACTS: On October 20, 1999, a group of 19 private organizations (Petitioners) filed a rulemaking petition asking the EPA to regulate “greenhouse gas emissions from new motor vehicles under §202 of the Clean Air Act.” These organizations argued that greenhouse gas emissions have significantly accelerated climate change, and that “carbon dioxide remains

the most important contributor to [man-made] forcing of climate change.”

Fifteen months after the petition was filed, the EPA requested public comment on “all the issues raised in [the] petition,” adding a “particular” request for comments on “any scientific, technical, legal, economic or other aspect of

⁹The Government in the Sunshine Act can be found at 5 U.S.C. §552b.

¹⁰5 U.S.C. §552b(a)(2).

¹¹APA codified at 5 U.S.C. §552. See the section “Proposed Regulations” in this chapter for a description of the *Federal Register*, the publication in which these agency rules, principles, and procedures are printed.

¹²*National Elec. Mfrs. Ass’n v. U.S. Dept. of Energy*, 654 F.3d 496 (4th Cir. 2011); *King v. Burwell*, 759 F.3d 358 (4th Cir. 2014).

¹³*United States v. Midwest Video Corp.*, 406 U.S. 649 (1972).

Can an Agency Regulate Hot Air? continued

these issues that may be relevant to EPA's consideration of this petition, including whether there was global warming due to carbon emissions." The EPA received more than 50,000 comments over the next five months.

On September 8, 2003, the EPA entered an order denying the rulemaking petition because (1) the Clean Air Act does not authorize the EPA to issue mandatory regulations to address global climate change; and (2) even if the agency had the authority to set greenhouse gas emission standards, it would be unwise to do so at this time. Massachusetts, other states, and private organizations filed suit, challenging the EPA denial as arbitrary and capricious, violative of the APA, and *ultra vires* because of statutory mandates for EPA action.

The court of appeals dismissed the appeal from the agency denial and the Supreme Court granted *certiorari*.

DECISION: The Court held that greenhouse gases were a form of pollution and that the Clean Air Act required the EPA to take steps to curb those emissions. The Court found that any justification the EPA gave for inaction was not supported by either the statutory construction or the evidence on global warming. The decision was 5 to 4 in which the dissent maintained that no matter how strongly we feel about global warming, action is left to the executive and legislative branches, not the courts. The dissent also noted that agencies should be given great deference in making their decisions on whether to regulate certain issues and that the statute did not mandate regulation—it gave the EPA broad discretion and its discretion could include lack of scientific conclusions, deference to the president, or other agencies. [*Massachusetts v. EPA*, 549 U.S. 497 (2007)]

When an agency's proposed regulation deals with a policy question that is not specifically addressed by statute, the agency that was created or given the discretion to administer the statute may establish new policies covering such issues.¹⁴ **For Example**, the FCC has authority to deal with cell phones and cell phone providers even though when the agency was created, there were only the traditional types of land-line telephones.¹⁵

6-2b Agency Adoption of Regulations

Congressional Enabling Act

Before an agency can begin rulemaking proceedings, it must be given jurisdiction by congressional enactment in the form of a statute. **For Example**, Congress has enacted broad statutes governing discrimination in employment practices and has given authority to the Equal Employment Opportunity Commission (EEOC) to establish definitions, rules, and guidelines for compliance with those laws. Sometimes an existing agency is assigned the responsibility for new legislation implementation and enforcement. **For Example**, the Department of Labor has been assigned the responsibility to handle the whistle-blower protection provisions of Sarbanes-Oxley that provide protection against retaliation and/or termination to those who report financial chicanery at their companies. The Department of Labor has been in existence for almost a century, but it was assigned a new responsibility and given new jurisdiction by Congress.

Agency Research of the Problem

After jurisdiction is established, the agency has the responsibility to research the issues and various avenues of regulation for implementing the statutory framework. As the agency does so, it determines the cost and benefit of the problems, issues, and solutions. The study may be done by the agency itself, or it may be completed by someone hired by the agency. **For Example**, before red lights were required equipment in the rear windows

¹⁴ *Anglers Conservation Network v. Pritzker*, 70 F. Supp. 3d 427 (D.D.C. 2014).

¹⁵ *Fones4All Corp. v. F.C.C.*, 550 F.3d 811 (9th Cir. 2008).



E-COMMERCE & CYBERLAW

The Open Net, Net Neutrality, and the FCC's Authority

Several subscribers to Comcast's Internet services discovered that the company was interfering with their use of peer-to-peer networking applications. The subscribers asked the FCC to regulate the Internet management practices of Comcast. However, the court held that there was no statutory authority that permitted the FCC to regulate the internal practices of communication providers. [*Comcast Corp. v. F.C.C.*, 600 F.3d 642 (C.A.D.C. 2010); see also *Verizon v. FCC*, 740 F.3d 624 (D.C. Cir. 2014)].

The case was the beginning of an ongoing legal battle for net neutrality. Net neutrality would mean that all data on the Internet would be treated equally. ISPs would not be able to charge differently depending on users, platform, etc. The ISPs claim that different treatment is necessary in order to ensure quality and access for all. The FCC has adopted a net neutrality standard, but the challenges continue.

of all cars, the Department of Transportation developed a study using taxicabs with the red lights in the rear windows and found that the accident rate for rear-end collisions with taxicabs was reduced dramatically. The study provided justification for the need for regulation as well as the type of regulation itself.

Proposed Regulations

Following a study, the agency proposes regulations, which must be published. The **Federal Register Act**¹⁶ requires that proposed administrative regulation be published in the *Federal Register*. This is a government publication published five days a week that lists all administrative regulations, all presidential proclamations and executive orders, and other documents and classes of documents that the president or Congress directs to be published.

The Federal Register Act provides that printing an administrative regulation in the *Federal Register* is public notice of the contents of the regulation to persons subject to it or affected by it, but in addition, the Regulatory Flexibility Act,¹⁷ passed during the Reagan administration, requires that all proposed rules be published in the trade journals of those trades that will be affected by the proposed rules. **For Example**, any changes in federal regulations on real property closings and escrows have to be published in real estate broker trade magazines. In addition to the public notice of the proposed rule, the agency must also include a "regulatory flexibility analysis" that "shall describe the impact of the proposed rule on small entities."¹⁸ The goal of this portion of the APA was to be certain that small businesses were aware of proposed regulatory rules and their cost impact.

Public Comment Period

Following the publication of the proposed rules, the public has the opportunity to provide input on the proposed rules. Called the *public comment period*, this time must last at least 30 days (with certain emergency exceptions)¹⁹ and can consist simply of letters written by

Federal Register Act—federal law requiring agencies to make public disclosure of proposed rules, passed rules, and activities.

Federal Register—government publication issued five days a week that lists all administrative regulations, all presidential proclamations and executive orders, and other documents and classes of documents that the president or Congress direct to be published.

¹⁶ 44 U.S.C. §1505 *et seq.*

¹⁷ 5 U.S.C. §601 *et seq.*

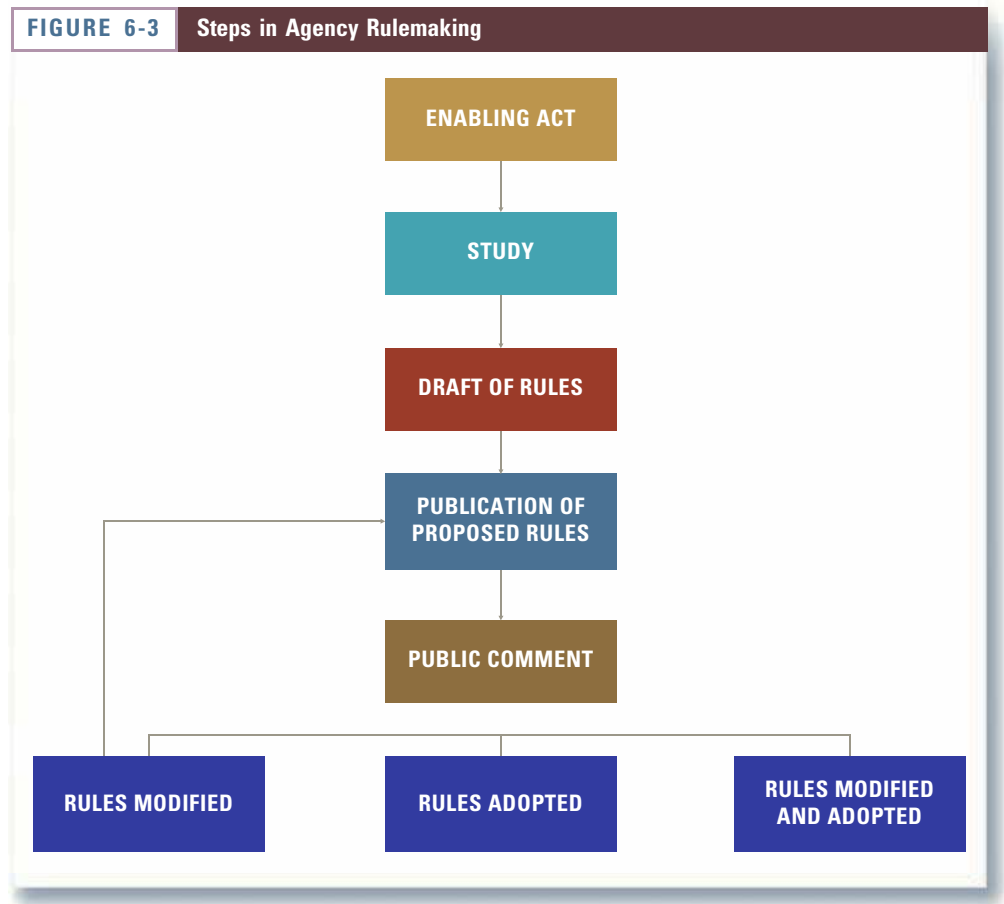
¹⁸ 5 U.S.C. §603(a).

¹⁹ An emergency exemption for the 30-day comment period was made when airport security measures and processes were changed following the September 11, 2001, attacks on the World Trade Center and the Pentagon that were carried out using domestic, commercial airliners.

those affected that are filed with the agency or of hearings conducted by the agency in Washington, D.C., or at specified locations around the country. **For Example**, when the FAA was considering allowing cell phone usage during flights, the public, flight attendants, pilots, and airlines were concerned about the negative consequences of passengers using cell phones. From air rage, to safety concerns, to noise factors, the comments were almost unanimously against the proposal. The agency responded appropriately with a no-go on usage.

Options after Public Comment

After receiving the public input on the proposed rule, an agency can decide to pass, or promulgate, *the rule*. The agency can also decide to withdraw the rule. **For Example**, the EEOC had proposed rules on handling religious discrimination in the workplace. The proposed rules, which would have required employers to police those wearing a cross or other religious symbol, met with so much public and employer protest that they were withdrawn. Finally, the agency can decide to modify the rule based on comments and then promulgate or, if the modifications are extensive or material, modify and put the proposed rule back out for public comment again. A diagram of the rulemaking process can be found in Figure 6-3.



6-3 Executive Power of the Agency

The modern administrative agency has the power to execute the law and to bring proceedings against violators.

6-3a Enforcement or Execution of the Law

An agency has the power to investigate, to require persons to appear as witnesses, to require witnesses to produce relevant papers and records, and to bring proceedings against those who violate the law. In this connection, the phrase *the law* embraces regulations adopted by an agency as well as statutes and court decisions.

An agency may investigate to determine whether any violation of the law or of its rules generally has occurred. An agency may also investigate to determine whether additional rules need to be adopted, to ascertain the facts with respect to a particular suspected or alleged violation, and to see whether the defendant in a proceeding before it is complying with its final order. An agency may issue subpoenas to obtain information reasonably required by its investigation.²⁰

6-3b Constitutional Limitations on Administrative Investigation

Although administrative agencies have broad enforcement authority, they remain subject to the constitutional protections afforded individuals and businesses.

Inspection of Premises

Agency officials have the right to conduct inspections, pursuant to the warrant protections afforded by the Fourth Amendment (see Chapter 7). However, when violation of the law is dangerous to health and safety, a workplace inspection without advance notice or a search warrant is permitted when such a requirement could defeat the purpose of the inspection.

Production of Papers

For the most part, the constitutional guarantee against unreasonable searches and seizures does not afford much protection for the papers and records of a business being investigated by an agency. **For Example**, a subpoena to testify or to produce records cannot be opposed on the ground that it is a search and seizure. The constitutional protection is limited to cases of actual physical search and seizure rather than obtaining information by compulsion. Employers must turn over to the Occupational Health and Safety Administration (OSHA) their records on workplace injuries and lost workdays.

The protection afforded by the guarantee against self-incrimination likewise cannot be invoked when a corporate employee or officer in control of corporate records is compelled to produce those records even though he or she would be incriminated by them.²¹ The privilege against self-incrimination cannot be invoked if records required to be kept by law are involved.

Inspections and Reports

To ensure that a business is obeying the law, including an agency's regulations and orders, the administrative agency may require proof of compliance through the submission of

²⁰ *EEOC v. Sidley, Austen, Brown and Wood*, 35 F.3d 696 (7th Cir. 2002).

²¹ *Braswell v. United States*, 487 U.S. 99 (1988); see also *U.S. S.E.C. v. Narvett*, 16 F. Supp. 3d 979 (E.D. Wis. 2014).

periodic reports. **For Example**, OSHA requires reports on injuries and fatalities in the workplace. **For Example**, at the local level, cities require that businesses have their tax licenses on display and that those licenses be up-to-date. An agency may also require the regulated person or enterprise to file reports in a specified form.²²

Administrative agencies also have the right of inspection or the examination either of a building or plant or documents that businesses are required to retain. The element of surprise is important in administrative agency inspections. In fact, in some industries, it is a federal crime for company officers and managers to notify employees about the presence of federal inspectors at the business. **For Example**, following the Massey Energy Company's Upper Big Branch mine disaster that killed 29 miners, several managers and executives were criminally charged for notifying miners that inspectors were on the way and ordering miners to conceal hazards that would result in shut-downs or fines.²³ Three officials have entered guilty pleas or been convicted of the charges.²⁴ Don Blankenship, the CEO at the time, has also been charged with conspiring to violate safety standards.

6-4 Judicial Power of the Agency

Once the investigation of an agency reveals a potential violation of the law, an agency assumes its third role of judicial arbiter to conduct hearings on violations.

6-4a The Agency as a Specialized Court

An agency, although not a court by law, may be given power to sit as a court and to determine whether any violations of the law or of agency regulations have occurred. The National Labor Relations Board (NLRB) determines whether a prohibited labor practice has been committed.²⁵ The Securities Exchange Commission (SEC) acts as a court for determining violations of federal securities laws.

Beginning Enforcement—Preliminary Steps

Either a private individual or company or an agency may file a written complaint alleging some violation of law or regulation that is within the agency's jurisdiction. This complaint is then served on the company or individual named in the complaint, who then has the opportunity to file an answer to the allegations. There may be other phases of pleading between the parties and the agency, but, eventually, the matter comes before the agency to be heard. After a hearing, the agency makes a decision and enters an order either dismissing the complaint or directing remedies or resolutions.

The Administrative Hearing

To satisfy the requirements of due process, an agency handling a complaint must generally give notice and hold a hearing at which all persons affected may be present. A significant difference between an agency hearing and a court hearing is that there is no right of trial by jury before an agency. **For Example**, a workers' compensation board may decide a claim without any jury. Similarly, a case in which an employer protests the

²² *United States v. Morton Salt Co.*, 338 U.S. 632 (1950).

²³ The federal agency involved was the Mine Safety and Health Administration (MSHA).

²⁴ *U.S. v. Stover*, 499 Fed. Appx. 267 (4th Cir. 2012).

²⁵ One of the requirements for a valid hearing by an agency is legal appointments of the commissioners to the agency. In *N.L.R.B. v. Noel Canning*, 134 S. Ct. 2550 (2014), the U.S. Supreme Court held that a National Labor Relations Board (NLRB) order was invalid because the president's recess appointments of several members of the board was not valid, and the commissioners had to be nominated and approved by Congress before their actions would be valid.

administrative law judge—judicial figure who hears administrative agency actions.

informal settlements—negotiated disposition of a matter before an administrative agency, generally without public sanctions.

consent decrees—informal settlements of enforcement actions brought by agencies.

hearing officer (or examiner)—another name for an administrative law judge.

intervenors—in administrative actions, third parties who have an interest in the issues being determined by an ALJ.

unemployment tax rate assigned to her company by a state agency has no right to a jury trial. The lack of a jury does not deny due process (see Chapter 4). An **administrative law judge (ALJ)** hears the complaint and has the authority to swear witnesses, take testimony, make evidentiary rulings, and make a decision to recommend to the agency heads for action.

An agency hearing is ordinarily not subject to the rules of evidence. The hearing tends to be more open, with discussion, as opposed to procedural processes that exclude some evidence.

Streamlined Procedure: Consent Decrees

Informal settlements or **consent decrees** are practical devices used to settle administrative law complaints after wrongdoer business is notified of that complaint. A consent decree is similar to a *nolo contendere* plea where there is no admission of guilt, but there are promises related to fines and cease and desists on activities.²⁶ The Administrative Dispute Resolution Act of 1990 encourages consent decrees and the use of other processes approaches such as alternative dispute resolution in order to expedite cases.²⁷ **For Example,** Kellogg's settled with the FTC on deceptive advertising charges related to health claims about its Rice Krispies®, Frosted Flakes®, and Special K® cereals. Without admitting any violation of the law, Kellogg's agreed to change the ads and package claims for the cereals. Kellogg's could no longer claim that its cereals increased the attentiveness of children.

The Hearing Process

If the parties cannot reach an agreement through a consent decree, the questions of violations and penalties will go to an administrative hearing, which is quite different from the litigation described in Chapter 2. The defendant in an administrative law hearing is the person or company accused of a violation of an administrative regulation. The judge in these hearings is called an administrative law judge (ALJ) and at other levels of government is often called a **hearing examiner** or **hearing officer**.

Administrative hearings often have additional parties involved, parties with an interest in the case are permitted to participate, and are called **intervenors**. They enter the case through motions to intervene and are usually permitted to do so at any time before the start of a hearing. Typical intervenors are industry organizations. **For Example,** snowmobile manufacturers and the state of Wyoming, because of their economic interests in snowmobile activities, were intervenors in the national park cases challenging the Department of Interior snowmobile regulations for national parks.

The Administrative Agency Decision

When an administrative agency makes a decision, it usually files an opinion that sets forth findings of facts and reasons for that decision. In some instances, a statute expressly requires this type of opinion, but agencies usually file opinions so that the parties and the court (in the event of an appeal) will understand the agency's action and reasoning.²⁸

²⁶ The late comedian Johnny Carson said a defense decree is when a business says, "I didn't do anything, but I promise never to do it again."

²⁷ 5 U.S.C. §571 *et seq.*

²⁸ *Jordan v. Civil Service Bd., Charlotte*, 570 S.E.2d 912 (N.C. App. 2002).

6-4b Punishment and Enforcement Powers of Agencies

Penalty

Within the last few decades, agencies have increasingly been given the power to impose a penalty and to issue orders that are binding on a regulated party unless an appeal is taken to a court, which reverses the administrative decision. **For Example**, the Occupational Safety and Health Act of 1970 provides for the assessment of civil penalties against employers who fail to end dangerous working conditions when ordered to do so by the administrative agency created by that statute.²⁹ **For Example**, BP paid over \$150 million in fines following the explosion at its Texas City refinery because the company had failed to address over 400 previously cited OSHA violations.

Cease-and-Desist Order

Environmental protection statutes adopted by states commonly give a state agency the power to assess a penalty for violating environmental protection regulations. As an illustration of the issuance of binding orders, the FTC can issue a **cease-and-desist order** to stop a practice that it decides is improper. This order to stop is binding unless reversed on an appeal. **For Example**, the FTC can order a company to stop making claims in ads that have been determined by that agency to be deceptive.

cease-and-desist order—order issued by a court or administrative agency to stop a practice that it decides is improper.

6-4c Exhaustion of Administrative Remedies

The parties involved in an administrative agency action cannot obtain judicial review until the agency has made its final findings or decision in the case. The parties in administrative actions are required to go through the administrative process, something that is referred to as the exhaustion of administrative remedies before they can take the action to court.

Exceptions to the **exhaustion of administrative remedies** requirement are: (1) available remedies that provide no genuine opportunity for adequate relief; (2) irreparable injury that could occur if immediate judicial relief is not provided; (3) an appeal to the administrative agency that would be useless; or (4) a substantial constitutional question that the plaintiff has raised.

exhaustion of administrative remedies—requirement that an agency make its final decision before the parties can go to court.

6-4d Appeal from an Administrative Agency Action

There are several bases for challenging administrative agency actions. These bases are covered in the following sections.

Procedural Issues

If the procedure that an agency is to follow is specified by law, a decision of the agency that was made without following that procedure will be set aside and the matter sent back to the agency to proceed according to the required law.³⁰ An agency's actions, whether enforcement or rule promulgation, can be set aside if the agency has not followed the procedures required for rulemaking or, in the case of enforcement, the due process rights of the charged business or individual.

Substantive Law or Fact Issues

When the question that an agency decides is a question of law, a court will reverse the agency if the court disagrees with the legal interpretation.³¹ Courts tend to accept the

²⁹ 29 U.S.C. §651 *et seq.*

³⁰ *Tingler v. State Board of Cosmetology*, 814 S.W.2d 683 (Mo. App. 1991).

³¹ *Wallace v. Iowa State Bd. of Educ.*, 770 N.W.2d 344 (Iowa 2009).

agency's interpretation so long as it was reasonable even though it was not the only interpretation that could have been made.

A court will not reverse an agency's decision merely because the court would have made a different decision based on the same facts.³² Courts assume that the agency has acted properly and those who appeal an agency decision must be able to show that the agency did not act on the basis of the facts or deliberately excluded facts.

Ultra Vires or Beyond the Jurisdiction of the Agency

The action of an agency can be set aside if what the agency has done is beyond the authority granted in the enabling statute for its creation. Several groups and businesses filed suit against the EPA challenging the Transport Rule, a rule designed to limit pollution across state lines. [*EME Homer City Generation, L.P. v. EPA*, 134 S. Ct. 1584 (2014)] The rule was challenged as *ultra vires* (beyond an agency's statutory authority). The court held that the Clean Air Act gave the EPA authority to determine how to allocate responsibility for a downwind state's excess pollution and that the Transport Rule was a permissible way for the EPA to construct the good neighbor concept.

Arbitrary and Capricious

When an agency changes its prior decisions and customary actions, it must give its reasons. In the absence of such an explanation, a reviewing court can set aside the agency action.³³

CASE SUMMARY

Drilling Down to Arbitrary and Capricious Rules

FACTS: Hornbeck and others (plaintiffs) provide services to support offshore oil and gas drilling, exploration, and production activities in the Gulf of Mexico. Kenneth Salazar is the Secretary of the Department of Interior (DOI), a federal agency that includes the Minerals Management.

Following the BP Deepwater Horizon drilling platform explosion on April 20, 2010, and the resulting devastation and unprecedented disaster, President Obama asked DOI to conduct a study to determine what steps were needed to be taken to prevent another problem with oil rigs in the Gulf.

DOI did a 30-day study, consulting respected experts from state and federal governments, academic institutions, and industry and advocacy organizations. On May 27, 2010, DOI issued a Report that recommended a six-month moratorium on permits for new wells and an immediate halt to drilling operations on the 33 permitted wells in the Gulf of Mexico. The DOI report also stated that "the recommendations contained in this report have been peer-reviewed by seven experts identified by the National Academy of

Engineering." The experts pointedly observed that this statement was misleading and called it a "misrepresentation." Although the experts agreed with the safety recommendations contained in the body of the main Report, five of the National Academy of Engineering experts and three of the other experts publicly stated that they "do not agree with the six month blanket moratorium" on floating drilling. They envisioned a more limited kind of moratorium, but a blanket moratorium was added after their final review and was never agreed to by them. The plaintiffs moved for a preliminary injunction against the moratorium.

DECISION: The court held that the experts balking at the conclusion of the report, the inconsistency of the moratorium with the report information, and the availability of alternatives made the moratorium unlikely to survive a challenge of the action being arbitrary and capricious and issued an injunction. [*Hornbeck Offshore Services, L.L.C. et al. v. Salazar*, 696 F. Supp. 2d 627 (E.D. La. 2010)]

³² *Dorchester Associates LLC v. District of Columbia Bd. of Zoning Adjustment*, 976 A.2d 200 (D.C. 2009).

³³ *Lorillard Tobacco Co. v. Roth*, 786 N.E.2d 7 (N.Y. App. 2003).

Constitutional Rights

Challenges to administrative agency rules and actions can also be based in constitutional rights.³⁴ **For Example,** agency restrictions on language or religious freedom have been successfully challenged in court. EEOC regulations on employees wearing religious jewelry (such as necklaces with crosses) were withdrawn after the agency realized through congressional actions that the regulations could not survive a constitutional challenge.

CASE SUMMARY

The Obscenity Case That Has Been Around as Long as Cher

FACTS: In a case that has been around almost as long as Cher, the U.S. Supreme Court, once again, issued a decision related to three FCC charges against Fox and ABC Television. First, in the 2002 Billboard Music Awards, broadcast by Fox Television, the singer Cher exclaimed during an unscripted acceptance speech: “I’ve also had my critics for the last 40 years saying that I was on my way out every year. Right. So f * * * ‘em.” At the 2003 Billboard Music Awards, Nicole Richie made the following unscripted remark while presenting an award: “Have you ever tried to get cow s * * * out of a Prada purse? It’s not so f * * *ing simple.” The third incident involved an episode of *NYPD Blue*, a regular television show broadcast by respondent ABC Television Network. The episode, broadcast on February 25, 2003, showed the nude buttocks of an adult female character for approximately seven seconds and for a moment the side of her breast. During the scene, in which the character was preparing to take a shower, a child portraying her boyfriend’s son entered the bathroom. A moment of awkwardness followed. The FCC received indecency complaints about all three broadcasts.

After these incidents, but before the FCC issued Notices of Apparent Liability to Fox and ABC, it issued a decision sanctioning NBC for a comment made by the singer Bono during the 2003 Golden Globe Awards. Upon winning the award for Best Original Song, Bono exclaimed: “This is really, really, f * * *ing brilliant. Really, really great.” The FCC found that the use of the F-word was “one of the most vulgar, graphic and explicit descriptions of sexual activity in the English language,” and found that “any use of that word or a variation, in any context,

inherently” indecent. The FCC then found that both Fox and ABC had violated commission standards for decency.

The networks appealed the findings of indecency and their fines (\$1.4 million each). The U.S. Supreme Court [*FCC v. Fox Television Stations, Inc.* (Fox 1), 556 U.S. 502 (2009)] held that the FCC’s findings were not arbitrary nor capricious and remanded the case for findings related to the network’s First Amendment challenges to the fines. On remand, the Court of Appeals found that the FCC indecency policy failed to give broadcasters sufficient notice of what would be considered indecent. The Court of Appeals found that the FCC was inconsistent as to which words it deemed patently offensive. The FCC standard was held to be void for vagueness. The FCC appealed.

DECISION: On appeal the U.S. Supreme Court held that the FCC failed to give Fox or ABC fair notice prior to the broadcasts in question that fleeting expletives and momentary nudity could be found indecent. Therefore, the FCC’s standards, as applied to these broadcasts, were vague and void under the First Amendment. The Court set aside the FCC’s findings as well as its orders and fines against the networks.

The FCC is free to create standards of decency for broadcasting programs. However, the standards must be established in advance of any charges of violations and those standards must be clear and applied consistently. Because the broadcasters would not have understood the standard at the time the violations occurred, the U.S. Supreme Court struck down the standards as void for vagueness. [*F.C.C. v. Fox Television Stations, Inc.*, 132 S. Ct. 2307 (2012)]

³⁴ *CBS Corp. v. F.C.C.*, 663 F.3d 122 (3rd Cir. 2011).

Make the Connection

Summary

The administrative agency is unique because it combines the three functions that are kept separate under our traditional governmental system: legislative, executive, and judicial. By virtue of legislative power, an agency adopts regulations that have the force of law, although agency members are not elected by those subject to the regulations. By virtue of the executive power, an agency carries out and enforces the regulations, makes investigations, and requires the production of documents. By virtue of the judicial power, an agency acts as a court to determine whether a violation of any regulation has occurred.

To some extent, an agency is restricted by constitutional limitations in inspecting premises and requiring the production of papers. These limitations, however, have a very narrow application in agency actions. When an agency acts as a judge, a jury trial is not required, nor must ordinary courtroom procedures be followed. Typically, an agency gives notice to the person claimed to be acting improperly, and a hearing is then held before the agency. When the agency has determined that there has

been a violation, it may order that the violation stop. Under some statutes, the agency may go further and impose a penalty on the violator.

No appeal from an administrative agency's action can be made until every step available before the agency has been taken; that is, the administrative remedy must first be exhausted. An agency's actions can be reversed by a court if the agency exceeded its authority, the decision is not based in law or fact, the decision is arbitrary and capricious, the decision violates the laws or the rights of those affected by the agency's rule or actions, or, finally, the agency violated procedural steps.

Protection from secret government is provided by Sunshine laws that afford the right to know what most administrative agency records contain; by the requirement that most agency meetings be open to the public; by the invitation to the public to take part in rulemaking; and by publicity given, through publication in the *Federal Register* and trade publications, to the guidelines followed by the agency and the regulations it has adopted.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

6-1 Nature of the Administrative Agency

LO.1 Describe the nature and purpose of administrative agencies

See the discussion of the unique nature of agencies, pages 87–88.

See the discussion of obligations of administrative agencies, including APA and FOIA, page 88.

See Ethics & the Law on the IRS, page 89.

See the net neutrality Cyberlaw issue, page 92.

6-2 Legislative Power of the Agency

LO.2 Discuss the legislative or rulemaking power of administrative agencies

See the *Massachusetts v. EPA* case, pages 90–91.

6-3 Executive Power of the Agency

LO.3 Explain the executive or enforcement function of administrative agencies

See the *FCC* case, page 99.

See the Massey Energy example, page 95.

See the Kellogg's example on consent decrees, page 96.

6-4 Judicial Power of the Agency

LO.4 Discuss the judicial power of administrative agencies including the rule on exhaustion of administrative remedies

See the *Salazar* case, page 98.

Key Terms

administrative agency

administrative law

administrative law judge (ALJ)

Administrative Procedure Act

cease-and-desist order

consent decrees

exhaustion-of-administrative remedies

Federal Register

Federal Register Act

Freedom of Information Act

hearing examiner

hearing officer

informal settlements

intervenor

open meeting law

Questions and Case Problems

1. Following the events of September 11, 2001, in which four airplanes crashed as a result of the presence of terrorists on those flights, the FAA concluded that it needed to implement new procedures for airports and flights. The new procedures for security and flights took effect when the airports reopened five days later. Why did the FAA not need to go through the promulgation and public comment processes and time periods to have the new rules take effect?
2. The FDA was challenged by tobacco companies for its new rules that required the tobacco companies to put one of the FDA's 12 picture labels on its packaging. The tobacco companies argued that their First Amendment rights were violated by the rules, forcing them to speak in a certain way using government-mandated materials. The new labels were promulgated by both the FDA and the Department of Health and Human Services (HHS) pursuant to authority granted by Congress in 2009 under the Family Smoking Prevention and Tobacco Control Act.

Under the law, the following nine textual statements were to be included on cigarette labels:

WARNING: Cigarettes are addictive.

WARNING: Tobacco smoke can harm your children.

WARNING: Cigarettes cause fatal lung disease.

WARNING: Cigarettes cause cancer.

WARNING: Cigarettes cause strokes and heart disease.

WARNING: Smoking during pregnancy can harm your baby.

WARNING: Smoking can kill you.

WARNING: Tobacco smoke causes fatal lung diseases in nonsmokers.

WARNING: Quitting smoking now greatly reduces serious risks to your health.

The act required that these warnings and graphic labels take up 50 percent of the cigarette package label and 20 percent of all cigarette ads.

After publishing the proposed rule and receiving more than 1,700 comments, the FDA published its final rule in June 2011. Explain how the tobacco companies could challenge the rules. Discuss whether the rules will be set aside. [In the case of

R.J. Reynolds Tobacco Company et al. v. FDA et al., 696 F.3d 1205 (D.C. Cir.)]

3. The Tacoma-Pierce County Health Department conducted an investigation into the quality of care provided by ambulance service providers in its jurisdiction. On the basis of that investigation, the department issued a set of temporary rules and regulations that established minimum requirements for equipment, drugs, and service availability for ambulance service providers in Pierce County. The *Tacoma News* wanted to publish an article on the matter and sought discovery of everything that had led to the adoption of the regulations, including all details of the investigation made by the health department. The health department objected to disclosing the names of the persons who had volunteered information on which the department had based its action and the names of the ambulance companies. Were the names subject to a Freedom of Information Act (FOIA) request? [*Tacoma News, Inc. v. Tacoma-Pierce County Health Dept.*, 778 P.2d 1066 (Wash. App.)]
4. Congress adopted a law to provide insurance to protect wheat farmers. The agency in charge of the program adopted regulations to govern applications for this insurance. These regulations were published in the *Federal Register*. Merrill applied for insurance, but his application did not comply with the regulations. He claimed that he was not bound by the regulations because he never knew they had been adopted. Is he bound by the regulations? [*Federal Crop Ins. Corp. v. Merrill*, 332 U.S. 380]
5. Santa Monica adopted a rent control ordinance authorizing the Rent Control Board to set the amount of rents that could be charged. At a hearing before it, the board determined that McHugh was charging his tenants a rent higher than the maximum allowed. McHugh claimed that the action of the board was improper because there was no jury trial. Is McHugh correct? Why or why not? [*McHugh v. Santa Monica Rent Control Board*, 777 P.2d 911 (Cal.)]
6. New York City's charter authorized the New York City Board of Health to adopt a health code that it declared to have the force and effect of law. The board adopted a code that provided for the fluoridation of the public water supply. A suit was brought to enjoin the carrying out of this program on the grounds that it was unconstitutional and that money

could not be spent to carry out such a program in the absence of a statute authorizing the expenditure. It was also claimed that the fluoridation program was unconstitutional because there were other means of reducing tooth decay; fluoridation was discriminatory by benefiting only children; it unlawfully imposed medication on children without their consent; and fluoridation was or may be dangerous to health. Was the code's provision valid? [*Paduano v. City of New York*, 257 N.Y.S.2d 531]

7. What is the *Federal Register*? What role does it play in rulemaking? What is the difference between the *Federal Register* and the Code of Federal Regulations?
8. The Consumer Product Safety Commission is reconsidering a rule it first proposed in 1997 that would require child-resistant caps on household products, including cosmetics. When the rule was first proposed in 1997, it was resisted by the cosmetics industry and abandoned. However, in May 2001, a 16-month-old baby died after drinking baby oil from a bottle with a pull-tab cap.

The proposed rule would cover products such as baby oil and suntan lotion and any products containing hydrocarbons such as cleansers and spot removers. The danger, according to the commission, is simply the inhalation by children, not necessarily the actual ingestion of the products. Five children have died from inhaling such fumes since 1993, and 6,400 children under the age of five were brought into emergency rooms and/or hospitalized for treatment after breathing in hydrocarbons. There is no medical treatment for the inhalation of hydrocarbons.

Several companies in the suntan oil/lotion industry have supported the new regulations. The head of a consumer group has said, "We know these products cause death and injury. That is all we need to know."³⁵

What process must the CPSC follow to promulgate the rules? What do you think of the consumer group head's statement? Will that statement alone justify the rulemaking?

9. The *Federal Register* contained the following provision from the Environmental Protection Agency on January 14, 2002:

We, the U.S. Fish and Wildlife Service (Service), announce the re-opening of the comment period on the proposed listing of Lomatium cookii

(Cook's lomatium) and Limnanthes floccosa ssp. grandiflora (large-flowered wooly meadowfoam) as endangered species under the Endangered Species Act of 1973, as amended (Act). We are re-opening the comment period to provide the public an opportunity to review additional information on the status, abundance, and distribution of these plants, and to request additional information and comments from the public regarding the proposed rule. Comments previously submitted need not be resubmitted as they will be incorporated into the public record as part of this extended comment period; all comments will be fully considered in the final rule.

DATES: We will accept public comments until March 15, 2002.

What was the EPA doing and why? What could those who had concerns do at that point?

10. Macon County Landfill Corp. applied for permission to expand the boundaries of its landfill. Tate and others opposed the application. After a number of hearings, the appropriate agency granted the requested permission to expand. Tate appealed and claimed that the agency had made a wrong decision on the basis of the evidence presented. Will the court determine whether the correct decision was made? [*Tate v. Illinois Pollution Control Board*, 544 N.E.2d 1176 (Ill. App.)]
11. The planning commissioner and a real estate developer planned to meet to discuss rezoning certain land that would permit the real estate developer to construct certain buildings not allowed under the then-existing zoning law. A homeowners association claimed it had the right to be present at the meeting. This claim was objected to on the theory that the state's Open Meetings Act applied only to meetings of specified government units and did not extend to a meeting between one of them and an outsider. Was this objection valid?
12. The Michigan Freedom of Information Act declares that it is the state's policy to give all persons full information about the actions of the government and that "the people shall be informed so that they may participate in the democratic process." The union of clerical workers at Michigan State University requested the trustees of the university to give them the names and addresses of persons making monetary donations to the university. Michigan State objected because the disclosure of addresses was a violation of the right of privacy. Decide. [*Clerical-Technical*

³⁵Julian E. Barnes, "Safety Caps Are Considered for Cosmetics," *New York Times*, October 10, 2001, C1, C8.

Union of Michigan State University v. Board of Trustees of Michigan State University, 475 N.W.2d 373 (Mich.)]

13. The Department of Health and Human Services has proposed new guidelines for the interpretation of federal statutes on gifts, incentives, and other benefits bestowed on physicians by pharmaceutical companies. The areas on which the interpretation focused follow:
- Paying doctors to act as consultants or market researchers for prescription drugs
 - Paying pharmacies fees to switch patients to new drugs
 - Providing grants, scholarships, and anything more than nominal gifts to physicians for time, information sessions, and so on, on new drugs³⁶

The Office of Inspector General is handling the new rules interpretation and has established a public comment period of 60 days. Explain the purpose of the public comment period. What ethical issues do the regulations attempt to address?

14. San Diego Air Sports (SDAS) Center operates a sports parachuting business in Otay Mesa, California. SDAS offers training to beginning parachutists and facilitates recreational jumping for experienced parachutists. It indicates that the majority of SDAS jumps occur at altitudes in excess of 5,800 feet. The jump zone used by SDAS overlaps the San Diego Traffic Control Area (TCA). Although the aircraft carrying the parachutists normally operate outside the TCA, the parachutists themselves are dropped through it. Thus, the air traffic controllers must approve each jump.

In July 1987, an air traffic controller in San Diego filed an Unsatisfactory Condition Report with the Federal Aviation Administration (FAA), complaining of the strain that parachuting was putting

on the controllers and raising safety concerns. The report led to a staff study of parachute jumping within the San Diego TCA. This was followed by a letter in March 1988 from the FAA to SDAS, informing SDAS that “[e]ffective immediately parachute jumping within or into the San Diego TCA in the Otay Reservoir Jump Zone will not be authorized.” The FAA stated that the letter was final and appealable. SDAS challenged the letter in federal court on grounds that it constituted rulemaking without compliance with required Administrative Procedure Act (APA) procedures. Who is correct in this dispute and why? [*San Diego Air Sports Center, Inc. v. FAA*, 887 F.2d 966 (9th Cir.)]

15. The Endangered Species Act (ESA) charges the National Marine Fisheries Service (a federal agency) with the duty to “ensure” that any proposed action by the Council does not “jeopardize” any threatened or endangered species. The Steller sea lion is on the list of endangered species. The agency developed a North Pacific marine fishery plan that permitted significant harvest of fish by commercial fisheries in the area. Greenpeace, an environmental group, challenged the agency on the grounds that the plan was not based on a sufficient number of biological studies on the impact of the allowed fishing on the Steller sea lion. Greenpeace’s biologic opinion concluded that the fishery plan would reduce the level of food for the sea lions by about 40 percent to 60 percent, if the juvenile fish were not counted in that figure. Greenpeace’s expert maintained that counting juvenile fish was misleading because they were not capable of reproducing and the government agency’s figure was, as a result, much lower at 22 percent. What would Greenpeace need to show to be successful in challenging the agency’s fishery plan? [*Greenpeace, American Oceans Campaign v. National Marine Fisheries Service*, 237 F. Supp. 2d 1181 (W.D. Wash.)]

³⁶See 67 *Federal Register* 62057, October 3, 2002. Go to <http://www.oig.hhs.gov>. See also Robert Pear, “U.S. Warning to Drug Makers Over Payments,” *New York Times*, October 1, 2002, A1, A23; Julie Appleby, “Feds Warn Drugmakers: Gifts to Doctors May Be Illegal,” *USA Today*, October 2, 2002, 1A.



Crimes

>>> Learning Outcomes

After studying this chapter, you should be able to

- LO.1** Discuss the nature and classification of crimes
- LO.2** Describe the basis of criminal liability
- LO.3** Identify who is responsible for criminal acts
- LO.4** Explain the penalties for crimes and the sentencing for corporate crimes
- LO.5** List examples of white-collar crimes and their elements
- LO.6** Describe the common law crimes
- LO.7** Discuss crimes related to computers
- LO.8** Describe the rights of businesses charged with crimes and the constitutional protections afforded them

7-1 General Principles

- 7-1a Nature and Classification of Crimes
- 7-1b Basis of Criminal Liability
- 7-1c Responsibility for Criminal Acts
- 7-1d Indemnification of Crime Victims

7-2 White-Collar Crimes

- 7-2a Conspiracies
- 7-2b Money Laundering
- 7-2c Racketeering
- 7-2d Bribery
- 7-2e Commercial Bribery
- 7-2f Extortion and Blackmail
- 7-2g Corrupt Influence
- 7-2h Counterfeiting
- 7-2i Forgery
- 7-2j Perjury
- 7-2k False Claims and Pretenses
- 7-2l Bad Checks
- 7-2m Credit Card Crimes
- 7-2n Embezzlement
- 7-2o Obstruction of Justice: Sarbanes-Oxley (SOX)
- 7-2p Corporate Fraud: SOX
- 7-2q The Common Law Crimes

7-3 Criminal Law and the Computer

- 7-3a What Is a Computer Crime?
- 7-3b The Computer as Victim
- 7-3c Unauthorized Use of Computers
- 7-3d Computer Raiding
- 7-3e Diverted Delivery by Computer
- 7-3f Economic Espionage by Computer
- 7-3g Electronic Fund Transfer Crimes
- 7-3h Circumventing Copyright Protection Devices Via Computer
- 7-3i Spamming

7-4 Criminal Procedure Rights for Businesses

- 7-4a Fourth Amendment Rights for Businesses
- 7-4b Fifth Amendment Self-Incrimination Rights for Businesses
- 7-4c Due Process Rights for Businesses

7-1 General Principles

Society sets certain standards of conduct and punishes a breach of those standards as a crime. This chapter introduces the means by which government protects people and businesses from prohibited conduct.

Detailed criminal codes and statutes define crimes and specify their punishment. Crimes vary from state to state but still show the imprint of a common law background through similar elements and structure.

crime—violation of the law that is punished as an offense against the state or government.

misdemeanor—criminal offense with a sentence of less than one year that is neither treason nor a felony.

felony—criminal offense that is punishable by confinement in prison for more than one year or by death, or that is expressly stated by statute to be a felony.

7-1a Nature and Classification of Crimes

A **crime** is conduct that is prohibited and punished by a government. Crimes are classified as *common law* or *statutory* according to their origin. Offenses punishable by less than one year in prison are called **misdemeanors**. More serious crimes are called **felonies**, including serious business crimes such as bribery and embezzlement, which are punishable by confinement in prison for more than one year. Misdemeanors include weighing goods with uninspected scales or operating without a sales tax license. An act may be a felony in one state and a misdemeanor in another.¹

7-1b Basis of Criminal Liability

A crime generally consists of two elements: (1) a mental state (*scienter* or intent) and (2) an act or omission. Harm may occur as a result of a crime, but harm is not an essential element of a crime.

Mental State

Mental state, *scienter*, or intent, does not require an awareness or knowledge of guilt. In most crimes, the voluntary commission of the act is sufficient for proving mental state. Ignorance that a law is being broken does not mean there is not mental state. **For Example**, dumping waste without a permit is still a criminal act even when the party releasing the waste did not know about the permit requirement.

Act or Omission

Specific statutes define the conduct, or *actus reus*, that, when coupled with sufficient mental state, constitutes a crime. **For Example**, writing a check knowing you do not have the funds available is a crime. Likewise, the failure to file your annual income tax returns is also a crime.

CASE SUMMARY

Did I Know Pumping Gas Was a Crime?

FACTS: Ahmad owns a Spin-N-Market in Texas, a convenience store and gas station. One of the Spin-N-Market's gasoline tanks developed a leak. Jewel McCoy of CIT

Environmental Services inspected the tank and said it needed to be drained and then pumped. McCoy gave Ahmad the cost of draining, and he suggested he would do it himself despite

¹ Some states further define crimes by seriousness with different degrees of a crime, such as first-degree murder, second-degree murder, and so on. Misdemeanors may be differentiated by giving special names to minor misdemeanors.

Did I Know Pumping Gas Was a Crime? continued

McCoy's warning about violations of the law. Ahmad rented a pump at the local hardware store and pumped over 5,000 gallons into a manhole near his store (4,690 of those gallons were gasoline). The gasoline made its way to the storm sewer system and then a creek as well as the city sewage treatment center. While firemen were working to divert the gasoline, the treatment center and two nearby schools had to be evacuated. Ahmad was charged with violation of the Clean Water Act and was convicted of two charges.

DECISION: The appeals court held that Ahmad did not have the intent to violate the statute, the CWA, because he thought that he was discharging water, not gasoline. There is more knowledge required for CWA violations; it is a criminal statute and there cannot be just strict liability—there still must be a showing of mental intent. [*United States v. Ahmad*, 101 F.3d 386 (5th Cir. 1996)]

7-1c Responsibility for Criminal Acts

In some cases, persons who did not necessarily commit the criminal act itself are still held criminally responsible for acts committed by others.

Corporate Liability

Corporations are held responsible for the acts of their employees. A corporation may also be held liable for crimes based on the failure of its employees to act. In the past decade, some of the nation's largest corporations have paid fines for crimes based on employees' failure to take action or for the actions they did take. **For Example**, Siemens, an international company, paid the largest fine in the history of the Foreign Corrupt Practices Act for paying bribes in order to win contracts in countries around the world, a total of \$1.6 billion in fines, including \$350 million in the United States.

Officers and Agents of Corporations

One of the main differences between nonbusiness and business crimes is that more people in a company can be convicted for the same business crime. For nonbusiness crimes, only those who are actually involved in the act itself can be convicted of the crime. For business crimes, however, managers of firms whose employees commit criminal acts can be held liable if the managers authorized the conduct of the employees or knew about their conduct and did nothing or failed to act reasonably in their supervisory positions to prevent the employees from engaging in criminal conduct. **For Example**, the former security chief for Massey Energy was sentenced to three years in prison after being found guilty of notifying employees in advance of the arrival of federal mine inspectors at the company's mines.²

CASE SUMMARY

Rats in the Warehouse and a CEO with a Fine

FACTS: Acme Markets, Inc., was a national food retail chain headquartered in Philadelphia. John R. Park was president of Acme, which, in 1970, employed 36,000 people and operated 16 warehouses.

In 1970, the Food and Drug Administration (FDA) forwarded a letter to Park describing, in detail, problems with rodent infestation in Acme's Philadelphia warehouse facility. In December 1971, the FDA found the same types

²Ken Maher, "Ex-Massey Official Gets Three Years," *Wall Street Journal*, March 1, 2012, p. A3.
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Rats in the Warehouse and a CEO with a Fine continued

of conditions in Acme's Baltimore warehouse facility. In January 1972, the FDA's chief of compliance for its Baltimore office wrote to Park about the inspection:

We note with much concern that the old and new warehouse areas used for food storage were actively and extensively inhabited by live rodents. Of even more concern was the observation that such reprehensible conditions obviously existed for a prolonged period of time without any detection, or were completely ignored.

We trust this letter will serve to direct your attention to the seriousness of the problem and formally advise you of the urgent need to initiate whatever measures are necessary to prevent recurrence and ensure compliance with the law.

After Park received the letter, he met with the vice president for legal affairs for Acme and was assured that he

was “investigating the situation immediately and would be taking corrective action.”

When the FDA inspected the Baltimore warehouse in March 1972, there was some improvement in the facility, but there was still rodent infestation. Acme and Park were both charged with violations of the federal Food, Drug and Cosmetic Act. Acme pleaded guilty. Park was convicted and fined \$500; he appealed.

DECISION: Officers of a corporation can be held criminally liable for the conduct of others within the company if it can be shown that the officers knew of the issue and failed to take the steps necessary to eliminate the criminal activity. In this case, Park had been warned and had been given several opportunities to remedy the problem. Part of his responsibility as an officer is following up to be certain that tasks he has assigned are completed. Failure to follow through can be a basis for criminal liability. [*United States v. Park*, 421 U.S. 658 (1975)]

Federal Laws Targeting Officer and Director Criminal Responsibility

Following the Michael Milken and Ivan Boesky junk bond era on Wall Street in 1988, the Insider Trading and Securities Fraud Act of 1988 increased the criminal penalties for officers and directors who violated the law tenfold. In addition, the “white-collar kingpin” law imposed mandatory minimum sentences for corporate officers. Sarbanes-Oxley, which followed the 2000-era dot-com failures increased penalties for officers and directors from 5 years to 20 years, along with an increase in fines by 20 times. Under The Dodd-Frank Wall Street Reform and Consumer Protection Act, the types of white-collar executives covered under criminal laws increased to include brokers, insurers, and any financial services firms. In addition, Dodd-Frank created the Consumer Financial Protection Bureau (CFPB) that has the ability to refer cases to the Justice Department for prosecution. **For Example**, the CFPB would receive information about mortgage lenders, banks, and insurers from consumers that could then be turned over for possible criminal charges.

So-called honest services fraud has been refined by Dodd-Frank and court decisions.³ Executives can no longer be convicted on the basis that something went wrong at their company. Proof of fraud requires something more than an officer just being an officer at the company—there must be active engagement in operations that led to the officer's committing fraud or some underlying crime, such as bribery that led to the company problems and loss in value.

Penalty for Crime: Forfeiture

When a defendant is convicted of a crime, the court may also declare that the defendant's rights in any property used or gained from a crime (an instrument of that crime) be confiscated. Some types of instruments of the crime are automatically forfeited, such as the tools of a crime. **For Example**, the U.S. government confiscated from confessed \$50 billion Ponzi schemer, Bernie Madoff, everything from his yacht to his bank accounts

³ *Skilling v. U.S.*, 561 U.S. 538 (2010).

to his seat on NASDAQ. Confiscation is, in effect, an increased penalty for the defendant's crime.

Penalties for Business and White-Collar Crimes

Most common law criminal penalties were created with “natural” persons in mind, as opposed to “artificial” or corporate persons. A \$100,000 fine may be significant to an individual but to a corporation with \$3 billion in assets and hundreds of millions in income, such a fine could be viewed as a minimal cost of doing business.

As a result of these fine amount realities, corporate penalties and processes have been reformed. Congress, prosecutors, and the courts are in continual processes of developing penalties for corporations and white-collar crimes so that the result is both a deterrent effect as well as changes in cultures of corporations to prevent additional violations.

Computing New Penalties for Corporations. Criminal penalties have been increased to allow judges to fine corporations according to how much a bad decision would cost. Rather than using fixed-amount fines for corporations, statutes and courts apply percentage of income, revenue, or profits penalties. **For Example**, a bad decision on a product line would cost a company 10 to 20 percent of its earnings. A criminal penalty could be imposed using that type of computation for the knowing sale of a defective product in this same percentage fashion with the idea that the company simply made a bad legal decision that should be reflected by an imposed earnings.

Corporate Integrity Agreements. Using a corporate integrity agreement (CIA), judges are able to, in effect, place corporations on probation. Under CIAs, companies are assigned monitors who are on-site and follow up to be sure the company is not committing any further violations. **For Example**, because of environmental law violations, ConEd was assigned a monitor from the National Resources Defense Council to observe the company's activities. Likewise, Apple has a monitor to prevent antitrust violations as a result of its civil charges of noncompetitive behavior. CIAs do not require an admission of guilt but generally require the payment of a fine and an agreement to “stay clean” for three to five years.

Federal Sentencing Guidelines. Another change in penalties for business and white-collar crimes has been the requirement for mandatory prison sentences for officers and directors who are convicted of crimes committed as they led their corporations. The human element of the corporation is then punished for the crimes that the business committed. The U.S. Sentencing Commission, established by Congress in 1984, has developed both federal sentencing guidelines and a carrot-and-stick approach to fighting business crime. If the managers of a company are involved and working to prevent criminal misconduct in the company and a crime occurs, the guidelines permit sentence reductions for the managers' efforts. If the managers do not adequately supervise conduct and do not encourage compliance with the law, the guidelines require judges to impose harsher sentences and fines. The guidelines, referred to as the **Federal Sentencing Guidelines** (or the *U.S. Sentencing Guidelines*), apply to federal crimes such as securities fraud, antitrust violations, racketeering, theft (embezzlement), Medicare fraud, and other business crimes. The sentencing guidelines permit a judge to place a guilty company on probation, with the length of the probation controlled by whether the company had prevention programs in place.

Officer and Executive Banishment from Business Fields. One of the rapidly increasing forms of business crime punishment is barring executives and officers from working in their fields if they have a criminal conviction. **For Example**, the SEC can bar those who are

Federal Sentencing Guidelines—federal standards used by judges in determining mandatory sentence terms for those convicted of federal crimes.

convicted from the securities industry for a period of years or even for life (as in the case of junk bond king Michael Milken). In the health care field, federal agencies use the “responsible corporate officer” (RCO) doctrine to hold those who head up companies criminally responsible when their hospitals submit false Medicare claims or their drug firms misbrand prescription drugs. In addition to criminal sanctions for RCOs, agencies prosecuting the health care cases also seek to have the RCOs barred from the health care industry for periods that range from one year to life, with the typical time being 12 to 20 years.

Mandatory Sentences for Officers of Corporations Who Mastermind Crimes. The increased corporate and white-collar criminal penalties enacted under Sarbanes-Oxley (SOX) (see the next section for more discussion of SOX) also allow judges to consider the seriousness of the offense, the company’s history of violations, its cooperation in the investigation, the effectiveness of its compliance program (often called an *ethics program*), and the role of senior management in the wrongdoing in determining fines and sentences. Corporate managers found to have masterminded any criminal activity must be sentenced to prison time.⁴ Figure 7-1 is a summary of the current penalties for federal crimes. Under a U.S. Supreme Court decision, *U.S. v. Booker*, judges may only use the guidelines as just

FIGURE 7-1 Roster of White-Collar Criminal Charges

COMPANY/PERSON	ISSUE	STATUS
Boeing (2003)	Charges of illicit use of competitor’s proprietary documents; charges of recruiting government official	Loss of 7 government contracts worth \$250 million; \$615 million fine; guilty plea by official who was wooed; 9-month sentence for that official
Countrywide Mortgage (2009)	Insider trading; securities fraud	Former CEO Angelo Mozilo charged with insider trading, CFO and COO charged with failure to disclose firm’s relaxed lending standards; settled case for fines
Andrew Fastow, former CFO of Enron (2004)	Multimillion-dollar earnings from serving as principal in SPEs (special purpose entities) of Enron created to keep debts off the company books	Entered guilty plea to securities and wire fraud; sentenced to 6 years; helping plaintiffs in shareholder suits
Jeffrey Skilling, former CEO of Enron (2004)	Questions about his role in the Enron fraud; resigned just prior to company’s collapse	Found guilty of securities fraud and sentenced to 24.4 years; U.S. Supreme Court partially reversed his conviction on honest services fraud; sentence reduced to 14 years
Galleon Group (2011)	Insider trading charges related to hedge fund’s operations	23 executives, including the CEO, convicted or entered guilty pleas; Galleon’s \$3.7 billion fund liquidated; CEO (Raj Rajaratnam) sentenced to 11 years; a Goldman Sachs director (Rajat Gupta) also convicted of insider trading and sentenced to 2 years in prison for feeding information to Rajaratnam
HealthSouth (2003)	\$2.7 billion accounting fraud; overstatement of revenues	16 former executives indicted; 5 guilty pleas

⁴ *U.S. v. Booker*, 543 U.S. 220 (2005).

FIGURE 7-1 Roster of White-Collar Criminal Charges (continued)

COMPANY/PERSON	ISSUE	STATUS
Richard Scrushy, CEO of HealthSouth (2003)	85 federal felony counts, including violations of Sarbanes-Oxley financial certification provisions	Acquitted of financial fraud charges; found guilty of bribery and sentenced to 7 years
Martha Stewart, CEO of Martha Stewart Omnimedia and close friend of Sam Waksal, CEO of ImClone (2003)	Sold 5,000 shares of ImClone one day before public announcement of negative FDA action on Ebritux	Convicted of making false statements and conspiracy; served 5 months in prison, 5 months of home confinement, and two years of probation; fine of \$30,000
KMPG (2006)	Tax shelter fraud	Settled with federal regulators by payment of \$456 million penalty
Sotheby's (2003)	Price-fixing	Chairman given 1 year and 1 day in prison and a \$7.5 million fine; CEO placed under house arrest for 1 year
WorldCom (2003)	Accounting issues centered on swaps—selling to other telecommunications companies and hiding expenses, thereby overstating revenue	WorldCom emerged from bankruptcy as MCI; 4 officers and managers entered guilty pleas; CEO Bernard Ebbers convicted and sentenced to 25 years
Bernie Madoff (2009)	\$50 billion Ponzi scheme	Entered guilty plea to all charges; sentenced to 150 years (was 71 years old at time of sentencing); direct reports convicted
BP (2012)	Violation of Clean Air Act; willful failure to correct OSHA violations; manslaughter and obstruction	\$50 million fine to EPA; \$58 million fine to OSHA (largest in U.S. history) for pre-Deepwater Horizon explosion; \$4 billion for crimes related to Deepwater Horizon explosion; \$18 billion to settle suits
Stanford Securities (2012)	\$9 billion Ponzi scheme	CEO convicted of mail, wire, and securities fraud and sentenced to 110 years; Laura Pendergest-Holt, the former chief investment officer, entered a guilty plea and was sentenced to 3 years; CFO entered a guilty plea
Massey Coal (2012)	Mine collapse resulting in the deaths of 29 miners	Three company officials entered guilty pleas and one was convicted of charges related to tipping off employees on mine inspections and destroying records to avoid government review; former CEO under indictment
Peanut Corporation of America (2013)	Indictments for producing and selling product without cleaning up salmonella issue at plant; falsifying tests that showed the salmonella was gone when it was not	Four company officers, including owner and CEO, convicted of criminal fraud and conspiracy
SAC Capital	Charges of insider trading; use of information from doctors about drug trial on new pharmaceuticals	Settled charges for \$600 billion fine; 11 current and former employees convicted or entered guilty pleas

White-Collar Crime Penalty Enhancement Act of 2002—federal reforms passed as a result of the collapses of companies such as Enron; provides for longer sentences and higher fines for both executives and companies.

that, guidelines; the sentencing ranges are no longer mandatory for judges.⁵ Going outside those ranges, however, is carefully reviewed by appellate courts.⁶ Federal judges can consider evidence of prior convictions, but only if that evidence was presented at trial or if the defendant has a chance to present evidence about those convictions at the sentencing.⁷

Sarbanes-Oxley Reforms to Criminal Penalties. Part of SOX, passed by Congress following the collapses of Enron and WorldCom corporations, was the **White-Collar Crime Penalty Enhancement Act of 2002**.⁸ This act increases penalties substantially. **For Example**, the penalties for mail and wire fraud are increased from a maximum of 5 years to a maximum of 20 years. Penalties for violation of pension laws increased from 1 year to 10 years and the fines increased from \$5,000 to \$100,000.⁹ In addition, many federal statutes now require executives to reimburse their companies for any money earned as a result of illegal activity. **For Example**, the former CEO of UnitedHealth Group Inc. was required to pay back \$448 billion in profits he had made from stock options that were granted illegally.¹⁰



THINKING THINGS THROUGH

Can a Pharmacy's License Be Revoked for Too Many Cash Sales of Oxycodone?

The Drug Enforcement Administration (DEA) has moved to revoke the controlled medication licenses of two pharmacies because the pharmacies were filling prescriptions for oxycodone (the painkiller) in excess of their monthly allowances for controlled substances. In addition, the DEA alleges that the pharmacies' corporate entities failed to conduct on-site inspections and failed to notice that 42 to 58 percent of all the sales of the substances were cash sales, something that is considered a red flag in the sale and distribution of controlled substances. In addition, the number of prescriptions filled continued to escalate.

The two pharmacies won an injunction against the revocation in federal district court. However, the DEA is hoping to persuade the judge to lift the injunction once it is able to show that the corporations should have known there was a problem. The rate of cash sales at these pharmacies was eight times the national rate for filling prescriptions with cash. Pharmacists at the drug stores, in interviews with the DEA agents, indicated that the customers paying cash for the oxycodone were "shady," and that they suspected that some of the prescriptions were not legitimate. One of the companies adjusted

(increased) the levels of shipment of oxycodone to the pharmacies five times. In one on-site visit by a DEA agent, the following information emerged: one of every three cars that came to the drive-thru window had a prescription for oxycodone; many patients living at the same address had the same prescriptions for oxycodone from the same doctor.

Both companies, CVS and Cardinal Health, have indicated in court filings that they have changed their practices and provided training to pharmacy personnel so that they can spot these types of illegal prescriptions and report suspicious activity. Both pharmacy companies have terminated customers, meaning that they will no longer fill prescriptions for those customers.

The DEA seeks to hold the corporations responsible because of the lack of on-site presence and the failure to follow the numbers for sales and distribution at the pharmacies. Can the corporation be held liable when it was not actually participating in the distribution of the oxycodone?

Source: Timothy W. Martin and Devlin Barrett, "Red Flags Ignored, DEA Says," *Wall Street Journal*, February 21, 2012. p. B1.

⁵ *U.S. v. Skilling*, 554 F.3d 529 (5th Cir. 2009).

⁶ *Gall v. U.S.*, 552 U.S. 38 (2007).

⁷ Miriam H. Baer, "Choosing Punishment," 92 *Boston Univ. Law Rev.* 577 (2010).

⁸ 18 U.S.C. §1314 *et seq.*

⁹ 18 U.S.C. §§1341 and 1343; 29 U.S.C. §1131.

¹⁰ S. Almashat et al., "Rapidly Increasing Criminal and Civil Monetary Penalties Against the Pharmaceutical Industry: 1991 to 2010," *Public Citizen's Health Research Group*, December 16, 2010, available at <http://www.citizen.org/hrg1924>.



ETHICS & THE LAW

When Addictions Are Off and On Again

In 1994, Congress passed a law that permitted nonviolent convicts to reduce their sentences by up to 12 months if they completed a drug-rehab/counseling program. When the program was first created, 3,755 inmates entered the program. In 2008, 18,000 federal prisoners were in the program and there was a waiting list of 7,000 inmates.

Dr. Sam Waksal, the former CEO of ImClone, served nine fewer months than his original seven-year sentence because he participated in a prison rehab program for inmates who have a problem with substance abuse. However, when Dr. Waksal was interviewed for the presentencing report, he told the probation officer that he was a “social drinker” and had perhaps five glasses of wine per week. One month after the interview with the probation officer, Waksal’s lawyers informed a federal judge that Waksal now had a “dependence on alcohol” and requested approval for Waksal’s entry into a prison rehab program.

The former mayor of Atlanta, Bill Campbell, was admitted into a federal rehab program and, as a result, got a 9-month reduction on his 30-month sentence for tax evasion. He was admitted to rehab despite the fact that his lawyers argued at his sentencing hearing that he had no substance abuse problem and that he hated the taste of alcohol, therefore urging the judge to conclude that Campbell’s imprisonment was not necessary.

The Bureau of Prisons indicates that it is cracking down on admissions to the program, looking more closely at doctors’ letters and past histories of the inmates.

Evaluate the ethics of the inmates who feign addiction. Evaluate the ethics of the consulting firms that help them get into the program.

Source: Kai Falkenberg, “Time Off for Bad Behavior,” *Forbes*, January 12, 2009, pp. 64–65.

Creative Penalties for White-Collar Crime. Federal judges are developing new types of sentences in order to use those convicted to convince businesspeople to avoid criminal conduct. **For Example**, in 2009, a federal judge required an executive who entered a guilty plea to spend his two years of probation writing a book about what he did and offer guidance to business executives so that they can avoid his missteps. He was required to publish and distribute the book.¹¹ In 2010, a federal agency agreed to defer penalties if an officer agreed to travel around the country and speak to companies and executives about the mistakes he had made in order to help them understand the need for vigilance in stopping missteps that lead to crimes.

7-1d Indemnification of Crime Victims

Penalties are paid to the government. Typically, the victim of a crime does not benefit from the criminal prosecution and conviction of the wrongdoer, although courts can order that restitution be paid to victims.

The Victims of Crime Act of 1984 creates a federal Crime Victims Fund.¹² Using the fines paid into the federal courts as well as other monies, the federal government makes grants to the states to assist them in financing programs to provide assistance for victims of crime.¹³ The Victim and Witness Protection Act of 1982 authorizes the sentencing judge in a federal district court to order, in certain cases, that the defendant make restitution (restoration) to the victim or pay the victim the amount of medical expenses or loss of income caused by the crime.¹⁴

¹¹ Natasha Singer, “Judge Orders Former Bristol-Myers Executive to Write Book,” *New York Times*, June 9, 2009, p. B3.

¹² 18 U.S.C. §3771. The act was amended in 2004 to include a type of bill of rights for crime victims, including assistance through the newly created Office for Victims of Crime.

¹³ 18 U.S.C. §1401 *et seq.*

¹⁴ 18 U.S.C. §3579, as amended by 18 U.S.C. §18.18; see *Hughey v. United States*, 495 U.S. 411 (1990). In 2002, Congress passed another victims’ compensation statute, with this one providing relief and assistance to the victims of terrorist attacks in the United States. 42 U.S.C. §10603b.

white-collar crimes—crimes that do not use nor threaten to use force or violence or do not cause injury to persons or property.

conspiracy—agreement between two or more persons to commit an unlawful act.

Racketeer Influenced and Corrupt Organizations (RICO) Act—federal law, initially targeting organized crime that has expanded in scope and provides penalties and civil recovery for multiple criminal offenses, or a pattern of racketeering.

7-2 White-Collar Crimes

White-collar crime is generally considered business crime, the type committed generally in the course of doing business and usually involving some form of deceit used to get gains.

7-2a Conspiracies

The crime of conspiracy is committed before the actual crime; it is the planning of the crime. A **conspiracy** is an agreement between two or more persons to commit an unlawful act or to use unlawful means to achieve an otherwise lawful result. Some conspiracy statutes do require that those charged must have done something to carry out the agreement before the crime of conspiracy is committed. Almost all white-collar criminal charges involve a count of conspiracy, something that results from the fact that individuals work together in corporations to accomplish frauds.

7-2b Money Laundering

The federal government has adopted a Money Laundering Control Act (MLCA).¹⁵ The act prohibits the knowing and willful participation in a financial transaction when the transaction is designed to conceal or disguise the source of the funds. The so-called *USA Patriot Act* that was passed on October 26, 2001, less than two months after the destruction of the World Trade Center and the damage to the Pentagon on September 11, 2001, includes a substantial number of changes and amendments to the MLCA and the Bank Secrecy Act (BSA).¹⁶ Both statutes have been used as means to control bribery, tax evasion, and money laundering. Their changes and amendments were designed to curb the funding of terrorist activities in the United States.

The Patriot Act expands the coverage of the law from banks and financial institutions to anyone involved in financial transactions, which includes securities brokers; travel agents; those who close real estate transactions; insurance companies; loan or finance companies; casinos; currency exchanges; check-cashing firms; auto, plane, and boat dealers; and branches and agencies of foreign banks located in the United States. The amendments make even small businesses subject to the requirements of disclosure under MLCA and BSA, such as reporting cash transactions in excess of \$10,000.

In addition, the types of accounts covered have been expanded. The accounts covered are not only securities accounts but also money market accounts. Furthermore, banks are now more actively involved in supervising accounts and following through on government information furnished to the bank on suspicious transactions and activities as well as individuals. Banks are required to implement new policies to prevent the types of transactions tagged by the government and conduct internal investigations for suspicious transactions. Because of the required close-watch provisions of these laws, banks and others covered under the federal statutes have developed anti-money-laundering programs. These programs must include a “Know Your Customer” training segment that teaches employees how to spot suspicious customers and transactions.

7-2c Racketeering

Congress passed the **Racketeer Influenced and Corrupt Organizations (RICO) Act**¹⁷ in 1970 as part of the Organized Crime Control Act. The law was designed primarily to

¹⁵ 18 U.S.C. §§1956–1957 (2000). *U.S. v. Prince*, 214 F.3d 740 (6th Cir. 2000).

¹⁶ 31 U.S.C. §531(h).

¹⁷ 18 U.S.C. §§1961–1968.

prevent individuals involved in organized crime from investing money obtained through racketeering in legitimate businesses. However, the broad language of the act, coupled with a provision that allows individuals and businesses to sue for treble damages, has resulted in an increasing number of lawsuits against ordinary business persons not associated with organized crime.

Criminal and Civil Applications

RICO authorizes criminal and civil actions against persons who use any income derived from racketeering activity to invest in, control, or conduct an enterprise through a pattern of *racketeering activity*.¹⁸ In criminal and civil actions under RICO, a pattern of racketeering activity must be established by proving that at least two acts of racketeering activity—so-called *predicate acts*—have been committed within 10 years.¹⁹ For example, the former Atlanta Public Schools administrators and teachers who were involved in the cheating scandal on the state’s standardized tests were convicted of racketeering because they had engaged in fraud to obtain bonuses. Conviction under RICO’s criminal provisions may result in a \$25,000 fine and up to 20 years’ imprisonment as well as forfeiture of the property involved. A successful civil plaintiff may recover three times the actual damages suffered and attorney fees.²⁰

Expanding Usage

Civil RICO actions have been successful against business entities, such as accounting firms, labor unions, insurance companies, commercial banks, and stock brokerage firms. However, under the Private Securities Litigation Reform Act of 1995, securities fraud was eliminated as a **predicate act**, or a qualifying underlying offense, for private RICO actions, absent a prior criminal conviction.²¹

predicate act—qualifying underlying offense for RICO liability.

7-2d Bribery

Bribery is the act of giving money, property, or any benefit to a particular person to influence that person’s judgment in favor of the giver.²² At common law, the crime was limited to doing such acts to influence a public official.

The giving and the receiving of a bribe constitute separate crimes. In addition, the act of trying to obtain a bribe may be a crime of solicitation of bribery in some states, while in other states bribery is broadly defined to include solicitation of bribes.

¹⁸ §1961. Definitions:

(1) “Racketeering activity” means any act or threat involving murder, kidnapping, gambling, arson, robbery, bribery, extortion, dealing in obscene matter, dealing in a controlled substance or listed chemical, or sports bribery; counterfeiting; theft from interstate shipment; embezzlement from pension and welfare funds; extortionate credit transactions; fraud; wire fraud; mail fraud; procurement of citizenship or nationalization unlawfully; reproduction of naturalization or citizenship papers; obstruction of justice; tampering with a witness, victim, or an informant; retaliating against a witness, victim, or an informant; false statement in application and use of passport; forgery or false use of passport; fraud and misuse of visas, permits, and other documents; racketeering; unlawful welfare fund payments; laundering of monetary instruments; use of interstate commerce facilities in the commission of murder-for-hire; sexual exploitation of children; interstate transportation of stolen motor vehicles; interstate transportation of stolen property; trafficking in counterfeit labels of phonorecords, computer programs or computer program documentation, or packaging and copies of motion pictures or other audiovisual works; criminal infringement of a copyright; trafficking in contraband cigarettes; and white slave traffic.

¹⁹ Brian Slocum, “RICO and the Legislative Supremacy Approach to Federal Criminal Lawmaking,” 31 *Loyola Univ. Chicago Law Journal* 639 (2000).

²⁰ *Criminal RICO: 18 U.S.C. 1961–1968: A Manual for Federal Prosecutors*. Washington, D.C.: U.S. Dept. of Justice, Criminal Division, Organized Crime and Racketeering Section [2013].

²¹ 15 U.S.C. §78(a), (n)–(t).

²² In re *Mangone*, 923 N.Y.S.2d 679 (2011).

7-2e Commercial Bribery

Commercial bribery is a form of bribery in which an agent for another is paid or given something of value in order to make a decision on behalf of his or her principal that benefits the party paying the agent. **For Example**, a napkin supplier who pays a restaurant agent \$500 in exchange for that agent's decision to award the restaurant's napkin contract to that supplier has engaged in commercial bribery.²³

7-2f Extortion and Blackmail

Extortion and *blackmail* are crimes in which money is exchanged for either specific actions or restraint in taking action.

Extortion

extortion—illegal demand by a public officer acting with apparent authority.

When a public officer makes an illegal demand, the officer has committed the crime of **extortion**. **For Example**, if a health inspector threatens to close down a restaurant on a false sanitation law charge unless the restaurant pays the inspector a sum of money, the inspector has committed extortion. (If the restaurant voluntarily offers the inspector the money to prevent the restaurant from being shut down because of actual violations of the sanitation laws, the crime committed would be bribery.)

Blackmail

blackmail—extortion demands made by a nonpublic official.

In jurisdictions where extortion is limited to the conduct of public officials, a nonofficial commits **blackmail** by making demands that would be extortion if made by a public official. Ordinarily, blackmail is the act of threatening someone with publicity about a matter that would damage the victim's personal or business reputation.

7-2g Corrupt Influence

Legislative bodies have increasingly outlawed certain practices that exert a corrupting influence on business transactions.

Improper Political Influence

At the federal and state levels, it is a crime for one who holds public office to hold a financial interest in or to receive money from an enterprise that seeks to do business with the government. Such conduct is a conflict of interest between the official's duty to citizens and his or her personal financial interests. **For Example**, the former governor of Illinois, Rod Blagojevich, was convicted of seeking funds, fundraisers, and positions in exchange for political favors. To keep officials' conduct transparent, lobbyists must register in Washington, D.C.,²⁴ and adhere to statutory limits on gifts and contributions to political campaigns. Public officials must file annual disclosure forms about their financial positions as well as provide a disclosure of all gifts and their value.

²³ Connecticut's commercial bribery statute is a good example. It provides: *A person is guilty of commercial bribery when he confers, or agrees to confer, any benefit upon any employee, agent or fiduciary without the consent of the latter's employer or principal, with intent to influence his conduct in relation to his employer's or principal's affairs.* CGSA §53a-160 (2014). Other examples of commercial bribery statutes can be found at Minn. Stat Ann §609.86 (Minnesota 2014); NH Rev Stat §638:8 (New Hampshire 2014); Alaska Stat §11.45.670 (Alaska 2014); and Ala. Code §13A-11-120 (Alabama 2014). Mississippi prohibits commercial bribery as well as sports bribery, which is paying the agent of a sports team in order to influence the outcome of a sporting event. Miss. Code Ann §97-9-10 (2014).

²⁴ Foreign Agents Registration Act, 22 U.S.C. §611 *et seq.*, as amended.

Foreign Corrupt Practices Act (FCPA)—federal law that makes it a felony to influence decision makers in other countries for the purpose of obtaining business, such as contracts for sales and services; also imposes financial reporting requirements on certain U.S. corporations.

forgery—fraudulently making or altering an instrument that apparently creates or alters a legal liability of another.

uttering—crime of issuing or delivering a forged instrument to another person.

Foreign Corrupt Practices Act

The **Foreign Corrupt Practices Act (FCPA)** is a federal criminal statute that applies to businesses whose principal offices are in the United States; it is an antibribery and anticorruption statute covering these companies' international operations.²⁵ There is additional information on the FCPA in Chapter 10.

7-2h Counterfeiting

Counterfeiting is making, with fraudulent intent, a document or coin that appears to be genuine but is not because the person making it did not have the authority to make it. It is a federal crime to make, to possess with intent to transfer, or to transfer counterfeit coins, bank notes, or obligations or other securities of the United States. Various states also have statutes prohibiting the making and passing of counterfeit coins and bank notes. These statutes often provide, as does the federal statute, a punishment for the mutilation of bank notes or the lightening (of the weight) or mutilation of coins.

7-2i Forgery

Forgery consists of the fraudulent making or material altering of an instrument, such as a check, that attempts to create or changes a legal liability of another person.²⁶ Ordinarily, **forgery** consists of signing another's name with intent to defraud, but it may also consist of making an entire instrument or altering an existing one. It may also result from signing a fictitious name or using the identity of another in order to obtain funds or property. In lay language we talk about "identity theft," but it is a form of forgery because they are placing someone else's name and signature on documents.²⁷

The issuing or delivery of a forged instrument to another person constitutes the crime of **uttering** a forged instrument. Sending a forged check through the channels of commerce or of bank collection constitutes an uttering of a forged instrument. The act of depositing a forged check into the forger's bank account by depositing it in an automatic teller machine constitutes uttering within the meaning of a forgery statute.²⁸

7-2j Perjury

Perjury consists of knowingly giving false testimony in a judicial proceeding after having been sworn to tell the truth. Knowingly making false answers on any form filed with a government typically constitutes perjury or is subjected to the same punishment as perjury. In some jurisdictions, the false answers given in a situation other than in court or the litigation process is called the crime of *false swearing*. The penalties for perjury were increased substantially under SOX.

7-2k False Claims and Pretenses

Many statutes make it a crime to submit false claims or to obtain goods by false pretenses.

²⁵ 15 U.S.C. §78dd-1 *et seq.*

²⁶ Using another person's ID to obtain property or funds is a form of forgery. *Warlick v. State*, 330 P.3d 946 (Alas. App. 2014).

²⁷ *People v. Lloyd*, 987 N.Y.S.2d 672 (2014) (where defendants used stolen drivers' licenses and checks to forge checks and cash them).

²⁸ *Warren v. State*, 711 S.E.2d 108 (Ga. App. 2011).

False Claims

The federal false statement statute makes it a crime to knowingly and willfully make a false material statement about any matter within the jurisdiction of any department or agency of the United States. **For Example**, it is a crime to make false statements about income and assets on a student's application for federal financial aid.



SPORTS & ENTERTAINMENT LAW

Cycling Through Federal Funds

After cyclist Lance Armstrong admitted to doping during his cycling career, he was stripped of his seven Tour de France titles. However, the private punishment and disgrace pale in comparison to the action that the federal government is taking. The Justice Department has filed suit to collect from Mr. Armstrong the \$40 million that the U.S. Postal Service paid to Mr. Armstrong's team during his career in exchange for the advertising and endorsements the USPS received. One-half of

that money went to Mr. Armstrong. The suit alleges that the USPS was deceived into paying the money because Mr. Armstrong represented to the USPS that he was following the rules of cycling's governing bodies that prohibit the use of performance enhancing drugs.

A guilty verdict would mean that Mr. Armstrong would have to pay the USPS treble damages—the remedy afforded under the federal False Claims Act.

Obtaining Goods by False Pretenses

Almost all states have statutes that forbid obtaining money or goods under false pretenses.²⁹ An intent to defraud is an essential element of obtaining property by false pretenses.³⁰

Examples of false pretense include delivering a check knowing that there is insufficient money in the bank account to cover the check.³¹ False representations as to future profits in a business are also forms of false pretenses. Failing to perform on a contract is not a false pretense crime unless the contract had been entered into with the intent of not performing it.³²

False Information Submitted to Banks

Knowingly making false statements in a loan application to a federally insured bank is a federal crime.³³ It is also a crime for a landowner to put a false value on land transferred to a bank as security for a loan.³⁴ **For Example**, many of the initial criminal charges in the subprime mortgage market collapse have involved mortgage brokers and appraisers who misrepresented property value or applicants' income in their mortgage applications for federally insured loans.

7-2| Bad Checks

Under a bad check statute, it is a crime to use or pass a check with the intent to defraud with the knowledge that there are insufficient funds in the bank to pay the check when it is presented for payment. Knowledge that the bad check will not be paid when presented

²⁹ *People v. Hussain*, 179 Cal. Rptr. 3d 679 (Cal. App. 2014).

³⁰ *U.S. v. Swisher*, 14 Cal. Daily Op. Serv. 12,314 (9th Cir. 2014)—wearing military uniform without actually having served in the military in order to obtain benefits was false pretense.

³¹ *U.S. v. Tudeme*, 457 F.3d 577 (Fed. App. 2006).

³² *Higginbotham v. State*, 356 S.W.3d 584 (Tex. App. 2011) and *People v. Headley*, 951 N.Y.S.2d 317 (2012).

³³ 18 U.S.C. §1014. See *U.S. v. Luis*, 765 F.3d 1061 (9th Cir. 2014).

³⁴ *U.S. v. Rizk*, 660 F.3d 1125 (9th Cir. 2011).

to the bank is an essential element of the crime. The bad check statutes typically provide that if the check is not made good within a specified number of days after payment by the bank is refused, it is presumed that the defendant acted with the intent to defraud.³⁵ For more information on checks, see Chapters 27 and 30.

7-2m Credit Card Crimes

It is a crime to steal a credit card and, in some states, to possess the credit card of another person without that person's consent. Using a credit card without the permission of the card owner is the crime of obtaining goods or services by false pretenses or with the intent to defraud. Likewise, a person who continues to use a credit card with the knowledge that it has been canceled is guilty of the crime of obtaining goods by false pretenses. Federal law also makes it a crime to use counterfeit credit cards for purposes of obtaining goods, services, or cash. The statute now covers the use of credit card numbers on the Internet in order to obtain goods and services.³⁶

7-2n Embezzlement

embezzlement—statutory offense consisting of the unlawful conversion of property entrusted to the wrongdoer.

Embezzlement is the fraudulent conversion of another's property or money by a person to whom it has been entrusted.³⁷ Employees who take or sell their employer's property or funds for personal use have committed the crime of embezzlement. An agent employee commits embezzlement when he receives and keeps payments from third persons—payments the agent should have turned over to the principal. **For Example**, when an insured gives money to an insurance agent to pay the insurance company but the insurance agent uses the money to pay premiums on the policies of other persons, the agent is guilty of embezzlement. Generally, the intent to return the property or money embezzled or eventually actually returning it, is no defense.

7-2o Obstruction of Justice: Sarbanes-Oxley (SOX)

Another SOX provision clarifies what constitutes obstruction of justice and increases the penalties for such an act. The new section makes it a felony for anyone, including company employees, auditors, attorneys, and consultants,

*to alter, destroy, mutilate, conceal, cover up, falsify or make a false entry with the "intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States."*³⁸

The statute goes on to address audit records specifically and requires auditors to retain their work papers related to a client's audit for at least five years. Any destruction of documents prior to that time constitutes a felony and carries a penalty of up to 20 years. The statute was passed in response to the conduct of Arthur Andersen, the audit firm for the collapsed Enron Corporation. Many of the firm's audit papers on Enron were destroyed, but the firm and partner-in-charge escaped criminal liability because the government could not establish that the senior managers in Andersen were aware of the shredding.³⁹

³⁵ *McMillan v. First Nat. Bank of Berwick*, 978 A.2d 370 (Pa. Super. 2009).

³⁶ 18 U.S.C. §1029. Fines for credit card fraud have been increased to between \$50,000 and \$100,000 per offense.

³⁷ *State v. Henry*, 73 So. 3d 958 (La. App. 2011); *Stern v. Epps*, 464 Fed. Appx. 388 (5th Cir. 2012).

³⁸ 18 U.S.C. §1519. *U.S. v. Hunt*, 526 F.3d 739 (11th Cir. 2008).

³⁹ *Arthur Andersen LLP v. U.S.*, 544 U.S. 696 (2005). The obstruction conviction of the firm was reversed because of insufficient proof of the firm's actual knowledge of document destruction.

7-2p Corporate Fraud: SOX

SOX also created a new form of mail and wire fraud. Ordinarily, mail or wire fraud consists of the use of the mail or telephones for purposes of defrauding someone of money and/or property. However, the SOX form of mail or wire fraud is based on new requirements imposed on corporate officers to certify their financial statements when they are issued. If a corporate officer fails to comply with all requirements for financial statement certification or certifies financial statements that contain false material information, the officer and company have committed corporate fraud with penalties that range from fines of \$1,000,000 and/or 10 years to \$5,000,000 and/or 20 years for willful violation of the certification requirements.

7-2q The Common Law Crimes

In contrast to white-collar crimes, *common law crimes* are crimes that involve the use of force or the threat of force or cause injury to persons or damage to property. The following sections discuss crimes of force and crimes against property that affect businesses.

Larceny

Larceny is the wrongful or fraudulent taking of the personal property of another by any person with fraudulent intent. Shoplifting is a common form of larceny. In many states, shoplifting is made a separate crime. In some states, all forms of larceny and robbery are consolidated into a statutory crime of theft. At common law, there was no crime known as theft.

Robbery

Robbery is the taking of personal property from the presence of the victim by use of force or fear. Most states have aggravated forms of robbery, such as robbery with a deadly weapon. Snatching a necklace from the neck of the victim involves sufficient force to constitute robbery. When the unlawful taking is not by force or fear, as when the victim does not know that the property is being taken, the offense is larceny, but it cannot be robbery.

Some statutes may be aimed at a particular kind of robbery. **For Example**, carjacking is a federal crime under the Anti-Car Theft Act of 1992.⁴⁰

Burglary

At common law, *burglary* was the breaking and entering during the night into the dwelling house of another with the intent to commit a felony. Inserting the automatic teller card of another, without their knowledge or permission, into an automatic teller machine set in the wall of the bank may constitute an entry into the bank for the purpose of committing burglary.⁴¹ Some states word their burglary *statutes*, however, so that there is no burglary in this automatic teller case. This act would be covered by other criminal statutes.

Modern statutes have eliminated many of the elements of the common law definition so that under some statutes it is now immaterial when or whether there was an entry to commit a felony. The elements of breaking and entering are frequently omitted. Under some statutes, the offense is aggravated and the penalty is increased, depending on the

⁴⁰ 18 U.S.C. §2119. See *U.S. v. Runyon*, 707 F.3d 475 (4th Cir. 2013).

⁴¹ *People v. Cardwell*, 137 Cal. Rptr. 3d 525 (2012).

place where the offense was committed, such as a bank building, freight car, or warehouse. Related statutory offenses, such as the crime of possessing burglars' tools, have been created.

Arson

At common law, *arson* was the willful and malicious burning of another's dwelling. The law was originally designed to protect human life, although arson has been committed just with the burning of the building even if no one is actually hurt. In most states, arson is a felony, so if someone is killed in the resulting fire, the offense is considered a felony-murder. Under the felony-murder rule, homicide, however unintended, occurring in the commission of a felony is automatically classified as murder. Virtually every state has created a special offense of burning to defraud an insurer.

Riots and Civil Disorders

Damage to property in the course of a riot or civil disorder is ordinarily covered by other types of crimes such as the crime of larceny or arson. In addition, the act of assembling as a riotous mob and engaging in civil disorders is generally some form of crime in itself under either common law concepts of disturbing the peace or modern antiriot statutes, even without destruction or theft of property. However, statutes on civil disorders must be carefully drawn to avoid infringing on constitutionally protected free speech.

7-3 Criminal Law and the Computer

In some situations, ordinary crimes cover computer crime situations. In other situations, new criminal law statutes are required.

7-3a What Is a Computer Crime?

computer crimes—
wrongs committed using
a computer or with
knowledge of computers.

Generally, the term **computer crime** is used to refer to a crime that can be committed only by a person having some knowledge of the operation of a computer. Just as stealing an automobile requires knowledge of how to operate and drive a car, so the typical computer crime requires the knowledge of how the computer works.

Because the more serious and costly wrongs relating to computers do not fit into the ordinary definitions of crime, there are now computer-specific criminal statutes: Computer crimes can be committed against the computer, using the computer, or through the computer.

7-3b The Computer as Victim

A traditional crime may be committed by stealing or intentionally damaging a computer.

Theft of Hardware

When a computer itself is stolen, the ordinary law relating to theft crimes should apply. Theft of a computer is subject to the same law as the theft of a truck or a desk.

Theft of Software

When a thief takes software, whether in the form of a program written on paper or a program on a disk or memory stick, something has been taken, but it is not tangible property as larceny requires. Virtually every state makes stealing software a crime.

Intentional Damage

The computer may be the “victim” of a crime when it is intentionally destroyed or harmed. In the most elementary form of damage, the computer could be harmed if it was smashed with an ax or destroyed in an explosion or a fire. In such cases, the purpose of the intentional damage is to cause the computer’s owner the financial loss of the computer and the destruction of the information that is stored in it.

Intentional damage can result from more subtle means. Gaining access to the computer and then erasing or altering the data is also the crime of intentional damage. Likewise, interfering with the air conditioning so computers are damaged or malfunction would also be covered under intentional damage statutes. Planting a bug or virus in the software, causing a program to malfunction or to give incorrect output, is a form of intentional damage. Angry employees, former employees, and competitors have all been convicted of intentional damage.

7-3c Unauthorized Use of Computers

The unlawful use of a computer belonging to someone else is also a crime in some states. There are specific statutes at the state and federal levels that make it unlawful to use government computers without permission. One of the issues that is critical in criminal prosecution is whether the use was, in fact, “unauthorized.” With Wi-Fi networks, the ease of access and openness has proven to be a challenge in prosecution for unauthorized use.⁴² The key to prosecution in misuse of computer cases is proof that the access was not authorized.

CASE SUMMARY

Rifling Through Videos on Your Fellow Officers

FACTS: Sergeant Kenneth Riley used videos of a fellow officer, not for training purposes, but for purposes of getting a fellow officer disciplined. He showed the videos to those within the department who would not have authorization to view them. Riley was indicted for unauthorized use of a computer and unauthorized access and disclosure of computer data. Riley moved to have the indictment dismissed.

DECISION: Riley’s access and use of computer data did not constitute the crime of unauthorized use of computers. The court held that what Riley did was a violation of workplace policies but did not fit within the criminal conduct intended to be covered by the statute. The judge was concerned about arbitrary definitions and enforcement and a criminal statute being used for retaliatory purposes. [*New Jersey v. Riley*, 988 A.2d 1252 (N.J. 2009)]



7-3d Computer Raiding

Taking information from a computer without the consent of the owner is a crime. Whether theft is accomplished by instructing the computer to make a printout of stored information or by tapping into its data bank by electronic means is not important. In some states, taking information is known as the crime of “computer trespass.”⁴³

⁴²U.S.C. §1030(e)(6); for an article summarizing the issues, see Orin S. Kerr, “Cybercrime’s Scope: Interpreting ‘Access’ and ‘Authorization’ in Computer Misuse Statutes,” 78 *N.Y.U. L. Rev.* 1596, 1632–37 (2003).

⁴³*Washington v. Riley*, 846 P.2d 1365 (Wash. 1993).

Both Congress and state legislatures have adopted statutes that make it a crime to gain unauthorized access to a computer or use information so gained to cause harm to the computer or its rightful user.⁴⁴ Again, the presence of Wi-Fi when there are unsecured users has complicated prosecutions for taking information.

7-3e Diverted Delivery by Computer

In many industries, a computer controls the delivery of goods. The person in charge of that computer or someone unlawfully gaining access to it may cause the computer to direct delivery to an improper place. That is, instead of shipping goods to the customers to whom they should go, the wrongdoer diverts the goods to a different place, where the wrongdoer or a confederate receives them.

Instructing the computer to give false directions can cause this fraudulent diversion of goods. Because the computer allows changes in delivery of goods through a mere keystroke, the depth of diversion cases is great. **For Example**, in one case, several hundred loaded freight cars disappeared. In another case, a loaded oil tanker was diverted to unload into a fleet of tank trucks operated by an accomplice of the computer operator.

Economic Espionage Act (EEA)—federal law that makes it a felony to copy, download, transmit, or in any way transfer proprietary files, documents, and information from a computer to an unauthorized person.

7-3f Economic Espionage by Computer

The **Economic Espionage Act (EEA)** is a federal law⁴⁵ passed in response to several cases in which high-level executives took downloaded proprietary information from their computers to their new employers. The EEA makes it a felony to steal, appropriate, or take a trade secret as well as to copy, duplicate, sketch, draw, photograph, download, upload, alter, destroy, replicate, transmit, deliver, send, mail, or communicate a trade secret. The penalties for EEA violations are up to \$500,000 and 15 years in prison for individuals and \$10 million for organizations. When employees take new positions with another



E-COMMERCE & CYBERLAW

They Were Bullies: Mean Girls in Cyberspace

On May 14, 2008, a federal grand jury indicted Lori Drew, 49, of Missouri, the first of what would become known as the cyber bully. Ms. Drew had created a MySpace site for Josh Evans, a fictitious teen boy she used as a means of getting information from Megan Meier, a 13-year-old girl with whom Ms. Drew's daughter had had a falling-out. Josh pretended to be interested in Megan, but then said that she was "fat" and that the world would be a better place without her. Megan hanged herself within an hour of receiving the final comments from "Josh." Ms. Drew was later charged and convicted of conspiracy and accessing computers without authorization.*

Since the time of that case, there have been a number of similar incidents in which friends, parents, and others harass individuals using the various sites available from Facebook to Instagram. States now have very specific cyberbullying statutes for prosecution. As one expert phrased it, we have to take responsibility for what we post online and the consequences that can stem from hurtful or fearsome comments. There are both civil and criminal statutes that provide curbs for victims. Civil remedies allow for injunctions, and criminal penalties are at a level that allows them to serve as a deterrent for the types of postings that began with the Drew case.

**U.S. v. Lori Drew*, 259 F.R.D. 449 (C.D. Cal. 2009).

⁴⁴The Counterfeit Access Device and Computer Fraud Act of 1984, 18 U.S.C. §1030 *et seq.*; Computer Fraud and Abuse Act of 1986, 18 U.S.C. §1001; Electronic Communications Privacy Act of 1986, 18 U.S.C. §2510; Computer Fraud Act of 1987, 15 U.S.C. §§272, 278, 40 U.S.C. §759; National Information Infrastructure Protection Act, 18 U.S.C. §1030 (protecting confidentiality and integrity on the Internet).

⁴⁵18 U.S.C. §1831.

company, their former employers are permitted to check the departing employees' computer e-mails and hard drives to determine whether the employees have engaged in computer espionage.

7-3g Electronic Fund Transfer Crimes

The Electronic Fund Transfers Act (EFTA)⁴⁶ makes it a crime to use any counterfeit, stolen, or fraudulently obtained card, code, or other device to obtain money or goods in excess of a specified amount through an electronic fund transfer system. The EFTA also makes it a crime to ship in interstate commerce devices or goods so obtained or to knowingly receive goods that have been obtained by means of the fraudulent use of the transfer system.

7-3h Circumventing Copyright Protection Devices Via Computer



The Digital Millennium Copyright Act (DMCA)⁴⁷ makes it a federal offense to circumvent or create programs to circumvent encryption devices that copyright holders place on copyrighted material to prevent unauthorized copying. Circumventing the encryption devices on software or CDs or DVDs is a violation of the DMCA. **For Example**, Dmitry Sklyarov, a Russian computer programmer, was the first person to be charged with a violation of the DMCA. Mr. Sklyarov was arrested in early 2002 at a computer show after giving a speech in Las Vegas at the Defcon convention on his product that he had developed to permit the circumvention of security devices on copyrighted materials. His program unlocked password-protected e-books and PDF files. He gave his speech and was returned to Russia in exchange for his agreement to testify in a case that will determine the constitutionality of DMCA.

The No Electronic Theft Act makes it a federal criminal offense to willfully infringe copyrighted material worth more than \$1,000 using the Internet or other electronic devices even if the infringer does not profit from others' use of the material. **For Example**, sending along copyrighted articles on the Internet to friends, without permission from the site would be a violation even though there is no profit.

7-3i Spamming

Spamming, or the practice of sending out thousands of e-mails at once to many different computer users, is an ever-increasing problem. Congress passed the **Controlling the Assault of Non-Solicited Pornography and Marketing (CAN-SPAM) Act**, which allows private companies to bring suit against spammers for their unauthorized use of Internet Service Providers (ISPs).

For example, in March 2013, security experts said that we experienced what was "the biggest cyberattack in history." At the root of it was a fight over spam. Spamhaus, a Dutch company that fights spam, added Cyberbunker to its so-called blacklist. Spamhaus's blacklist consists of companies e-mail providers use as a screen to weed out spam. Cyberbunker is a Web-hosting service that, by its own description, will host any site except "child porn and anything related to terrorism."⁴⁸ Cyberbunker wants to spam and Spamhaus wants to protect e-mail servers from spam, so there is a war in

Controlling the Assault of Non-Solicited Pornography and Marketing (CAN-SPAM) Act—allows private companies to bring suit against spammers for their unauthorized use of Internet Service Providers (ISPs).

⁴⁶ 15 U.S.C. §1693(n).

⁴⁷ 17 U.S.C. §512 (2010).

⁴⁸ John Markoff and Nicole Perloth, "Dispute on Spam Stirs Big Assault on the Internet," *New York Times*, March 27, 2013, p. A1.

cyberspace. Because of the international nature of these activities, prosecution is difficult, and authorities continue to investigate the combination of spamming and hacking crimes.

7-4 Criminal Procedure Rights for Businesses

The U.S. Constitution guarantees the protection of individual and corporate rights within the criminal justice system.

7-4a Fourth Amendment Rights for Businesses

Search and Seizure: Warrants

Fourth Amendment—privacy protection in the U.S. Constitution; prohibits unauthorized searches and seizures.

search warrant—judicial authorization for a search of property where there is the expectation of privacy.

The **Fourth Amendment** of the U.S. Constitution provides that “the right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated.” This amendment protects individual privacy by preventing unreasonable searches and seizures. Before a government agency can seize the property of individuals or businesses, it must obtain a valid **search warrant** issued by a judge or magistrate, based on probable cause, unless an exception to this warrant requirement applies. In other words, there must be good reason to search the location named. The Fourth Amendment applies equally to individuals and corporations. If an improper search is conducted, evidence obtained during the course of that search may be inadmissible in the criminal proceedings for the resulting criminal charges.⁴⁹

Exceptions to the Warrant Requirement

Exceptions to the warrant requirement are emergencies, such as a burning building, and the “plain-view” exception, which allows law enforcement officials to take any property that anyone can see, for no privacy rights are violated when items and property are left in the open for members of the public to see. **For Example**, you have an expectation of privacy in the garbage in your garbage can when it is in your house. However, once you move that garbage can onto the public sidewalk for pickup, you no longer have the expectation of privacy because you have left your garbage out in plain view of the public. **For Example**, in *Dow Chemical Co. v. United States*, 476 U.S. 1819 (1986), the U.S. Supreme Court held that a company does not have a right of privacy from low-flying planes of its production facilities. Pictures taken from the airplanes of plant operations were not a violation of privacy.

Another exception allows officers to enter when they are needed to give aid because of an ongoing criminal act. **For Example**, officers who are able to see a fight through the windows of a house and resulting injuries can enter to render help. Another exception would be that the person who lives in the property to be searched has given permission for the search.



Privacy and Cyber Space: Access to Our Messages and Files. One of the questions related to privacy is how much of what we post online and put on our computers at work is protected by privacy rights that would require a warrant before law enforcement could examine the content. However, if employers have access to the information on your work computer and e-mails, you do not enjoy the protection of privacy.

⁴⁹ See *Arizona v. Gant*, 556 U.S. 332 (2009) in which the U.S. Supreme Court held that evidence obtained searching the vehicle of a suspect who is handcuffed and locked in a police car cannot be used. A search warrant is needed when the suspect has no access to the evidence to destroy it.

CASE SUMMARY

Shared Drive + Shared Access = NO PRIVACY

FACTS: In February 2003, while serving as a civilian contractor, Michael D. King resided in a dormitory at the Prince Sultan Air Base in Saudi Arabia. During his stay in the dormitory, King kept his personal laptop computer in his room and connected it to the base network. All users of the base network signed agreements indicating that they understood their communications over and use of the base network were subject to monitoring.

An enlisted airman was searching the base network for music files when he came across King's computer on the network. The airman was able to access King's hard drive because it was a "shared" drive. The airman discovered a pornographic movie and text files "of a pornographic nature." The airman reported his discovery to a military investigator, who, in turn, referred the matter to a computer specialist. This specialist located King's computer and hard drive on the base network and verified the presence of pornographic videos and explicit text files on the computer. She also discovered a folder on the hard drive labeled "pedophilia."

Military officials seized King's computer and also found CDs containing child pornography.

Two years later, the government obtained an indictment, charging King with possession of child pornography. After his arrest, the government searched his residence pursuant to a search warrant and found additional CDs and hard drives containing over 30,000 images of child pornography.

King entered a guilty plea and was sentenced to 108 months in prison. King then appealed his conviction on the grounds that there had been an illegal search and seizure of his computer and files.

DECISION: The court held that there was no Fourth Amendment violation because the investigators did not search King's files or computer initially to discover the pornographic materials. They merely had to access the universally accessible files of the military base. King had no expectation of privacy in whatever was posted on the shared drive. The search of his home computer and files in his room was with a warrant that was based on probable cause obtained from public access to the files. [*U.S. v. King*, 509 F.3d 1338 (11th Cir. 2007)]

Business Records and Searches

In many business crimes, the records that prove a crime was committed are not in the hands of the person who committed that crime. Accountants, attorneys, and other third parties may have the business records in their possession. In addition to the Fourth Amendment issues involved in seizing these records (a warrant is still required), there may be protections for the business defendants. The next section covers those protections.

Protections for Privileged Records and Documents

All states recognize an attorney-client privilege, which means that an individual's conversations with her lawyer and the notes of those conversations are not subject to seizure unless the privilege is waived. In many of the prosecutions of companies, the Justice Department has asked companies to waive the attorney-client privilege so that it can have access to information that is then used to find other companies that may have participated in criminal activity.

Some states recognize an accountant-client privilege and other privileges, such as those between priest and parishioner or doctor and patient. A privileged relationship is one in which the records and notes resulting from the contact between individuals cannot be seized even with a warrant (with some exceptions).

7-4b Fifth Amendment Self-Incrimination Rights for Businesses

Self-Incrimination

Fifth Amendment—constitutional protection against self-incrimination; also guarantees due process.

The words “I take the Fifth” are used to invoke the constitutional protections against self-incrimination provided under the **Fifth Amendment** that prevents compelling a person to be a witness against himself. **For Example**, Mark McGwire, the former St. Louis baseball player, invoked the Fifth Amendment in his testimony during congressional hearings on steroid use. **For Example**, Edith O’Brien, an employee at the collapsed investment fund, MF Global, refused to answer questions before Congress, claiming her right against self-incrimination. Lois Lerner, a former administrator with the IRS, took the Fifth Amendment when she was subpoenaed to testify before Congress.

The Fifth Amendment protection applies only to individuals; corporations are not given Fifth Amendment protection. A corporation cannot prevent the disclosure of its books and records on the grounds of self-incrimination. The officers and employees of a corporation can assert the Fifth Amendment, but the records of the corporation belong to the corporation, not to them.

Miranda Rights

Miranda warnings—warnings required to prevent self-incrimination in a criminal matter.

The famous **Miranda warnings** come from a case interpreting the extent of Fifth Amendment rights. In *Miranda v. Arizona*,⁵⁰ the U.S. Supreme Court ruled that certain warnings must be given to persons who face custodial interrogation for the purposes of possible criminal proceedings. The warnings consist of an explanation to individuals that they have the right to remain silent; that if they do speak, anything they say can be used against them; that they have the right to have an attorney present; and that if they cannot afford an attorney, one will be provided for them. Failure to give the *Miranda* warnings means that any statements, including a confession, obtained while the individual was being interrogated cannot be used as evidence against that individual. The prosecution will have to rely on evidence other than the statements made in violation of *Miranda*, if such evidence exists.

7-4c Due Process Rights for Businesses

due process—the constitutional right to be heard, question witnesses, and present evidence.

Also included in the Fifth Amendment is the language of due process. **Due process** is the right to be heard, question witnesses, and present evidence before any criminal conviction can occur. Due process in criminal cases consists of an initial appearance at which the charges and the defendant’s rights are outlined; a preliminary hearing or grand jury proceeding in which the evidence is determined to be sufficient to warrant a trial; an arraignment for entering a plea and setting a trial date when the defendant pleads innocent; a period of discovery for obtaining evidence; and a trial at which witnesses for the prosecution can be cross-examined and evidence presented to refute the charges. In addition to these procedural steps, the **Sixth Amendment** guarantees that the entire process will be completed in a timely fashion because this amendment guarantees a speedy trial.

Sixth Amendment—the U.S. constitutional amendment that guarantees a speedy trial.

⁵⁰ 384 U.S. 436 (1966).

Make the Connection

Summary

When a person does not live up to the standards set by law, this punishable conduct, called *crime*, may be common law or statutory in origin. Crimes are classified as *felonies*, which generally carry greater sentences and more long-term consequences, and *misdemeanors*.

Employers and corporations may be criminally responsible for their acts and the acts of their employees. The federal sentencing guidelines provide parameters for sentences for federal crimes and allow judges to consider whether the fact that a business promotes compliance with the law is a reason to reduce a sentence.

White-collar crimes include those relating to financial fraud. Sarbanes-Oxley reforms increased the penalties for financial fraud and added fraudulent financial statement certification as a crime. Other white-collar crimes include bribery, extortion, blackmail, and corrupt influence in politics and in business. Also included as white-collar crimes are counterfeiting, forgery, perjury, making false claims against the government, obtaining goods or money by false pretenses, using bad checks, false financial reporting, and

embezzlement. The common law crimes include those that involve injury to person and/or property, such as arson and murder.

Statutes have expanded the area of criminal law to meet situations in which computers are involved. Both federal and state statutes make the unauthorized taking of information from a computer a crime. The diversion of deliveries of goods and the transfer of funds, the theft of software, and the raiding of computers are made crimes to some extent by federal laws. Newer federal statutes that apply to computers are the Economic Espionage Act, which prohibits downloading or copying information via computer to give to a competitor, and the Digital Millennium Copyright Act that prohibits circumventing or designing programs to circumvent encryption devices.

Criminal procedure is dictated by the Fourth, Fifth, and Sixth Amendments. The Fourth Amendment protects against unreasonable searches, the Fifth Amendment protects against self-incrimination and provides due process, and the Sixth Amendment guarantees a speedy trial.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

7-1 General Principles

- LO.1** Discuss the nature and classification of crimes
See the discussion of crimes and misdemeanors, page 105.
- LO.2** Describe the basis of criminal liability
See the *U.S. v. Ahmad* case, pages 105–106.
See the Massey Energy example, page 106.
- LO.3** Identify who is responsible for criminal acts
See *U.S. v. Park*, pages 106–107.
See the discussion of CVS in Thinking Things Through, page 111.
- LO.4** Explain the penalties for crimes and the sentencing for corporate crimes
See Figure 7-1, pages 109–110.
See the example on Michael Milken, page 109.
See the discussion of the sentencing guidelines and the various cases related to them, page 108.
See the Ethics & the Law feature, page 112.

7-2 White-Collar Crimes

- LO.5** List examples of white-collar crimes and their elements

See the discussion on White Collar Crimes, pages 113–120.

See the *Andersen* example of obstruction, page 118.

LO.6 Describe the common law crimes

See the discussion on Common Law Crimes, pages 119–120.

See the Sports & Entertainment Law feature on Lance Armstrong and false claims, page 117.

See the E-Commerce & Cyberlaw discussion of cyber-bullying, page 122.

7-3 Criminal Law and the Computer

LO.7 Discuss crimes related to computers

See generally the section on Computer Crimes, page 120.

See the *New Jersey v. Riley* case for unauthorized access, page 121.

See the Cyberbunker-Spamhaus example for spamming, page 123.

7-4 Criminal Procedure Rights for Businesses

LO.8 Describe the rights of businesses charged with crimes and the constitutional protections afforded them

See the *U.S. v. King* case, page 125.

Key Terms

blackmail	embezzlement	misdemeanors
computer crime	extortion	predicate act
conspiracy	Federal Sentencing Guidelines	Racketeer Influenced and Corrupt Organizations (RICO) Act
Controlling the Assault of Non-Solicited Pornography and Marketing (CAN-SPAM) Act	felonies	search warrant
crime	Fifth Amendment	Sixth Amendment
due process	Foreign Corrupt Practices Act (FCPA)	uttering
Economic Espionage Act (EEA)	forgery	white-collar crime
	Fourth Amendment	White-Collar Crime Penalty Enhancement Act of 2002
	<i>Miranda</i> warnings	

Questions and Case Problems

- Bernard Flinn operated a business known as Harvey Investment Co., Inc./High Risk Loans. Flinn worked as a loan broker, matching those who came to him with lenders willing to loan them money given their credit history and the amount involved. From 1982 through 1985, Flinn found loans for five people. Indiana requires that persons engaged in the business of brokering loans obtain a license from the state. Flinn was prosecuted for brokering loans without having a license. He raised the defense that he did not know that a license was required and that, accordingly, he lacked the criminal intent to broker loans without having a license. Does Flinn have a good defense? [*Flinn v. Indiana*, 563 N.E.2d 536 (Ind.)]
- H. J., Inc., and other customers of Northwestern Bell Corp. alleged that Northwestern Bell had furnished cash and tickets for air travel, plays, and sporting events and had offered employment to members of the Minnesota Public Utilities Commission in exchange for favorable treatment in rate cases before the commission. A Minnesota statute makes it a felony to bribe public officials. H. J. and other customers brought suit against Northwestern for violating the criminal bribery statute. Can the customers bring a criminal action? [*H. J., Inc. v. Northwestern Bell Corp.*, 420 N.W.2d 673 (Minn. App.)]
- Baker and others entered a Wal-Mart store shortly after 3:00 A.M. by cutting through the metal door with an acetylene torch. They had moved some of the merchandise in the store to the rear door, but the police arrived before the merchandise could be taken from the store. Baker was prosecuted for larceny. He raised the defense that he was not guilty of larceny because no merchandise had ever left the store. Is there enough intent and action for a crime? [*Tennessee v. Baker*, 751 S.W.2d 154 (Tenn. App.)]
- Gail drove her automobile after having had dinner and several drinks. She fell asleep at the wheel and ran over and killed a pedestrian. Prosecuted for manslaughter, she raised the defense that she did not intend to hurt anyone and because of the drinks did not know what she was doing. Was this a valid defense?
- Dr. Doyle E. Campbell, an ophthalmologist, established his practice in southern Ohio in 1971. Many of Dr. Campbell's patients are elderly people who qualify for federal Medicare benefits and state Medicaid benefits. Under the existing financing system, a doctor who treats a Medicare patient is required to submit a "Medicare Health Insurance Claim Form" (HCFA Form 1500). The doctor is required to certify that "the services shown on this form were medically indicated and necessary for the health of the patient and were personally rendered by me or were rendered incident to my professional service by my employees." Claims Dr. Campbell submitted for his elderly patients ranged from \$900 to \$950, of which \$530 to \$680 were covered by the Medicare program. The government alleged that Dr. Campbell billed Medicare for several treatments that were either not performed or not necessary. Dr. Campbell was charged with fraud for the paperwork he submitted. Has he committed a crime? [*United States v. Campbell*, 845 F.2d 1374 (6th Cir.)]
- In the late 1980s, Life Energy Resources, Ltd. (LER), a New York corporation, was a multilevel marketing network. LER's marketing plan provided that members of the general public could purchase its products

only through an official LER distributor or by becoming LER distributors themselves. Each potential distributor had to be sponsored by an existing distributor and was required to sign a distributorship agreement with LER stating that he or she would not make medical claims or use unofficial literature or marketing aids to promote LER products.

Ballistrea and his partner Michael Ricotta were at the top of the LER distribution network. Two products sold by LER were the REM SuperPro Frequency Generator (REM) and the Lifemax Miracle Cream (Miracle Cream). The REM, which sold for \$1,350 to distributors, was a small box powered by electricity that ran currents through the feet and body of the user.

Ballistrea and Ricotta distributed literature and audiotapes to many potential downstream distributors and customers—some of whom were undercover government agents—touting the REM and the Miracle Cream. Other literature claimed that the Miracle Cream could alleviate the discomforts of premenstrual syndrome and reverse the effects of osteoporosis. The Food and Drug Administration charged Ballistrea and Ricotta with violating federal law for making medical claims concerning LER products. Their defense is that they never sold any of the products. They simply earned commissions as part of the marketing scheme and could not be held criminally liable on the charges. Are they correct? [*United States v. Ballistrea*, 101 F.3d 827 (2d Cir.)]

7. Carriage Homes, Inc. was a general contractor that built multifamily residential and land-development projects in Minnesota. John Arkell was Carriage Homes' chief executive officer, president, and sole shareholder. Carriage Homes built Southwinds, a condominium development of 38 residential units in Austin, Minnesota. The foundation elevations of some of the Southwinds units were lower than permitted under the State Building Code, causing storm water to pool in the units' driveways and garages. The city of Austin's development director sent Arkell a series of seven letters in 1999 and 2001 concerning the elevation problems, and Arkell gave the letters to the project managers, who failed to resolve the problems.

Minnesota makes a violation of the State Building Code a misdemeanor. On May 30, 2001, the state charged Carriage Homes and Arkell with three misdemeanor counts each, alleging a violation of the Uniform Building Code (UBC).

Carriage Homes pleaded guilty and was sentenced to a \$1,000 fine. But Arkell pleaded not guilty, asserting that he could not be held criminally responsible for the violation. After a bench trial, the district court found Arkell guilty. He was sentenced to pay a fine, pay restitution to the condominium owners, and serve 90 days in jail, with 80 days stayed pending his compliance with sentencing conditions. Mr. Arkell appealed on the grounds that the employees and subcontractors had simply not followed his orders and he was not responsible for their failures. Is he correct? [*State v. Arkell*, 657 N.W.2d 883 (Minn. App.)]

8. James Durham runs an art gallery. He has several paintings from unknown artists that he has listed for sale. The paintings always sell at his weekly auction for \$20,000 to \$50,000 above what James believes them to be worth. James learns that the bidders at the auctions are employed by an olive distributor located near the shipping yards of the city. What concerns should Durham have about the art, the bidders, and the large purchase prices?
9. Jennings operated a courier service to collect and deliver money. The contract with his customers allowed him a day or so to deliver the money that had been collected. Instead of holding collections until delivered, Jennings made short-term investments with the money. He always made deliveries to the customers on time, but because he kept the profit from the investments for himself, Jennings was prosecuted for embezzlement. Was he guilty? [*New York v. Jennings*, 504 N.E.2d 1079 (N.Y.)]
10. In April 2006, a DC-9 aircraft landed in the port city of Ciudad del Carmen, located 500 miles east of Mexico City. When the plane's crew began directing security personnel away from the plane, the suspicious activity piqued the curiosity of local law enforcement officials. They decided to search the plane and found 128 suitcases packed with over 56 tons of cocaine. The cocaine was to have been delivered to Toluca, near Mexico City. In investigating the plane and individual involved, law enforcement agents discovered that the plane had been purchased with money that had been laundered through two U.S. banks, Wachovia Corp. and Bank of America Corp. Neither bank was actually aware that the money was being used to purchase a plane that would then be used for drug trafficking. Are the banks still criminally liable for breaking the rules?

Explain why or why not. What if the banks were aware of large sums of money being run through particular customers' accounts? Would that knowledge make a difference?

11. Grabert ran Beck's, an amusement center in Louisiana. He held a license for video gambling machines. Louisiana makes it illegal to allow a minor to play a video gambling machine. A mother came into Grabert's center carrying her 23-month-old baby in her arms. She sat at the video poker machine with her child on her lap and proceeded to play. State troopers witnessed the baby pushing the buttons on the machine at least three times. The Department of Public Safety and Corrections revoked Grabert's video gaming license because a minor had been allowed to play the machines, and Grabert sought judicial review. The trial court reversed, and the department appealed. Has Grabert committed the crime of allowing a minor to engage in gaming? Is this the crime of allowing a minor to gamble? [*Grabert v. Department of Public Safety & Corrections*, 680 So. 2d 764 (La. App.) cert. denied; *Grabert v. State through Dept. of Public Safety and Corrections*, 685 So. 2d 126 (La.)]
12. The Banco Central administered a humanitarian plan for the government of Ecuador. Fernando Banderas and his wife presented false claims that the bank paid. After the fraud was discovered, the bank sued Banderas and his wife for damages for fraud and treble damages under the Florida version of RICO. Banderas and his wife asserted that they were not liable for RICO damages because there was no proof that they were related to organized crime and because the wrong they had committed was merely ordinary fraud. They had not used any racketeering methods. Is involvement with organized crime a requirement for liability under RICO? [*Banderas v. Banco Central del Ecuador*, 461 So. 2d 265 (Fla. App.)]
13. Kravitz owned 100 percent of the stock of American Health Programs, Inc. (AHP). To obtain the Philadelphia Fraternal Order of Police as a customer for AHP, Kravitz paid money bribes to persons who he thought were officers of that organization but who in fact were federal undercover agents. He was prosecuted for violating RICO. He was convicted, and the court ordered the forfeiture of all of Kravitz's shares of AHP stock. Can a forfeiture be ordered? [*United States v. Kravitz*, 738 F.2d 102 (3d Cir.)]
14. Kathryn Erickson was the general manager of the Uintah Special Services District (USSD), an entity created to use federal-mineral-lease revenues for road projects. She, along with her secretary, Cheryl

McCurdy, administered the USSD from a small office in Vernal, Utah. Ms. Erickson's authority was limited and she was not permitted to enter into or modify contracts for or to expend more than \$1,000 of USSD funds, without board approval.

Mitchell Construction was a major contractor for USSD. In 1998, USSD awarded Mitchell Construction a contract to haul gravel from a site called Hamaker Bottoms and another contract to carry out small asphalt-paving projects. Both contracts were to be completed within the 1998 construction year.

During 1999 and 2000 Mitchell Construction continued to perform work on the projects covered by its 1998 contracts with USSD, despite their expiration. It submitted invoices to USSD and was paid for this work.

In June 1999 a federal grand jury began to investigate contracting irregularities at USSD and the Uintah County Road Department and issued a *subpoena duces tecum* to USSD requesting copies of "project contracts, invoices" between USSD and contractors.

While the office was preparing the response for the grand jury subpoena, Ms. McCurdy saw Ms. Erickson prepare a handwritten change order for the Hamaker Bottoms contract and saw Ms. Erickson and Gilman N. Mitchell both sign it. The change order, which was backdated to January 13, 1999, extended the contract through December 31, 2000.

Ms. McCurdy later discovered that two other change orders had been created and backdated. She spent a day copying documents for the grand jury and recording, on a handwritten list, all of the documents that she had copied. However, she left Ms. Erickson in the office while she was working on the list in order to go home for dinner. Ms. Erickson called her and told her not to come back because all the copying was done. Later, Ms. McCurdy found on Ms. Erickson's desk a photocopy of the grand jury document list and saw that two entries not in her handwriting had been added. These entries were for change orders for contracts between Mitchell Construction and USSD. Ms. McCurdy reported the change to the government.

Ms. Erickson and Mr. Mitchell were each indicted by a grand jury in the U.S. District Court for the District of Utah on three counts of obstruction of justice by knowingly falsifying a document with the knowledge and intent that the grand jury would rely on it. Are both the elements of mental intent (scienter) and action present for criminal convictions here? [*U.S. v. Erickson*, 561 F.3d 1150 (10th Cir.)]



Torts

8-1 General Principles

- 8-1a What Is a Tort?
- 8-1b Tort and Crime Distinguished
- 8-1c Types of Torts

8-2 Intentional Torts

- 8-2a Assault
- 8-2b Battery
- 8-2c False Imprisonment
- 8-2d Intentional Infliction of Emotional Distress
- 8-2e Invasion of Privacy
- 8-2f Defamation
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8-3 Negligence

- 8-3a Elements of Negligence
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8-4 Strict Liability

- 8-4a What Is Strict Liability?
- 8-4b Imposing Strict Liability

Learning Outcomes <<<

After studying this chapter, you should be able to

- LO.1** Explain the difference between torts and crimes
- LO.2** Distinguish between an assault and a battery
- LO.3** Explain the three different torts of invasion of privacy
- LO.4** Explain the torts of defamation and defenses
- LO.5** Explain the elements of negligence and defenses
- LO.6** Explain the tort of strict liability and why very few defenses are available

The law of torts permits individuals and companies to recover from other individuals and companies for wrongs committed against them. Tort law provides rights and remedies for conduct that meets the elements required to establish that a wrong has occurred.

8-1 General Principles

Civil, or noncriminal, wrongs that are not breaches of contract are governed by tort law. This chapter covers the types of civil wrongs that constitute torts and the remedies available for those wrongs.

8-1a What Is a Tort?

tort—civil wrong that interferes with one’s property or person.

Tort comes from the Latin term *tortus*, which means “crooked, dubious, twisted.” Torts are actions that are not straight but are crooked, or civil, wrongs. A tort is an interference with someone’s person or property. **For Example**, entering someone’s house without his or her permission is an interference and constitutes the tort of trespass. Causing someone’s character to be questioned is a wrong against the person and is the tort of defamation. The law provides protection against these harms in the form of remedies awarded after the wrongs are committed. These remedies are civil remedies for the acts of interference by others.

8-1b Tort and Crime Distinguished

A *crime* is a wrong that arises from a violation of a public duty, whereas a *tort* is a wrong that arises from a violation of a private duty. A crime is a wrong of such a serious nature that the appropriate level of government steps in to prosecute and punish the wrongdoer to deter others from engaging in the same type of conduct. However, whenever the act that is committed as a crime causes harm to an identifiable person, that person may recover from the wrongdoer for monetary damages to compensate for the harm. For the person who experiences the direct harm, the act is called a *tort*; for the government, the same act is called a *crime*.

When the same act is both a crime and a tort, the government may prosecute the wrongdoer for a violation of criminal law, and the individual who experiences the direct harm may recover damages. **For Example**, O. J. Simpson was charged by the state of California with the murder of his ex-wife, Nicole Brown Simpson, and her friend Ron Goldman. A criminal trial was held in which O. J. Simpson was acquitted. Simpson was subsequently sued civilly by the families of Nicole Simpson and Ron Goldman for the tort of wrongful death. The jury in the civil case found Simpson civilly liable and the court ordered him to pay nearly \$20 million in damages plus interest. Only \$382,000 of this judgment was paid to the families.

8-1c Types of Torts

intentional tort—civil wrong that results from intentional conduct.

There are three types of torts: intentional torts, negligence, and strict liability. **Intentional torts** are those that occur when wrongdoers engage in intentional conduct. **For Example**, striking another person in a fight is an intentional act and would be the tort of battery and possibly also the crime of battery. Your arm striking another person’s nose in a fast-moving crowd of people at a rock concert is not a tort or crime because your arm was

negligence—failure to exercise due care under the circumstances in consequence of which harm is proximately caused to one to whom the defendant owed a duty to exercise due care.

strict liability—civil wrong for which there is absolute liability because of the inherent danger in the underlying activity, for example, the use of explosives.

pushed unintentionally by the force of the crowd. If you stretched out your arms in that crowd or began to swing your arms about and struck another person, you would be behaving carelessly in a crowd of people; and, although you may not have committed an intentional tort, it is possible that your careless conduct constitutes the tort of **negligence**. Careless actions, or actions taken without thinking through their consequences, constitute negligence. The harm to the other person’s nose may not have been intended, but there is liability for these accidental harms under negligence. **For Example**, if you run a red light, hit another car, and injure its driver, you did not intend the result. However, your careless behavior of disregarding a traffic signal resulted in the injury, and you would have liability for your negligence to that driver.

In transmission of disease cases, depending on the facts, both intentional torts and negligence theories may apply. A person who knows or should know that he or she has herpes and fails to disclose that fact, or misrepresents that he or she is disease-free, may be liable to a sexual partner. The torts theories may include negligence, battery, intentional infliction of emotional distress, and fraud. In most cases, the three words “I have herpes” is fair notice of the danger of infection.¹ However, saying it is okay to have sex because the individual was not having an outbreak of the disease is actionable. **For Example**, Thomas R. disclosed to his girlfriend that he had herpes but nevertheless told her that it was “okay” to have sex with him because he was not then experiencing an outbreak of the disease. The jury’s finding of negligence and fraudulent concealment in the transmission of the disease was upheld by the appeals court, and the plaintiff was awarded compensatory damages as well as \$2.75 million in punitive damages.²

Strict liability is another type of tort that imposes liability without regard to whether there was any intent to harm or any negligence occurred. Strict liability is imposed without regard to fault. Strict or absolute liability is imposed because the activity involved is so dangerous that there must be full accountability. Nonetheless, the activity is necessary and cannot be prohibited. The compromise is to allow the activity but ensure that its dangers and resulting damages are fully covered through the imposition of full liability for all injuries that result. **For Example**, contractors often need to use dynamite to take a roadway through a mountainside or demolish a building that has become a hazard. When the dynamite is used, noise, debris, and possibly dangerous pieces of earth and building will descend on others’ land and possibly on people. In most states, contractors are held strictly liable for the resulting damage from the use of dynamite. The activity is necessary and not illegal, but those who use dynamite must be prepared to compensate those who are injured as a result.

Other areas in which there is strict liability for activity include the storage of flammable materials and crop dusting. The federal government and the states have pure food laws that impose absolute liability on manufacturers who fail to meet the statutory standards for their products. Another area of strict liability is *product liability*, where a product is defective, and unreasonably dangerous, and has caused harm. **For Example**, Mr. Izell was awarded \$6 million in compensatory damages and \$18 million in punitive damages when he proved that exposure to inhalable asbestos fibers, supplied in part by Union Carbide, was a substantial factor in causing mesothelioma.³ Product liability is covered in Chapter 24.

¹ *R.A.P. v. B.I.P.*, 428 N.W.2d 103, 108 (Minn. App. 1988).

² *Behr v. Redmond*, 123 Cal. Rptr. 3d 97 (Cal. App. 2011).

³ *Izell v. Union Carbide Corp.*, 180 Cal. Rptr. 3d 382 (Cal. App. 2014).

8-2 Intentional Torts

8-2a Assault

An *assault* is intentional conduct that threatens a person with a well-founded fear of imminent harm coupled with the present ability to carry out the threat of harm. **For Example**, the angry assertion “I’m going to kick your butt” along with aggressive movement in the direction of the victim with the intent to carry out the threat is an assault, even though a third person intervenes to stop the intended action. Mere words, however, although insulting, are ordinarily insufficient to constitute an assault.

8-2b Battery

A *battery* is the intentional, wrongful touching of another person without that person’s consent. Thus, a threat to use force is an assault, and the actual use of force is the battery. The single action of striking an individual can be both a crime and a tort. A lawsuit for the tort of battery provides a plaintiff with the opportunity to recover damages resulting from the battery. The plaintiff must prove damages, however.

CASE SUMMARY

An Exchange of Unpleasantries...

FACTS: Moore and Beye had an altercation after a public meeting regarding airport expansion. Moore owned a ranch near the airport and staunchly opposed expansion. Beye owned a flying service and avidly supports expansion. Moore and Beye exchanged unpleasantries while leaving the meeting. Beye then punched Moore on the left side of the jaw. Moore stumbled but caught himself before falling. He then exclaimed to the crowd, “You saw that. You are my witnesses. I’ve been assaulted. I want that man arrested.” Ravalli County deputies took Beye into custody, and the state charged him with misdemeanor assault. Moore visited the hospital complaining of back and neck pain two days later and contended that he had injured his back while reeling from Beye’s punch. He filed a civil complaint against Beye for damages. Moore’s evidence mostly concerned his alleged

back injury. Beye did not contest that he had punched Moore. His evidence countered that Moore’s back problems had existed before the altercation. The judge instructed the jury that Beye had committed a battery as a matter of law and directed that they answer the question, “Was Moore damaged as a result of the battery?” The jury voted 11 to 1 that the battery did not injure Moore, and Moore appealed.

DECISION: Judgment for Beye. Beye presented the testimony of several eyewitnesses and a medical expert that Moore had sustained no damages. Although Moore presented considerable evidence to the contrary, it was not the court’s function to agree or disagree with the verdict. Beye presented sufficient evidence to uphold the jury’s verdict. [*Moore v. Beye*, 122 P.3d 1212 (Mont. 2005)]

8-2c False Imprisonment

false imprisonment—intentional detention of a person without that person’s consent; called the *shopkeeper’s tort* when shoplifters are unlawfully detained.

False imprisonment is the intentional detention of a person without that person’s consent.⁴ The detention need not be for any specified period of time, for any detention against one’s will is false imprisonment. False imprisonment is often called the *shopkeeper’s tort* because so much liability has been imposed on store owners for their unreasonable detention of customers suspected of shoplifting. Requiring a customer to sit in the manager’s office or not allowing a customer to leave the store can constitute the tort of false

⁴ *Forgie-Buccioni v. Hannaford Bros. Inc.*, 413 F.3d 175 (1st Cir. 2005).

shopkeeper's privilege—right of a store owner to detain a suspected shoplifter based on reasonable cause and for a reasonable time without resulting liability for false imprisonment.

imprisonment. Shop owners do, however, need the opportunity to investigate possible thefts in their stores. As a result, all states have some form of privilege or protection for store owners called a *shopkeeper's privilege*.

The **shopkeeper's privilege** permits the store owner to detain a suspected shoplifter based on reasonable suspicion for a reasonable time without resulting liability for false imprisonment to the accused customer.⁵ The privilege applies even if the store owner was wrong about the customer being a shoplifter, so long as the store owner acted based on reasonable suspicions and treated the accused shoplifter in a reasonable manner.

CASE SUMMARY

A Can of Mousse: A Tote Bag of Trouble

FACTS: Patricia Holguin went to Sally's Beauty Supply Store carrying her "eco-friendly canvas shopping tote," a large bag that is conspicuous when used. Upon entering the store, there were no posted signs stating that shopping totes were not allowed. She picked up a can of mousse that was not exactly what she wanted and started to carry it in her tote toward the front counter to ask the cashier a question about it. As she walked toward the front of the store the assistant manager approached her and asked what was in the bag. She was detained by this manager, who told her that once she put the hair mousse in her tote bag, she was shoplifting. Holguin's lawsuit for false imprisonment against the store was dismissed with prejudice by the trial court. This court held that once she placed the merchandise in her bag, the store had probable cause to believe she was shoplifting and had a statutory conditional privilege to detain her, free from civil liability for false imprisonment, because she "willfully concealed merchandise." Holguin appealed.

DECISION: The court of appeals reversed the district court's decision. In general, merchants and their employees have a

conditional privilege to detain a person free from civil liability based on probable cause, or reasonable grounds to believe that the individual "willfully concealed" merchandise without paying for it, provided the detention is for a reasonable time and conducted in a reasonable manner. "Willfully concealed," however, requires more than merely putting merchandise out of sight. In self-service stores customers have implied permission to pick up, handle, move, try on, replace, and carry about merchandise within the store. There must be circumstances which reflect that the purpose of the concealment is adverse to the store's right to be paid before the conclusion can be drawn that the merchandise was "willfully concealed" under the statute providing the conditional privilege to detain a customer. Placing the can of mousse in a reusable, personal canvas shopping bag to carry to the front of the store to ask a question, without more, did not constitute "willful concealment." [*Holguin v. Sally's Beauty Supply, Inc.*, 264 P.3d 732 (N. Mex. App. 2011)]

intentional infliction of emotional distress—tort that produces mental anguish caused by conduct that exceeds all bounds of decency.

8-2d Intentional Infliction of Emotional Distress

The **intentional infliction of emotional distress** (IIED) is a tort involving conduct that goes beyond all bounds of decency and produces mental anguish in the harmed individual. This tort requires proof of outrageous conduct and resulting emotional distress in the victim. **For Example**, Erica Schoen, a 16-year employee of Freightliner, returned to work on light duty after surgery for a work-related shoulder injury. She was assigned to work out of the nurse's station under two employees who intentionally worked her beyond her restrictions, assigned her to humiliating work, repeatedly called her worthless, and used her as a personal servant—ordering her to get snacks, sodas, and lunches for them and not reimbursing her. After five months of this treatment, Erica brought the matter to the human resources manager, who told her, in part, "Nobody wants you. You're

⁵ *Limited Stores, Inc. v. Wilson-Robinson*, 876 S.W.2d 248 (Ark. 1994); see also *Wal-Mart Stores, Inc. v. Binns*, 15 S.W.3d 320 (Ark. 2000).

worthless. We build trucks down here....” Erica became hysterical and thereafter required psychiatric care. The jury awarded \$250,000 for IIED, and the verdict was upheld on appeal because the repetitive misconduct and its duration, ratified by the human resource manager, was intolerable.⁶

8-2e Invasion of Privacy

invasion of privacy—tort of intentional intrusion into the private affairs of another.

The right to privacy is the right to be free of unreasonable intrusion into one’s private affairs. The tort of **invasion of privacy** actually consists of three different torts: (1) public disclosure of private facts; (2) intrusion into the plaintiff’s private affairs; and (3) appropriation of another’s name, likeness, or image for commercial advantage.⁷

Public Disclosure of Private Facts

This tort involves public disclosure of a private fact, such as a business posting returned checks from customers near its cash registers in public display.

The first widely recognized call in American law for a right to privacy based on the common law and enforceable in a tort action was raised in an article by Samuel Warren and Louis Brandeis in *The Harvard Law Review* of 1890.⁸ The authors recognized that the right to privacy must be subject to conditions if it is to coexist with freedom of speech, freedom of the press, and other established areas of the law. Accordingly they proposed limitations on the right such as it should not prevent publication of matters of general public interest. Or, if the person published the facts himself or consents, the facts are no longer private. The authors also speculated that the law would not grant redress for oral publications, where the injury would be so trifling that the law might well, in the interest of free speech, disregard it all together. Presently must a plaintiff in a right to privacy action produce documentation such as a writing, picture, or video to bring a common-law right-to-privacy action? The question is resolved in the *Yum! Brands, Inc.* decision.

CASE SUMMARY

Let’s Get With It! The Town Crier Is No Longer the Principal Purveyor of News

FACTS: Melissa Ignat suffered from a bipolar disorder for which she was being treated with medications. Side effects of medication adjustments occasionally caused her to miss work. She alleged that after returning from one such absence her supervisor, Mary Shipma, informed her that she had told everyone in the department that Ignat was bipolar. Subsequently her coworkers avoided and shunned her, and one of them asked Shipma if Ignat was likely to “go postal” at work. Ignat brought suit for public disclosure of private facts, and the trial court granted summary judgment for Yum! Brands

on the ground that the right of privacy can be violated only by a writing, not by word of mouth.

DECISION: Judgment reversed. Limiting liability for public disclosure of private facts to those recorded in a writing is contrary to the tort’s purpose, which has been since its inception to allow a person to control the kind of information about himself made available to the public—in essence, to define his public persona. While the restriction may have made sense in the 1890s—when no one dreamed of talk

⁶ *Schoen v. Freightliner LLC*, 199 P.3d 332 (Or. App. 2008).

⁷ A fourth tort of invasion of privacy also exists, known as “invasion of privacy by false light,” which is very similar to defamation discussed in this chapter. Like a claim of defamation, the plaintiff cannot succeed on a claim of invasion of privacy by false light if the alleged communication is accurate or true. See *Miller v. Central Indiana Community Foundation, Inc.* 11 N.E.3d 944 (Ind. App. 2014).

⁸ S. D. Warren and L. D. Brandeis, *The Right to Privacy*, 4 *Harv. L. Rev.* 193 (1890); the following analysis is derived from the *Ignat v. Yum Brands, Inc.* decision, 154 Cal. Rptr. 3d 275, 278 (Cal. App. 2013).

Let's Get With It! The Town Crier Is No Longer the Principal Purveyor of News continued

radio or confessional television—it certainly makes no sense now. Private facts can be just as widely disclosed—if not more so—through oral media as through written ones. To allow a plaintiff redress for one kind of disclosure but not the other, when both can be equally damaging to privacy, is a

rule better suited to an era when the town crier was the principal purveyor of news. It is long past time to discard this outmoded rule. [*Ignat v. Yum! Brands, Inc.* 154 Cal. Rptr. 3d 275 (Cal. App. 2013)]

Intrusion into the Plaintiff's Private Affairs

This tort involves intrusion into the plaintiff's private affairs or seclusion. An example would be planting a microphone in the plaintiff's office or home.

Appropriation of Another's Name, Likeness, or Image for Commercial Advantage

This form of invasion of privacy is generally referred to as the *right of publicity*. The elements of this tort are (1) appropriation of the plaintiff's name or likeness for the value associated with it, and not in an incidental manner or for a newsworthy purpose, (2) identification of the plaintiff in the publication, and (3) an advantage or benefit to the defendant. The right to publicity is designed to protect the commercial interest of celebrities in their identities. **For Example**, popular and critically acclaimed rock and roll musician Don Henley, the founder and member of the band The Eagles, successfully sued a department store chain that ran an international newspaper advertisement for its Henley shirt, which stated in large letters as the focus of the ad "This is Don's Henley." The ad (1) used the value associated with the famous name Don Henley to get consumers to read it, (2) the plaintiff was identifiable in the ad, and (3) the ad was created with the belief that use of the words "Don's Henley" would help sell the product.⁹ A "newsworthiness defense" protects the act of publishing or reporting factual data on public affairs or sporting activities.¹⁰

Some states refer to the right of publicity as a cause of action for *commercial misappropriation of a name or likeness* and provide two vehicles a plaintiff can use to protect the economic value of one's name: a common law action or a statutory remedy. The *Schlein* case involved a breach of contract action and an action for commercial misappropriation of a doctor's name.

CASE SUMMARY

The Name Game: We Are Discontinuing Your Royalty on the "Schlein Ultra," Dr. Schlein

FACTS: Orthopedic Systems, Inc. (OSI), and Dr. Schlein entered into a contract, whereby OSI would manufacture and sell an unpatented product originally designed by Dr. Schlein called the "Schlein Shoulder Positioner," to be

used in arthroscopic shoulder surgery. The contract called for a 5% royalty of the list price less discounts. Over the years OSI's marketing brochures thanked "Allen P. Schlein M.D. for his assistance in the development of the

⁹ *Henley v. Dillard Department Stores*, 46 F. Supp. 2d 587 (N.D. Tex. 1999).

¹⁰ *Dryer v. National Football League*, 2014 WL 5106738 (D. Minn. 2014).

The Name Game: We Are Discontinuing Your Royalty on the “Schlein Ultra,” Dr. Schlein continued

product.” OSI paid royalty checks from January 1991 to January 2005, when OSI paid its last royalty payment for the period ending December 2004. In January 2005, OSI sent a letter to Dr. Schlein stating that in light of the fact that there was no patent protection on the product, it would be discontinuing the royalty. From January 2005 until July 29, 2005, OSI continued to market and sell the product using Dr. Schlein’s name. OSI sued Dr. Schlein for declaratory relief and reformation of the royalty contract. Dr. Schlein cross-complained for breach of contract and commercial misappropriation of his name. The jury awarded Dr. Schlein \$616,043 for failure to pay royalties under the contract. OSI earned \$1,220,000 in profits attributed to the use of Dr. Schlein’s name during the period from January 1, 2005, to July 31, 2005, after which OSI stopped using Schlein’s name. The trial court declined to award the profits to Schlein, and both parties appealed.

DECISION: The statutory remedy of Section 3444(a) requires the payment of the greater of \$750, or the actual damages

suffered as a result of the unauthorized use, and any profits for the unauthorized use that are attributable to use and are not taken into account in computing actual damages. The legislative history for the minimum \$750 award was intended to fill the gap that existed in the common law tort of invasion of privacy as applied to noncelebrities whose names lacked commercial value on the open market. Unlike sports and entertainment stars, noncelebrities often could not prove damages under the common law; therefore, the statute established a concrete remedy for the little man with a minimum payment. An interpretation that limits damages to \$750 as an alternative to all other damages would be contrary to the spirit of the statute. Judgment for Dr. Schlein, who is entitled as well to the \$1,220,000 profits as a result of OSI’s unauthorized use of his name. [*Orthopedic Systems, Inc. v. Schlein*, 135 Cal. Rptr. 3d 200 (Cal. App. 2011)]

8-2f Defamation

defamation—untrue statement by one party about another to a third party.

slander—defamation of character by spoken words or gestures.

libel—written or visual defamation without legal justification.

Defamation is a false statement by one party about another to a third party. **Slander** is spoken defamation.¹¹ **Libel** is a false publication by writing, printing, picture, or other fixed representation to the eye, which exposes any person to hatred, contempt, or ridicule, or which has a tendency to injure the individual in his or her occupation.¹² The elements of defamation are (1) the making of defamatory statement; (2) publication of the defamatory material; and (3) damages that result from the statement.

In cases in which the victim is a public figure, such as a well-known entertainer, a professional athlete, or a political figure, another element is required: the element of *malice*, which means that the statement was made by the defendant with knowledge that it was false, or with reckless disregard for whether it was true or false.¹³ **For Example**, former wrestler and governor of Minnesota and former Navy SEAL Jesse Ventura sued Chris Kyle, the author of the bestselling autobiography entitled *American Sniper*, for defamation. Kyle, also a former Navy SEAL, wrote that a character named “ScruFF Face,” holding court in a Coronado, California, bar said, “he hates America,” that the SEALs “were killing men and women and children and murdering,” and that SEALs “deserve to lose a few”; at which point Kyle “punched him out.” While not naming Ventura in the book, Kyle confirmed in television, radio, and in print interviews about the book, that “ScruFF

¹¹ Regarding damages, where one publishes a slander that imputes to another a communicable disease, or would adversely affect that person’s fitness for the proper conduct of a lawful business, trade, or profession, the words are actionable in themselves, and the law implies compensatory damages. Once compensatory damages are established the jury will assess punitive damages to punish the party who committed the wrong and to deter others from committing similar wrongs in the future. See *Tanner v. Ebbrole*, 2011 WL 4425540 (Ala. App. 2011) where the jury returned “nominal” compensatory damages of \$1 and punitive damages of \$100,000 against Paul Averette, the owner of a competing tattoo business, for slanderous statements to several patrons that his competitor, Chassity Ebbrole, had hepatitis, syphilis, gonorrhea, and AIDS and that she used “nasty needles.”

¹² See *Wong v. Jing*, 117 Cal. Rptr. 3rd (Cal. App. 2010).

¹³ See *New York Times Co. v. Sullivan*, 376 U.S. 254 (1964).

Face” was Ventura. Kyle was killed by a troubled veteran, and his wife, as executor of his estate, was substituted as defendant. The case, brought by public figure Jesse Ventura, boiled down to a credibility contest, with several witnesses testifying that Ventura’s version of the events was true, while several other witnesses testified that Kyle’s version of the events was true. The jury decided the case for Ventura, with the court concluding that in believing Ventura’s version of the facts, then Kyle’s writing and telling of the story of punching out Ventura was itself a basis for the jury to make a finding of actual malice. On the defamation claim the jury awarded \$500,000 in damages. Some \$1,345,477 in damages was assessed for unjust enrichment for the money made in defaming Ventura in the book *American Sniper*.¹⁴

The defenses to defamation include truth and privilege. Also defendants may assert their free speech rights under the First Amendment to express their opinions as they see fit; and the courts are required to distinguish between statements of fact and statements of opinion.



Online Issues

Internet and mobile platforms have radically changed how society consumes and shares news, opinions, and other content. Courts are faced with an increase in Internet defamation cases, many of which involve anonymous posts, which must initially be addressed by the courts.

Unveiling Identities of Offending Anonymous Posters. Interactive Web sites are immune from liability for content created by a third-party user unless the Web site actively edits the content.¹⁵ It thus may be necessary for a “defamed” person to seek the identity of the anonymous poster through a court subpoena in a defamation lawsuit.

The First Amendment prohibits the government from abridging the freedom of speech and it also protects anonymous speech.¹⁶ Courts must strike a balance between the right to anonymous speech and the right of those harmed by anonymous speech to seek legal redress. Before a plaintiff can compel disclosure of the identity of an anonymous Internet speaker, the plaintiff must demonstrate to a court that he or she has a credible claim, and the anonymous speaker must be given an opportunity to defend himself before the court will order the unveiling of his or her identity.¹⁷ **For Example**, the Leshers filed a lawsuit against anonymous posters on the Internet forum Topix, who had accused the Leshers of being sexual deviants, molesters, and drug dealers. With a credible claim established, the court ordered Topix to turn over identifying information including Internet Protocol (IP) addresses, which led to the identity of the posters and, ultimately, a jury awarding \$13.78 million in damages against the posters.¹⁸

Vigorous Criticism Versus Defamation. Legitimate customer complaints based on opinion are not actionable defamation. And, hyperbole, figurative language, and rhetoric expression is protected opinion such as a posting claiming “the worst wedding experience of my life.” However, a factual assertion that “the bridal suite was a tool shed...” in context may be actionable in some courts.¹⁹ Other courts are less willing to interpret comments as assertions of fact. **For Example**, a defendant using a concealing screen name on an Internet discussion forum, felt free to claim that a corporate president was part of a management team of “boobs, losers, and crooks” and “has fat thighs, a fake medical

¹⁴ *Ventura v. Kyle*, 8 F. Supp. 3d 1115 (D. Minn. 2014).

¹⁵ Section 203(c)(1) of the Communication Decency Act of 1996.

¹⁶ *McIntyre v. Ohio Elections Comm’n*, 514 U.S. 334, 342 (1995). “Anonymity is a shield from the tyranny of the majority.” *Id.* at 357.

¹⁷ *Doe v. Coleman*, 436 S.W.3d 207 (Ky. App. 2014).

¹⁸ Ki Mae Heussner and Susanna Kim, ‘Anonymous’ Posters to Pay \$13 Million for Defamatory Comments, abcnews.com (Apr. 24, 2012), <http://abcnews.go.com/Business/jury-awards-13-million-texas-defamation-suit-anonymous/print?id=16194071>.

¹⁹ *Neumann v. Liles*, 261 Or. App. 567 (2014).

degree, ... and has poor ... hygiene.” The plaintiff served a subpoena on the forum’s host seeking the defendant’s identity, and the defendant, appearing as “Doe 6,” moved to quash. The appellate court, viewing the defendant’s post in the context of what was a particularly “[h]eated” discussion forum in which numerous other posts questioned the defendant’s credibility, and noting the defendant’s “crude, ungrammatical” language, satirical tone, and vituperative, “juvenile name-calling,” concluded that the defendant’s railing was nonactionable opinion and ordered the subpoena quashed.²⁰

Defenses: Truth and Privilege

The defenses to defamation include the truth. If the statement is true, even if it is harmful to the victim, it is not the tort of defamation.²¹

absolute privilege—complete defense against the tort of defamation, as in the speeches of members of Congress on the floor and witnesses in a trial.

Some statements are privileged, and this privilege provides a full or partial defense to the tort of defamation. **For Example**, members of Congress enjoy an **absolute privilege** when they are speaking on the floor of the Senate or the House because public policy requires a free dialogue on the issues pending in a legislative body. The same absolute privilege applies to witnesses in court proceedings to encourage witnesses with information to come forward and testify. Where a witness granted immunity from prosecution testifies before a governmental agency, the witness is entitled to immunity from defamation lawsuits. **For Example**, Roger Clemens sued his former trainer, Brian McNamee, for defamation, contending that McNamee falsely stated to a congressional committee that Clemens had used steroids during his professional baseball career. This defamation claim was dismissed because McNamee’s statements were entitled to absolute immunity on the reasoning that the proper administration of justice requires full disclosure from witnesses without fear of retaliatory lawsuits.²²

qualified privilege—media privilege to print inaccurate information without liability for defamation, so long as a retraction is printed and there was no malice.

The media enjoy a **qualified privilege** for stories that turn out to be false. Their qualified privilege is a defense to defamation so long as the information was released without malice and a retraction or correction is made when the matter is brought to their attention.

A *qualified privilege* to make a defamatory statement in the workplace exists when the statement is made to protect the interests of the private employer on a work-related matter, especially when reporting actual or suspected wrongdoing. **For Example**, Neda Lewis was fired from her job at Carson Oil Company for allegedly stealing toilet paper. The employee in charge of supplies noticed that toilet paper was regularly missing from the ladies room, and one evening from a third-floor window overlooking the parking lot, she observed that the plaintiff’s bag contained two rolls of toilet paper. She reported the matter to the executive secretary, who reported it to both the president and the CEO of the firm, who decided to fire her. Two other employees were also informed. The employer was able to successfully raise the defense of a qualified privilege to Ms. Lewis’ defamation action for “false accusations of theft” since all of the employees involved were participants in the investigation and termination of the employee.²³

A new statutory privilege has been evolving with respect to letters of recommendation and references given by employers for employees who are applying for jobs at other companies. Most companies, because of concerns about liability for defamation, will only confirm that a former employee did work at their firm and will provide the time period during which the person was employed. Numerous states now have statutes that provide employers a qualified privilege with respect to references and recommendations. So long

²⁰ *Krinsky v. Doe*, 72 Cal. Rptr. 3d 231 (2008).

²¹ See *Stark v. Zeta Phi Beta Sorority Inc.*, 587 F. Supp. 2d 170 (D.D.C. 2008).

²² *Clemens v. McNamee*, 608 F. Supp. 2d 811 (S.D. Tex. 2009). On June 18, 2012, Clemens was acquitted of all six counts of lying to Congress.

²³ *Lewis v. Carson Oil Co.*, 127 P.3d 1207 (Or. App. 2006).

as the employer acts in good faith in providing information, there is no liability for defamation to the former employee as a result of the information provided.

8-2g Product Disparagement

Although the comparison of products and services is healthy for competition, false statements about another's products constitute a form of slander called **slander of title** or libel called **trade libel**; collectively, these are known as **product disparagement**, which occurs when someone makes false statements about another business, its products, or its abilities.²⁴ The elements of product disparagement are (1) a false statement about a particular business product or about its service in terms of honesty, reputation, ability, or integrity; (2) communication of the statement to a third party; and (3) damages.

slander of title—malicious making of false statements as to a seller's title.

trade libel—written defamation about a product or service.

product disparagement—false statements made about a product or business.

contract interference—tort in which a third party interferes with others' freedom to contract.

8-2h Wrongful Interference with Contracts

The tort of **contract interference** (or tortious interference with contracts) occurs when parties are not allowed the freedom to contract without interference from third parties. While the elements required to establish the tort of contract interference are complex, a basic definition is that the law affords a remedy when a third party intentionally causes another to break a contract already in existence.²⁵ **For Example**, Nikke Finke, a newspaper reporter who had a contract with the *New York Post* to write stories about the entertainment industry for the *Post's* business section, wrote two articles about a lawsuit involving a literary agent and the Walt Disney Company over merchandising rights to the Winnie-the-Pooh characters. Finke reported that the trial court sanctioned Disney for engaging in "misuse of the discovery process" and acting in "bad faith" and ordered Disney to pay fees and costs of \$90,000. Disney's president, Robert Iger, sent a letter to the *Post's* editor-in-chief, Col Allan, calling Finke's reporting an "absolute distortion" of the record and "absolutely false." Approximately two weeks after the Pooh articles were published, the *Post* fired Finke; her editor told her she was being fired for the Pooh articles. She sued Disney on numerous tort theories, including interference with her contract with the *Post*. Disney sought to have the complaint dismissed, which motion was denied by the court. The Court of Appeals concluded that Finke demonstrated a reasonable probability of proving that Iger's allegations that she made false statements in her article were themselves false; and it concluded that a jury could find Disney liable for intentional interference with contractual relations based on circumstantial evidence and negligent interference with contractual relations because it was reasonably foreseeable to Disney that the nature of its accusations against Finke would result in her termination from employment.²⁶

8-2i Trespass

A **trespass** is an unauthorized action with respect to land or personal property. A *trespass to land* is any unpermitted entry below, on, across, or above the land of another. **For Example**, Joyce Ameral's home abuts the midway point of the 240-yard, par-4 ninth hole of the public Middlebrook Country Club. Balls sliced and hooked by golfers have damaged her windows and screens, dented her car, and made her deck too dangerous for daytime use. Her landscapers are forced to wear hard hats when cutting her lawn. In her lawsuit against the country club owner, the court ruled that the projection of golf balls onto Ameral's property constituted a continuing trespass and it enjoined the trespass.²⁷

trespass—unauthorized action with respect to person or property.

²⁴ *Sannerud v. Brantz*, 879 P.2d 341 (Wyo. 1994). See *Suzuki Motor Corp. v. Consumers Union*, 230 F.3d 1110 (9th Cir. 2003), cert. denied 540 U.S. 983 (2003), for an example of the complexity of a product disparagement action.

²⁵ See *Ventas, Inc. v. HCP, Inc.*, 647 F.3d 291 (6th Cir. 2011); *ASDI, Inc. v. Beard Research, Inc.*, 11 A.3d 749 (Del. 2010).

²⁶ *Finke v. The Walt Disney Co.*, 2 Cal. Rptr. 3d 436 (Cal. App. 2003).

²⁷ *Ameral v. Pray*, 831 N.E.2d 915 (Mass. App. 2005).

A *trespass to personal property* is the invasion of personal property without the permission of the owner. **For Example**, the use of someone’s car without that person’s permission is a trespass to personal property.

8-3 Negligence

The widest range of tort liability today arises in the field of negligence. Accidents happen! Property is damaged and/or injuries result. The fact that an individual suffers an injury does not necessarily mean that the individual will be able to recover damages for the injury. **For Example**, Rhonda Nichols was shopping in the outdoor garden center at a Lowe’s Home Center when a “wild bird” flew into the back of her head, causing injuries. Her negligence lawsuit against Lowe’s was dismissed because the owner did not have a duty to protect her from a wild bird attack because it was not reasonably foreseeable.²⁸ Jane Costa was passively watching a Boston Red Sox baseball game at Fenway Park when a foul ball struck her in the face, causing severe and permanent injuries. Her negligence lawsuit against the Boston Red Sox was unsuccessful because it was held that the owners had no duty to warn Ms. Costa of the obvious danger of foul balls being hit into the stands.²⁹ Although cases involving injury to spectators at baseball games in other jurisdictions have turned on other tort doctrines, injured fans, like Ms. Costa, are left to bear the costs of their injuries. Only when an injured person can demonstrate the following four elements of negligence is a right to recover established: (1) a duty, (2) breach of duty, (3) causation, and (4) damages.³⁰ Several defenses may be raised in a negligence lawsuit.

8-3a Elements of Negligence

Duty to Exercise Reasonable Care

The first element of negligence is a *duty*. There is a general duty of care imposed to act as a reasonably prudent person would in similar circumstances. **For Example**, Gustavo Guzman worked for a subcontractor as a chicken catcher at various poultry farms where a Tyson Foods employee, Brian Jones, operated a forklift and worked with the catchers setting up cages to collect birds for processing at a Tyson plant. Contrary to Tyson’s instructions “never to allow catchers to move behind the forklift or otherwise out of sight,” Brian moved his forklift and struck Guzman, who suffered a serious spinal injury. A general contractor, Tyson Foods, owes a duty to exercise reasonable care to a subcontractor’s employee, Gustavo Guzman.³¹

Professionals have a duty to perform their jobs at the level of a reasonable professional. For a professional such as an accountant, doctor, lawyer, dentist, or architect to avoid liability for **malpractice**, the professional must perform his or her skill in the same manner as, and at the level of, other professionals in the same field.

Those who own real property have a duty of care to keep their property in a condition that does not create hazards for guests. Businesses have a duty to inspect and repair their property so that their customers are not injured by hazards, such as spills on the

malpractice—when services are not properly rendered in accordance with commonly accepted standards; negligence by a professional in performing his or her skill.

²⁸ *Nichols v. Lowe’s Home Center, Inc.*, 407 F. Supp. 2d 979 (S.D. Ill. 2006).

²⁹ *Costa v. Boston Red Sox Baseball Club*, 809 N.E.2d 1090 (Mass. App. 2004).

³⁰ *Alfred v. Capital Area Soccer League, Inc.*, 669 S.E.2d 277 (N.C. App. 2008).

³¹ *Tyson Foods Inc. v. Guzman*, 116 S.W.3d 233 (Tex. App. 2003). But see *Pippin v. Hill-Rom Co., Inc.*, 615 F.3d 886 (8th Cir. 2010), where a shipper’s failure to load cargo onto an independent truck driver’s trailer, as required by the transportation contract, did not give rise to a cause of action for negligence, where the driver was injured loading the truck by himself. The shipper owed no duty to the driver, who chose to load the truck by himself.

floor or uneven walking areas. When customer safety is a concern, businesses have a duty to provide adequate security, such as security patrols in mall parking lots.

Breach of Duty

The second element of negligence is the breach of duty imposed by statute or by the application of the reasonable person standard. The defendant's conduct is evaluated against what a reasonable person would have done under the circumstances. That is, when there is sufficient proof to raise a jury question, the jury decides whether the defendant breached the duty to the injured person from a reasonable person's perspective.³²

For Example, the jury in Guzman's lawsuit against Tyson Foods (the *Tyson* case), after weighing all of the facts and circumstances, determined that Tyson's employee's operation of the forklift constituted a breach of Tyson's duty of care to Guzman.

Causation

A third element of negligence is *causation*, the element that connects the duty and the breach of duty to the injuries to the plaintiff. **For Example,** in Guzman's lawsuit, the forklift operator's careless conduct was the cause in fact of this worker's injuries. A "but for" test for causation is used. *But for* Tyson employee Brian Jones's negligent conduct in moving the forklift under the circumstances surrounding the accident, Guzman would not have been injured.

Once the cause in fact is established, the plaintiff must establish *proximate cause*. That is, it must establish that the harm suffered by the injured person was a foreseeable consequence of the defendant's negligent actions. Foreseeability requires only the general danger to be foreseeable. In the *Tyson* case, the court determined that while there was some evidence that a jury could possibly infer that Tyson could not foresee an accident similar to the one involving Guzman, the evidence was legally sufficient to support the jury's finding that Tyson's negligence was foreseeable and the cause in fact of Guzman's injuries.

The landmark *Palsgraf v. Long Island Rail Road Co.* case established a limitation on liability for unforeseeable or unusual consequences following a negligent act.

CASE SUMMARY

The Scales Tipped on Causation

FACTS: Helen Palsgraf lived in Brooklyn. On a summer's day, she purchased tickets to travel to Rockaway Beach on the Long Island Rail Road (LIRR) with her two daughters. She was standing on a platform on the LIRR's East New York station when two men ran to catch another train. One of the men made it onto the train, but the other

man, who was carrying a package, was unsteady as the train was about to pull out of the station. The LIRR conductor pulled him up, while the LIRR platform guard pushed him into the train, but in the process, he dropped the package. It contained fireworks and exploded! The concussion from the explosion caused the scales located next to

³²A breach of duty may be established by the very nature of the harm to the plaintiff. The doctrine of *res ipsa loquitur* ("the event speaks for itself") provides a rebuttable presumption that the defendant was negligent when a defendant owes a duty to the plaintiff, the nature of the harm caused the plaintiff is such that it ordinarily does not happen in the absence of negligence, and the instrument causing the injury was in the defendant's exclusive control. An example of the doctrine is a lawsuit against a surgeon after a surgical device is discovered in a former patient months after the surgery by another physician seeking the cause of the patient's continuing pain subsequent to the operation.

The Scales Tipped on Causation continued

Mrs. Palsgraf to fall over, striking and injuring her. Mrs. Palsgraf sued LIRR for the negligence of the two employees who had assisted the passenger with the package to board the train. A jury awarded her \$6,000, which was upheld 3-2 by the Appellate Division. Thereafter the state's highest court considered the railroad's appeal.

DECISION: Recovery for negligence is not available unless there has been some violation of a right. Helen Palsgraf was too remote in distance from the accident for any invasion of rights. To reach a different decision would mean that

there could be no end to those who might be harmed. By helping someone onto a moving train, the train employees can anticipate that the passenger himself might be injured, that other passengers might be injured, and that those around the immediate scene might be injured. But Mrs. Palsgraf was too remote for her injuries to be reasonably foreseeable as a consequence of the action of helping a passenger onto a moving train. She was 25 to 30 feet away from the scene, and the explosion cannot be called the proximate cause of her concussion and other injuries. [*Palsgraf v. Long Island R. R. Co.*, 162 N.E. 99 (N.Y. 1928)]

Damages

The plaintiff in a personal injury negligence lawsuit must establish the actual losses caused by the defendant's breach of duty of care and is entitled to be made whole for all losses. The successful plaintiff is entitled to compensation for (1) past and future pain and suffering (mental anguish), (2) past and future physical impairment, (3) past and future medical care, and (4) past and future loss of earning capacity. Life and work life expectancy are critical factors to consider in assessing damage involving permanent disabilities with loss of earning capacity. Expert witnesses are utilized at trial to present evidence based on worklife tables and present value tables to deal with these economic issues. The jury considers all of the evidence in the context of the elements necessary to prove negligence and all defenses raised, and it renders a verdict. **For Example**, in the *Tyson* case, the defendant presented evidence and argued that Gustavo Guzman was himself negligent regarding the accident. The jury found that both parties were negligent and attributed 80 percent of the fault to Tyson and 20 percent to Guzman (this is called *comparative negligence* and is discussed in the following section). The jury awarded Guzman \$931,870.51 in damages (\$425,000.00 for past physical pain and mental anguish, \$150,000.00 for future physical pain and mental anguish, \$10,000.00 for past physical impairment, \$10,000.00 for future physical impairment, \$51,870.51 for past medical care, \$5,000.00 for future medical care, \$70,000.00 for past lost earning capacity, and \$210,000.00 for future lost earning capacity). After deducting 20 percent of the total jury award for Guzman's own negligence, the trial court's final judgment awarded Guzman \$745,496.41.

In some situations, the independent actions of two defendants occur to cause harm. **For Example**, Penny Shipler was rendered a quadriplegic as a result of a Chevrolet S-10 Blazer rollover accident. She sued the driver Kenneth Long for negligence and General Motors for negligent design of the Blazer's roof. She was awarded \$18.5 million in damages. Because two causes provided a single indivisible injury, the two defendants were held jointly and severally liable.³³ Under *joint and several liability*, each defendant may be held liable to pay the entire judgment. However, should one defendant pay the entire judgment, that party may sue the other for "contribution" for its proportionate share.

In some cases in which the breach of duty was shocking, plaintiffs may be awarded *punitive damages*. However, punitive (also called *exemplary*) damages are ordinarily applied

³³ *Shipler v. General Motors Corp.*, 710 N.W.2d 807 (Neb. 2006).

when the defendant's tortious conduct is attended by circumstances of fraud, malice, or willful or wanton conduct.³⁴

contributory negligence—negligence of the plaintiff that contributes to injury and at common law bars recovery from the defendant although the defendant may have been more negligent than the plaintiff.

8-3b Defenses to Negligence

Contributory Negligence

A plaintiff who is also negligent gives the defendant the opportunity to raise the defense of **contributory negligence**, which the defendant establishes by utilizing the elements of negligence previously discussed, including the plaintiff's duty to exercise reasonable care for his or her own safety, the breach of that duty, causation, and harm. Under common law, the defense of contributory negligence, if established, is a complete bar to recovery of damages from the defendant.

CASE SUMMARY

Keep Your Eye on the Ball in Sports: Keep Your Eye on the 300-Pound Boxes in Trucking

FACTS: Lawrence Hardesty is an over-the-road tractor-trailer truck driver who picked up a load of stadium seating equipment for the NFL stadium under construction in Baltimore. The equipment was packaged in large corrugated cardboard boxes weighing several hundred pounds. The shipper, American Seating Co., loaded the trailer while Hardesty remained in the cab of his truck doing “paperwork” and napping. Considerable open space existed between the boxes and the rear door of the trailer. The evidence showed that Hardesty failed to properly examine the load bars used to secure the boxes from movement during transit. When Hardesty arrived at the Baltimore destination, he opened the rear trailer door and boxes at the end of the trailer fell out and injured him. Hardesty brought a personal injury negligence action against the shipper. American Seating Co. responded that Hardesty was contributorily negligent, thus barring his negligence claim.

DECISION: Judgment for American Seating Co. because the claim is barred by Hardesty's contributory negligence. His decision to ignore the loading process by remaining in his truck, oblivious to the manner and means of the loading of the trailer, coupled with his own failure to examine the load bars sufficiently to confirm that they would “adequately secure” the cargo, together with his decision, in the face of his prior omissions, to open the doors of the trailer upon his arrival in Baltimore while standing within the zone of danger created by the possibility (of which he negligently failed to inform himself) of injury from cargo falling out of the trailer, cohered to rise to the level of a cognizable breach of duty—contributory negligence. [*Hardesty v. American Seating Co.*, 194 F. Supp. 2d 447 (D. Md. 2002)]

The contributory negligence defense has given way to the defense of comparative negligence in most states.³⁵

Comparative Negligence

Because contributory negligence produced harsh results with no recovery of damages for an injured plaintiff, most states have adopted a fairer approach to handling situations in which both the plaintiff and the defendant are negligent; it is called *comparative*

³⁴ See *Eden Electrical, Ltd. v. Amana Co.*, 370 F.3d 824 (8th Cir. 2004); and *University of Colorado v. American Cyanamid Co.*, 342 F.3d 1298 (Fed. Cir. 2003).

³⁵ Alabama, the District of Columbia, Maryland, North Carolina, and Virginia are pure contributory negligence states, which hold that the damaged party cannot recover any damages even if it is just 1 percent at fault. See *RGR, LLC v. Settle*, 758 S.E.2d 215 (Va. 2014) where the Virginia Supreme Court set aside a \$2.5 million judgment finding that the plaintiff was contributorily negligent as a matter of law.

negligence. Comparative negligence is a defense that permits a negligent plaintiff to recover some damages but only in proportion to the defendant's degree of fault.³⁶ **For Example**, in the *Tyson* case, both the defendant and the plaintiff were found to be negligent. The jury attributed 80 percent of the fault for the plaintiff's injury to Tyson and 20 percent of the fault to the plaintiff, Guzman. While Guzman's total damages were \$931,870, they were reduced by 20 percent, and the final judgment awarded Guzman was \$745,496.

Some comparative negligence states refuse to allow the plaintiff to recover damages if the plaintiff's fault was more than 50 percent of the cause of the harm.³⁷

Assumption of the Risk

The assumption of the risk defense has two categories. *Express assumption of the risk* involves a written exculpatory agreement under which a plaintiff acknowledges the risks involved in certain activities and releases the defendant from prospective liability for personal injuries sustained as a result of the defendant's negligent conduct. Examples include ski lift tickets, white water rafting contracts, permission for high school cheerleading activities, and parking lot claim checks. In most jurisdictions these agreements are enforceable as written. However, in some jurisdictions they may be considered unenforceable because they violate public policy. **For Example**, Gregory Hanks sued the Powder Ridge Ski Resort for negligence regarding serious injuries he sustained while snowtubing at the defendant's facility. He had signed a release, which explicitly provided that the snowtuber: [*fully*] assume[s] all risks associated with [s]nowtubing, even if due to the NEGLIGENCE" of the defendants [emphasis in original]. The Supreme Court of Connecticut found that the release was unenforceable because it violated the public policy by shifting the risk of negligence to the weaker bargainer.³⁸

Implied primary assumption of the risk arises when a plaintiff has impliedly consented, often in advance of any negligence by the defendant, to relieve a defendant of a duty to the plaintiff regarding specific known and appreciated risks. It is a subjective standard, one specific to the plaintiff and his or her situation. **For Example**, baseball mom Delinda Taylor took her two boys to a Seattle Mariners baseball game and was injured during the pregame warm-up when a ball thrown by José Mesa got past Freddie Garcia, striking Taylor in the face and causing serious injuries. The defendant baseball team successfully raised the affirmative defense of implied primary assumption of the risk by showing that Mrs. Taylor had full subjective understanding of the specific risk of getting hit by a thrown baseball, and she voluntarily chose to encounter that risk.³⁹ However, John Coomer, a spectator at a Kansas City Royals baseball game was struck in the eye by a hotdog thrown by the team's mascot, Slugger, during a "Hotdog Launch," causing Coomer to suffer a detached retina. The Supreme Court of Missouri held that being injured by Slugger's hotdog toss was not a risk inherent in watching a Royals baseball game.⁴⁰

A number of states have either abolished the defense of assumption of the risk, reclassifying the defense as comparative negligence so as not to completely bar a plaintiff's recovery of damages, or have eliminated the use of the assumption of the risk terminology to handle cases under the duty, breach of duty, causation, and harm elements of negligence previously discussed.⁴¹

³⁶ *City of Chicago v. M/V Morgan*, 375 F.3d 563 (7th Cir. 2004).

³⁷ *Davenport v. Cotton Hope Plantation*, 482 S.E.2d 569 (S.C. App. 1997).

³⁸ *Hanks v. Powder Ridge*, 885 A.2d 734 (Conn. 2005).

³⁹ *Taylor v. Baseball Club of Seattle*, 130 P.3d 835 (Wash. App. 2006).

⁴⁰ *Coomer v. K.C. Royals Baseball Corp.*, 437 S.W.3d 184 (Mo. 2014).

⁴¹ See, for example, *Costa v. The Boston Red Sox Baseball Club*, 809 N.E.2d 1090 (Mass. App. 2004), where the court cites state precedent that "... the abolishment of assumption of the risk as an affirmative defense did not alter the plaintiff's burden ... to prove the defendant owed [the plaintiff] a duty of care ... and thus left intact the open and obvious damages rule, which operates to negate the existence of a duty to care."



SPORTS & ENTERTAINMENT LAW

Liability for Injuries under the Sports Exception Doctrine

Charles “Booby” Clark played football for the Cincinnati Bengals as a running back on offense. Dale Hackbart played defensive free safety for the Denver Broncos. As a consequence of an interception by the Broncos, Hackbart became an offensive player, threw a block, and was watching the play with one knee on the ground when Clark “acting out of anger and frustration, but without a specific intent to injure,” stepped forward and struck a blow to the back of Hackbart’s head and neck, causing a serious neck fracture. Is relief precluded for injuries occurring during a professional football game? The answer is no. While proof of mere negligence is insufficient to establish liability during such an athletic contest, liability must instead be premised on heightened proof of reckless or intentional conduct on the part of the defendant. In the *Hackbart* case, the court determined that if the evidence established that the injury was the result of acts of Clark that were in reckless disregard of Hackbart’s safety, Hackbart is entitled to damages.* Why didn’t Hackbart pursue recovery under negligence law, contending that Clark had a general duty of care to act as a reasonably prudent person

would in similar circumstances? Because football and other contact sports contain within the rules of the games inherent *unreasonable* risks of harm, a negligence theory is not applicable. What contact sports do you believe qualify under this “sports exception” doctrine for which proof of negligence is insufficient to establish liability for injuries sustained during the athletic contest? Is softball a contact sport for players? What about coaching or officiating decisions made in the middle of a fast-moving game?***

PGA golfer Walter Mallin sued PGA golfer John Paesani for injuries that Mallin sustained while competing in a PGA golf tournament when Paesani drove a golf ball that struck Mallin in the head on his right temple. Paesani contends that the “sports exception” doctrine applies and the negligence case must be dismissed. How would you decide this case?***

**Hackbart v. Cincinnati Bengals, Inc.*, 601 F.2d 516 (10th Cir. 1979).

**See *Guillo v. DeKamp Junction, Inc.*, 959 N.E.2d 215 (Ill. App. 2011).

****Mallin v. Paesani*, 892 A.2d 1043 (Conn. Super. 2005).

Immunity

Governments are generally immune from tort liability.⁴² This rule has been eroded by decisions and in some instances by statutes, such as the Federal Tort Claims Act. Subject to certain exceptions, this act permits the recovery of damages from the United States for property damage, personal injury, or death action claims arising from the negligent act or omission of any employee of the United States under such circumstances that the United States, if a private person, would be liable to the claimant in accordance with the law of the place where the act or omission occurred. A rapidly growing number of states have abolished governmental immunity, although many still recognize it.

Until the early 1900s, charities were immune from tort liability, and children and parents and spouses could not sue each other. These immunities are fast disappearing. **For Example**, if a father’s negligent driving of his car causes injuries to his minor child passenger, the child may recover from the father for his injuries.⁴³

8-4 Strict Liability

The final form of tort liability is known as *strict liability*. When the standards of strict liability apply, very few defenses are available. Strict liability was developed to provide guaranteed protection for those who are injured by conduct the law deems both serious and inexcusable.

⁴² *Kirby v. Macon County*, 892 S.W.2d 403 (Tenn. 1994).

⁴³ *Cates v. Cates*, 588 N.E.2d 330 (Ill. App. 1992); see also *Doe v. McKay*, 700 N.E.2d 1018 (Ill. 1998).



THINKING THINGS THROUGH

Torts and Public Policy

Over a decade ago, a jury awarded 81-year-old Stella Liebeck nearly \$3 million because she was burned after she spilled a cup of McDonald's coffee on her lap. Based on these limited facts, a national discussion ensued about a need for tort reform, and to this day "Stella Awards" are given on Web sites for apparently frivolous or excessive lawsuits. Consider the following additional facts and the actual damages awarded Stella Liebeck. Decide whether her recovery was just.

- McDonald's coffee was brewed at 195 to 205 degrees.
- McDonald's quality assurance manager "was aware of the risk [of burns] ... and had no plans to turn down the heat."
- Mrs. Liebeck spent seven days in the hospital with third-degree burns and had skin grafts. Gruesome photos of burns of the inner thighs, groin, and buttocks were entered as evidence.
- The compensatory damages were \$200,000, which were reduced to \$160,000 because Mrs. Liebeck was determined to be 20 percent at fault.
- The jury awarded \$2.7 million in punitive damages. The trial court judge reduced this amount to \$480,000.
- The total recovery at the trial court for Mrs. Liebeck was \$640,000. Both parties appealed, and a settlement was reached at what is believed to be close to the \$640,000 figure.

Tort remedies have evolved because of public policy incentives for the protection of individuals from physical,

mental, and economic damage. Tort remedies provide economic motivation for individuals and businesses to avoid conduct that could harm others.

The amount of the compensation and the circumstances in which compensation for torts should be paid are issues that courts, juries, and legislatures review. Many legislatures have examined and continue to review the standards for tort liability and damages.

The U.S. Supreme Court devoted several decisions in recent years to dealing with excessive punitive damages in civil litigation, and it has set "guideposts" to be used by courts in assessing punitive damages.* In *State Farm Mutual Automobile Insurance Co. v. Campbell*, compensatory damages for the plaintiffs at the trial court level were \$1 million, and punitive damages, based in part on evidence that State Farm's nationwide policy was to underpay claims regardless of merit to enhance profits, were assessed at \$145 million. The Supreme Court concluded that the facts of *Campbell* would likely justify a punitive damages award only at or near the amount of compensatory damages. Thus, even those who act very badly as State Farm Insurance did have a constitutionally protected right under the due process clause of the Fourteenth Amendment to have civil law damages assessed in accordance with the Supreme Court's guideposts.

**BMW of North America v. Gore*, 517 U.S. 559 (1996); *Cooper Industries v. Leatherman Tool Group, Inc.*, 532 U.S. 424 (2001); *State Farm Insurance v. Campbell*, 538 U.S. 408 (2003); *Exxon Shipping Co. v. Baker*, 544 U.S. 471 (2008).

8-4a What Is Strict Liability?

Strict liability is an absolute standard of liability imposed by the law in circumstances the courts or legislatures have determined require a high degree of protection. When strict liability is imposed, the result is that the company or person who has caused injury or damages by the conduct will be required to compensate for those damages in an absolute sense. Few, if any, defenses apply in a situation in which the law imposes a strict liability standard. **For Example**, as noted earlier in the chapter, engaging in ultrahazardous activities, such as using dynamite to excavate a site for new construction, results in strict liability for the contractor performing the demolition. Any damages resulting from the explosion are the responsibility of that contractor, so the contractor is strictly liable.

8-4b Imposing Strict Liability

Strict liability arises in a number of different circumstances, but the most common are in those situations in which a statutory duty is imposed and in product liability. **For Example**, at both the state and federal levels, there are requirements for the use,

transportation, and sale of radioactive materials, as well as the disposal of biomedical materials and tools. Any violation of these rules and regulations would result in strict liability for the company or person in violation.

Product liability, while more fully covered in Chapter 24, is another example of strict liability. A product that is defective through its design, manufacture, or instructions and that injures someone results in strict liability for the manufacturer.

Make the Connection

Summary

A *tort* is a civil wrong that affords recovery for damages that result. The three forms of torts are intentional torts, negligence, and strict liability. A tort differs from a crime in the nature of its remedy. Fines and imprisonment result from criminal violations, whereas money damages are paid to those who are damaged by conduct that constitutes a tort. An action may be both a crime and a tort, but the tort remedy is civil in nature.

Selected intentional torts are false imprisonment, defamation, product disparagement, contract interference or tortious interference, and trespass. False imprisonment is the detention of another without his or her permission. False imprisonment is often called the *shopkeeper's tort* because store owners detain suspected shoplifters. Many states provide a privilege to store owners if they detain shoplifting suspects based on reasonable cause and in a reasonable manner. Defamation is slander (oral) or libel (written) and consists of false statements about another that damage the person's reputation or integrity. With an increase in Internet cases, some of which involve anonymous posts, courts may compel disclosure of identity

only if the plaintiff can demonstrate a credible claim and the anonymous speaker is given the opportunity to defend before the unveiling of his or her name. Truth is an absolute defense to defamation, and there are some privileges that protect against defamation, such as those for witnesses at trial and for members of Congress during debates on the floor. There is a developing privilege for employers when they give references for former employees. Invasion of privacy is intrusion into private affairs; public disclosure of private facts; or appropriation of someone's name, image, or likeness for commercial purposes.

To establish the tort of negligence, one must show that there has been a breach of duty in the form of a violation of a statute or professional competency standards or of behavior that does not rise to the level of that of a reasonable person. That breach of duty must have caused the foreseeable injuries to the plaintiff, and the plaintiff must be able to quantify the damages that resulted. Possible defenses to negligence include contributory negligence, comparative negligence, and assumption of risk.

Strict liability is absolute liability with few defenses.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

8-1 General Principles

LO.1 Explain the difference between torts and crimes

See the discussion on wrongs that are a violation of a private duty as torts, and wrongs that are a violation of a public duty as crimes, page 132.

See the O. J. Simpson example of his acquittal of the crime of murder and his civil liability for the torts of wrongful death, page 132.

8-2 Intentional Torts

LO.2 Distinguish between an assault and a battery
See the “kick your butt” threat example of an assault, page 134.

LO.3 Explain the three different torts of invasion of privacy
See the discussion of the intrusion into a person's private affairs, public disclosure of private facts, and right of publicity torts, pages 136–137.

See the *Ignat* case, which determined that a right of privacy can be violated by word of mouth, pages 136–137.

See the *Schlein* case involving commercial misappropriation of one's name, pages 137–138.

LO.4 Explain the torts of defamation and defenses

See the discussion of slander, libel, and trade libel beginning, pages 138 and 141.

See the *Ventura* case involving the requirement of the enhanced element of malice for cases in which the victim is a public figure, page 138.

See the discussion involving unveiling the identity of offending anonymous posters of defamatory remarks on the Internet, page 139.

8-3 Negligence

LO.5 Explain the elements of negligence and defenses

See the discussion of the elements of negligence: duty, breach of duty, and causation and damages, pages 142–144.

See the discussion of the defenses of contributory negligence, comparative negligence, assumption of risk, and immunity, pages 145–147.

8-4 Strict Liability

LO.6 Explain the tort of strict liability and why very few defenses are available

See the dynamite excavation example, holding the contractor liable for any damages with no defenses because of the hazardous activity, page 148.

See the product liability example, page 149.

Key Terms

absolute privilege

contract interference

contributory negligence

defamation

false imprisonment

intentional infliction of emotional distress

intentional torts

invasion of privacy

libel

malpractice

negligence

product disparagement

qualified privilege

shopkeeper's privilege

slander

slander of title

strict liability

tort

trade libel

trespass

Questions and Case Problems

- Christensen Shipyards built a 155-foot yacht for Tiger Woods at its Vancouver, Washington, facilities. It used Tiger's name and photographs relating to the building of the yacht in promotional materials for the shipyard without seeking his permission. Was this a right of publicity tort because Tiger could assert that his name and photos were used to attract attention to the shipyard to obtain commercial advantage? Did the shipyard have a First Amendment right to present the truthful facts regarding its building of the yacht and the owner's identity as promotional materials? Does the fact that the yacht was named *Privacy* have an impact on this case? Would it make a difference as to the outcome of this case if the contract for building the yacht had a clause prohibiting the use of Tiger's name or photo without his permission?
- ESPN held its Action Sports and Music Awards ceremony in April, at which celebrities in the fields of extreme sports and popular music such as rap and heavy metal converged. Well-known musicians Ben Harper and James Hetfield were there, as were popular rappers Busta Rhymes and LL Cool J. Famed motorcycle stuntman Evel Knievel, who is

commonly thought of as the “father of extreme sports,” and his wife, Krystal, were photographed. The photograph depicted Evel, who was wearing a motorcycle jacket and rose-tinted sunglasses, with his right arm around Krystal and his left arm around another young woman. ESPN published the photograph on its “extreme sports” Web site with a caption that read “Evel Knievel proves that you're never too old to be a pimp.” The Knievels brought suit against ESPN, contending that the photograph and caption were defamatory because they accused Evel of soliciting prostitution and implied that Krystal was a prostitute. ESPN contends that the caption was a figurative and slang usage and was not defamatory as a matter of law. Decide. [*Knievel v. ESPN*, 393 F.3d 1068 (9th Cir.)]

- While snowboarding down a slope at Mammoth Mountain Ski Area (Mammoth), 17-year-old David Graham was engaged in a snowball fight with his 14-year-old brother. As he was “preparing to throw a snowball” at his brother, David slammed into Liam Madigan, who was working as a ski school instructor for Mammoth, and injured him. Madigan sued Graham for damages for reckless and dangerous

- behavior. The defense contended that the claim was barred under the doctrine of assumption of the risk, applicable in the state, arising from the risk inherent in the sport that allows for vigorous participation and frees a participant from a legal duty to act with due care. Decide. [*Mammoth Mountain Ski Area v. Graham*, 38 Cal. Rptr. 3d 422 (Cal. App.)]
4. Following a visit to her hometown of Coalinga, Cynthia wrote “An Ode to Coalinga” (Ode) and posted it in her online journal on MySpace.com. Her last name did not appear online. Her page included her picture. The Ode opens with “The older I get, the more I realize how much I despise Coalinga” and then proceeds to make a number of extremely negative comments about Coalinga and its inhabitants. Six days later, Cynthia removed the Ode from her journal. At the time, Cynthia was a student at UC Berkeley, and her parents and sister were living in Coalinga. The Coalinga High School principal, Roger Campbell, submitted the Ode to the local newspaper, the *Coalinga Record*, and it was published in the Letters to the Editor section, using Cynthia’s full name. The community reacted violently to the Ode, forcing the family to close its business and move. Cynthia and her family sued Campbell and the newspaper on the right-of-privacy theory of public disclosure of private facts. What are the essential elements of this theory? Was Cynthia and her family’s right of privacy violated? [*Moreno v. Hanford Sentinel, Inc.*, 91 Cal. Rptr. 3d 858 (Cal. App.)]
 5. Catherine Bosley worked as a television news anchor for WKBN Channel 27 in Youngstown, Ohio. While on vacation with her husband in Florida she participated in a “wet t-shirt” contest, which was videotaped without her consent by DreamGirls, Inc. and licensed to Marvad Corp., which runs a Web site for adult entertainment through a subscription service on the Internet. Marvad used depictions of her in advertisements to promote the materials and services it markets. Web site searches related to Catherine Bosley in 2004 were the most popular search on the World Wide Web. Due to the publicity, she resigned from her position at WKBN. Bosley sought an injunction against the defendants from using her image in any manner that promotes the sale of their goods or services. The defendants contend that an injunction would violate their First Amendment rights. What legal theory did Bosley rely on to seek the injunction? Would an injunction be in violation of the defendant’s First Amendment’s rights? Decide. [*Bosley v. Wildwett.com*, 310 F. Supp. 2d 914 (N.D. Ohio)]
 6. Juanita DeJesus was seriously injured when hit on the head by a foul ball at a minor league baseball game and sued the stadium operators for negligence and premises liability. The case progressed to the Indiana Supreme Court where the Indianapolis Indians urged the State Supreme Court to dispose of the premises liability and negligence claims in one fell swoop by adopting the so-called Baseball Rule, which provides that:

a ballpark operator that provides screening behind home plate sufficient to meet ordinary demand for protected seating has fulfilled its duty with respect to screening and cannot be subjected to liability for injuries resulting to a spectator by an object leaving the playing field.

 Should the Court adopt this clear and unambiguous rule for the national pastime? Does the Court have authority to make such a ruling? How would you decide her negligence claim? [*South Shore Baseball, LLC v. DeJesus*, 11 N.E.3d 903 (Ind.)]
 7. Mallinckrodt produces nuclear and radioactive medical pharmaceuticals and supplies. Maryland Heights Leasing, an adjoining business owner, claimed that low-level radiation emissions from Mallinckrodt damaged its property and caused a loss in earnings. What remedy should Maryland Heights have? What torts are involved here? [*Maryland Heights Leasing, Inc. v. Mallinckrodt, Inc.*, 706 S.W.2d 218 (Mo. App.)]
 8. An owner abandoned his van in an alley in Chicago. In spite of repeated complaints to the police, the van was allowed to remain in the alley. After several months, it was stripped of most of the parts that could be removed. Jamin Ortiz, age 11, was walking down the alley when the van’s gas tank exploded. The flames from the explosion set fire to Jamin’s clothing, and he was severely burned. Jamin and his family brought suit against the city of Chicago to recover damages for his injuries. Could the city be held responsible for injuries caused by property owned by someone else? Why or why not? [*Ortiz v. Chicago*, 398 N.E.2d 1007 (Ill. App.)]
 9. Carrigan, a district manager of Simple Time Recorder Co., was investigating complaints of mismanagement of the company’s Jackson office. He called at the home of Hooks, the secretary of that office, who expressed the opinion that part of the trouble was caused by the theft of parts and

- equipment by McCall, another employee. McCall was later discharged and sued Hooks for slander. Was she liable? [*Hooks v. McCall*, 272 So. 2d 925 (Miss.)]
10. Defendant no. 1 parked his truck in the street near the bottom of a ditch on a dark, foggy night. Iron pipes carried in the truck projected nine feet beyond the truck in back. Neither the truck nor the pipes carried any warning light or flag, in violation of both a city ordinance and a state statute. Defendant no. 2 was a taxicab owner whose taxicab was negligently driven at an excessive speed. Defendant no. 2 ran into the pipes, thereby killing the passenger in the taxicab. The plaintiff brought an action for the passenger's death against both defendants. Defendant no. 1 claimed he was not liable because it was Defendant no. 2's negligence that had caused the harm. Was this defense valid? [*Bumbardner v. Allison*, 78 S.E.2d 752 (N.C.)]
 11. Carl Kindrich's father, a member of the Long Beach Yacht Club before he died, expressed a wish to be "buried at sea." The Yacht Club permitted the Kindrich family the use of one of its boats, without charge, for the ceremony, and Mr. Fuller—a good friend of Carl's father—piloted the boat. Portable stairs on the dock assisted the attendees in boarding. Upon returning, Fuller asked for help to tie up the boat. The steps were not there, and Carl broke his leg while disembarking to help tie up the boat. Carl sued the Yacht Club for negligence in failing to have someone on the dock to ensure that the portable steps were available. The Yacht Club contended that it was not liable because Carl made the conscious decision to jump from the moving vessel to the dock, a primary assumption of risk in the sport of boating. The plaintiff contended that he was not involved in the sport of boating, and at most his actions constituted minimal comparative negligence, the type that a jury could weigh in conjunction with the defendant's negligence in assessing damages. Decide. [*Kindrich v. Long Beach Yacht Club*, 84 Cal. Rptr. 3d 824 (Cal. App.)]
 12. Hegyes was driving her car when it was negligently struck by a Unjian Enterprises truck. She was injured, and an implant was placed in her body to counteract the injuries. She sued Unjian, and the case was settled. Two years later Hegyes became pregnant. The growing fetus pressed against the implant, making it necessary for her doctor to deliver the child 51 days prematurely by Cesarean section. Because of its premature birth, the child had a breathing handicap. Suit was brought against Unjian Enterprises for the harm sustained by the child. Was the defendant liable? [*Hegyes v. Unjian Enterprises, Inc.*, 286 Cal. Rptr. 85 (Cal. App.)]
 13. Kendra Knight took part in a friendly game of touch football. She had played before and was familiar with football. Michael Jewett was on her team. In the course of play, Michael bumped into Kendra and knocked her to the ground. He stepped on her hand, causing injury to a little finger that later required its amputation. She sued Michael for damages. He defended on the ground that she had assumed the risk. Kendra claimed that assumption of risk could not be raised as a defense because the state legislature had adopted the standard of comparative negligence. What happens if contributory negligence applies? What happens if the defense of comparative negligence applies?
 14. A passenger on a cruise ship was injured by a rope thrown while the ship was docking. The passenger was sitting on a lounge chair on the third deck when she was struck by the weighted end of a rope thrown by an employee of Port Everglades, where the boat was docking. These ropes, or heaving lines, were being thrown from the dock to the second deck, and the passenger was injured by a line that was thrown too high.

The trial court granted the cruise line's motion for directed verdict on the ground there was no evidence that the cruise line knew or should have known of the danger. The cruise line contended that it had no notice that this "freak accident" could occur. What is the duty of a cruise ship line to its passengers? Is there liability here? Does it matter that an employee of the port city, not the cruise lines, caused the injury? Should the passenger be able to recover? Why or why not? [*Kalendareva v. Discovery Cruise Line Partnership*, 798 So. 2d 804 (Fla. App.)]
 15. Blaylock was a voluntary psychiatric outpatient treated by Dr. Burglass, who became aware that Blaylock was violence prone. Blaylock told Dr. Burglass that he intended to do serious harm to Wayne Boynton, Jr., and shortly thereafter he killed Wayne. Wayne's parents then sued Dr. Burglass on grounds that he was liable for the death of their son because he failed to give warning or to notify the police of Blaylock's threat and nature. Was a duty breached here? Should Dr. Burglass be held liable? [*Boynton v. Burglass*, 590 So. 2d 446 (Fla. App.)]

Intellectual Property Rights and the Internet



9-1 Trademarks and Service Marks

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9-5 Protection of Computer Software and Mask Works

- 9-5a Copyright Protection of Computer Programs
- 9-5b Patent Protection of Programs
- 9-5c Trade Secrets
- 9-5d Restrictive Licensing
- 9-5e Semiconductor Chip Protection

Learning Outcomes <<<

After studying this chapter, you should be able to

- LO.1** Explain the spectrum of distinctiveness used to classify trademarks and explain why distinctiveness is important
- LO.2** Explain how courts determine whether there is a likelihood of confusion between trademarks
- LO.3** Explain how personal names can acquire trademark protection
- LO.4** List the remedies available for improper use of trademarks
- LO.5** Explain the difference between trademark infringement and trademark dilution
- LO.6** Explain what is and is not copyrightable; explain the fair use defense
- LO.7** Explain the “new and not obvious” requirement necessary to obtain a patent
- LO.8** Explain what constitutes a trade secret and what steps a company must take to ensure protection
- LO.9** Explain the extent of protection provided owners of software

Intellectual property comes in many forms: the writing by an author or the software developed by an employee, the new product or process developed by an inventor, the company name Hewlett-Packard, and the secret formula used to make Coca-Cola. Federal law provides rights to owners of these works, products, company names, and secret formulas that are called *copyrights*, *patents*, *trademarks*, and *trade secrets*. State laws provide protection for trade secrets. These basic legal principles are also applicable in an Internet and e-commerce context. This chapter discusses the federal and state laws governing intellectual property rights and their Internet context.

9-1 Trademarks and Service Marks

The Lanham Act is a federal law that grants a producer the exclusive right to register a trademark and prevent competitors from using that mark. This law helps ensure that the trademark holder and not an imitating competitor will reap the financial, reputation-related rewards of a desirable product. While unfair competition plays a role in trademark protection, courts are concerned with the impact that trademark infringement has on consumers. The trademark system seeks to ensure that trademarks serve their purpose of source identifiers that reduce consumers' search costs and allow consumers to make decisions that more closely coincide with their preferences.

9-1a Introduction

A mark is any word, name, symbol, device, or combination of these used to identify a product or service.¹ If the mark identifies a product, such as an automobile or soap, it is called a **trademark**. If it identifies a service, such as an airline or dry cleaner, it is called a **service mark**.

trademark—mark that identifies a product.

service mark—mark that identifies a service.

The owner of a mark may obtain protection from others using it by registering the mark in accordance with federal law at the United States Patent and Trademark Office (USPTO) in Washington, D.C.² To be registered, a mark must distinguish the goods or services of the applicant from those of others. Under the federal Lanham Act, a register, called the Principal Register, is maintained for recording such marks. Inclusion on the Principal Register grants the registrant the exclusive right to use the mark. Challenges may be made to the registrant's right within five years of registration, but after five years, the right of the registrant is incontestable.

A mark may be "reserved" before starting a business by filing an application for registration on the basis of the applicant's good-faith intent to use the mark. Once the mark is used in trade, then the USPTO will actually issue the registration with a priority date retroactive to the date the application was filed. The applicant has a maximum period of 36 months to get the business started and demonstrate that the mark is in "use in commerce." In the United States, the first party to use a trademark in commerce is the presumptive owner of the mark. Nevertheless, it is always preferable to register the trademark to secure legal protection.

9-1b International Registration

The Madrid Protocol is an international treaty that provides for a streamlined system of international registration of trademarks. The trademark holder can file with a single office, in one language, and pay a single fee to obtain protection in multiple countries. Changes

¹ 15 U.S.C. §1127.

² Lanham Act, 15 U.S.C. §§1050–1127.

in ownership of the mark as well as renewal of the mark (every 10 years) can also be effected through the Madrid Protocol. The United States became a party to the treaty in 2003. Ninety-four countries are signatories, including most of the United States' trading partners, with the exception of Canada. Before the mark can be the subject of an international application, it must have already been registered or applied for with the U.S. Patent and Trademark Office (USPTO).

9-1c Registrable Marks

distinctiveness—capable of serving the source-identifying function of a mark.

Trademark law categorizes marks along a spectrum of **distinctiveness**, based on a mark's capacity to serve a source-identifying function. A mark is classified as (1) coined or fanciful (most distinctive), (2) arbitrary, (3) suggestive, (4) descriptive, or (5) generic (least distinctive). **For Example**, the mark EXXON is fanciful because it was designed by its owner to designate petroleum and related products. The name CENGAGE is a coined creation of the owner of this trademark and has no other meaning in English, but it serves to distinguish the products of its owner from all others. The mark APPLE for computers, an arbitrary mark, consists of a word in common usage that is arbitrarily applied in such a way that it is not descriptive or suggestive. The mark COPPERTONE for suntan lotion is a suggestive mark—requiring some imagination to reach a conclusion about the nature of the product. Coined or fanciful, arbitrary, and suggestive marks may be registered on the Principal Register under the Lanham Act without producing any actual evidence of the source-identifying attribution or the public perception of these marks.

Descriptive marks are those that convey an immediate idea of the ingredients, qualities, or characteristics of the goods or service, such as SPORTS ILLUSTRATED for a sports magazine. Because descriptive marks are not inherently capable of serving as source identifiers, such marks may be registered on the Principal Register only after the owner has provided sufficient evidence to establish that the public associates the term or phrase not only with a specific feature or quality, but also with a single commercial source. When a descriptive phrase becomes associated with a single commercial source, the phrase is said to possess “**acquired distinctiveness**” or “**secondary meaning**,” and therefore functions as a trademark. **For Example**, when the public perceives the phrase SPORTS ILLUSTRATED as a particular sports magazine in addition to its primary meaning as a description of a specific feature or element, the phrase has “acquired distinctiveness” or “secondary meaning” and may receive trademark protection.

acquired distinctiveness—through advertising, use and association, over time, an ordinary descriptive word or phrase has taken on a new source-identifying meaning and functions as a mark in the eyes of the public.

Ordinarily geographic terms are not registrable on the Principal Register. **For Example**, BOSTON BEER was denied trademark protection because it was a geographic term.³ However, if a geographic term has acquired a secondary meaning, it would be registrable. **For Example**, the geographic term *Philadelphia* has acquired secondary meaning when applied to cream cheese products.

secondary meaning—a legal term signifying the words in question have taken on a new meaning with the public, capable of serving a source-identifying function of a mark.

A personal name can acquire trademark protection if the name has acquired secondary meaning. The name must be registered as a trademark for goods or services and must be used in commerce. A name acquires secondary meaning if the buying public associates the name with a product or service. **For Example**, David Beckham has registered his name in a variety of categories from mobile phones to swim wear.

With a limited number of colors available for use by competitors, along with possible shade confusion, courts had held for some 90 years that color alone could not function as a trademark. The U.S. Supreme Court has overturned this rule, finding that if a color serves as a symbol that distinguishes a firm's goods and identifies their source without serving any other significant function, it may, sometimes at least, meet the basic legal

³ *Boston Beer Co. v. Slesar Bros. Brewing Co.*, 9 F.3d 812 (1st Cir. 1994).

requirements for use as a trademark.⁴ **For Example**, Owens-Corning Fiberglass Corp. has been allowed to register the color pink as a trademark for its fiberglass insulation products.

Generic terms that describe a “genus” or class of goods such as soap, car, cola, or rosé wine are never registrable because they do not have a capacity to serve as a source identifier.

CASE SUMMARY

No Hogging Generic Terms

FACTS: Beginning in the late 1960s and thereafter, the word *hog* was used by motorcycle enthusiasts to refer to large motorcycles. Into the early 1980s, motorcyclists came to use the word *hog* when referring to Harley-Davidson (Harley) motorcycles. In 1981, Harley itself began using *hog* in connection with its merchandise. In 1983, it formed Harley Owners Group, used the acronym H.O.G., and registered the acronym in conjunction with various logos in 1987. Since 1909, Harley has used variations of its bar-and-shield logo. Ronald Grottanelli opened a motorcycle repair shop under the name The Hog Farm in 1969. At some point after 1981, he sold products such as Hog Wash engine degreaser and a Hog Trivia board game. Grottanelli had used variants of Harley’s bar-and-shield logo since 1979 on signs and T-shirts, dropping the name Harley-Davidson from the bar of the logo in 1982 after receiving a letter of protest from the company. He continued to use the bar and shield, however, and featured a drawing of a pig wearing sunglasses and a banner with the words “Unauthorized Dealer.” From a judgment for Harley for infringement of the bar-and-shield trademark and an injunction

prohibiting the use of the word *hog* in reference to some of his products and services, Grottanelli appealed.

DECISION: *Hog* was a generic word in the language as applied to large motorcycles before segments of the public began using it to refer to Harley-Davidson motorcycles. Neither a manufacturer nor the public can withdraw from the language a generic term, already applicable to a category of products, and accord it trademark significance as long as the term retains some generic meaning. It was an error to prohibit Grottanelli from using the word *hog*. Harley must rely on a portion of its trademark to identify the brand of motorcycles, for example, Harley Hogs. Grottanelli was properly enjoined from using the bar-and-shield logo. Grottanelli’s mark uses Harley’s mark in a somewhat humorous manner to promote his own products, which is not a permitted trademark parody use. The use of the prefix “UN” before “AUTHORIZED DEALER” is no defense. The courts have ordinarily found the use of such disclaimers insufficient to avoid liability for infringement. [*Harley-Davidson, Inc. v. Grottanelli*, 164 F.3d 806 (2d Cir. 1999)]

9-1d Proving Trademark Infringement

To bring a successful case in trademark infringement, a plaintiff must prove that it has a valid mark, that it was the first to use the mark, and that another’s use of the mark is likely to cause confusion to consumers. Courts have developed a list of factors to determine whether or not there is a likelihood of confusion. Courts consider all of the factors, with no one factor being determinative:

1. the strength of the plaintiff’s mark;
2. the similarity between the two marks;
3. the similarity of the products involved;
4. the likelihood that the plaintiff will enter the defendant’s market;
5. the extent of actual consumer confusion;
6. the defendant’s lack of good faith in adopting the mark;
7. the quality of the defendant’s product; and
8. the sophistication of the buyers

⁴ *Qualitex Co. v. Jacobson Products Co., Inc.*, 514 U.S. 159 (1995).

9-1e Remedies for Improper Use of Marks

Trademark holders frequently send “cease and desist” letters to those they believe are infringing on their mark. If the alleged infringer does not cooperate, the trademark holder may seek an injunction prohibiting a competitor from imitating or duplicating the mark. If the trademark holder prevails in an infringement suit, proving the validity of its mark and the likelihood of confusion, the court will enjoin the defendant from using the particular mark.

In some cases, courts have found that there is no likelihood of confusion when marks have similar names but are used to identify different products. **For Example**, a court held that Cadillac as applied to boats, is not confusingly similar to Cadillac as applied to automobiles; therefore, its use cannot be enjoined.⁵ In addition to broad injunctive relief, the prevailing party may recover lost profits and other actual damages. In cases of willful violations, the court has full discretion to award the plaintiff up to treble damages. In “exceptional cases” the court has discretion to award attorney’s fees.

9-1f Abandonment of Exclusive Right to Mark

An owner who has an exclusive right to use a mark may lose that right. If other persons are permitted to use that mark, it loses its exclusive character and is said to pass into the English language and become generic. Examples of formerly enforceable marks that have made this transition into the general language are *aspirin*, *thermos*, *cellophane*, and *shredded wheat*. Nonuse for three consecutive years is prima facie evidence of abandonment.⁶

9-1g Trade Dress Protection

Firms invest significant resources to develop and promote the appearance of their products and the packages in which these products are sold so that they are clearly recognizable by consumers.

trade dress—product’s total image including its overall packaging look.

Trade dress involves a product’s total image and, in the case of consumer goods, includes the overall packaging look in which each product is sold.

When a competitor adopts a confusingly similar trade dress, it dilutes the first user’s investment and goodwill and deceives consumers, hindering their ability to distinguish between competing brands. In 1992, the United States Supreme Court recognized that the look and feel of a place of business, such as a restaurant, may be sufficiently distinctive to receive trade dress protection.⁷ Subsequently, courts have become more receptive to claims of trade dress infringement under Section 43(a) of the Lanham Act. To prevail in a case of trade dress infringement, a plaintiff must prove that its trade dress is distinctive and nonfunctional and the defendant’s trade dress is confusingly similar to the plaintiff’s.⁸

For Example, a court found that Jose Cuervo International infringed upon Maker’s Mark Distillery’s red dripping-wax-seal trade dress element used on its bourbon bottles when it used a similar element on its tequila bottles. The court held that the wax seal was not functional because there was more than one way to seal a bottle. In cases involving trade

⁵ *General Motors Corp. v. Cadillac Marine and Boat Co.*, 226 F. Supp. 716 (W.D. Mich. 1964). See also *Amstar Corp. v. Domino’s Pizza Inc.*, 615 F.2d 252 (5th Cir. 1980), where the court held that the mark Domino as applied to pizza was not confusingly similar to Domino as applied to sugar.

⁶ *Doebler’s Pennsylvania Hybrids, Inc. v. Doebler*, 442 F.3d 812 (3rd Cir. 2006).

⁷ *Two Pesos, Inc. v. Taco Cabana, Inc.*, 505 U.S. 763 (1992).

⁸ *Clicks Billiards v. Sixshooters, Inc.*, 251 F.3d 1252 (9th Cir. 2001); *Woodsland Furniture, LLC v. Larsen*, 124 P.3d 1016 (Idaho 2005).

dress infringement, courts use the same factors employed in trademark cases to determine likelihood of confusion.⁹

9-1h Limited Lanham Act Protection of Product Design

Trade dress originally included only the packaging and “dressing” of a product, but in recent years, federal courts of appeals’ decisions have expanded trade dress to encompass the design of a product itself. Product design may include the shape, configuration, or pattern of a product such as a sofa, a handbag, or a teapot. Some manufacturers have been successful in asserting Section 43(a) Lanham Act protection against “knockoffs”—that is, copies of their designs. The Supreme Court has held that a product’s design is not inherently distinctive and can meet the “distinctiveness” element required by Section 43(a) only by a showing of secondary meaning. That is, the manufacturer must show that the design has come to be known by the public as identifying the product in question and its origin.¹⁰ A product’s design, like trade dress, cannot be protected under the Lanham Act if it is functional. Functional features should be protected under patent law.

It is clear from the Supreme Court’s *Wal-Mart Stores, Inc. v. Samara Bros, Inc.* decision that, ordinarily, only famous designers whose works are widely recognized by the public by their design alone, such as certain Tommy Hilfiger and Ralph Lauren garments, Dooney & Bourke handbags, and Movado watches, will be able to successfully pursue Section 43(a) trade dress protection for their designs against knockoff versions of their work. Of course if a manufacturer’s design is copied along with the manufacturer’s labels or logo, the makers and sellers of these counterfeit goods are always in clear violation of the Lanham Act.¹¹ As discussed later, design patents may protect new and nonobvious ornamental features of a product.

9-1i Prevention of Dilution of Famous Marks

The Federal Trademark Dilution Act of 1995 (FTDA)¹² provides a cause of action against the “commercial use” of another’s famous mark or trade name when it results in a “dilution of the distinctive quality of the mark.” The act prevents junior users from free-riding on the success of a famous mark. To prevail in an FTDA case, the plaintiff must prove: (1) that its mark is famous; (2) that another’s use of the mark impacts the distinctiveness of its mark through blurring or tarnishment. Blurring is defined as the “whittling away” of the senior mark’s value over time. Tarnishment involves a use that could harm the reputation of the senior mark owner. The FTDA was amended in 2006 by the Trademark Dilution Revision Act (TDRA). The TDRA makes it clear that a famous mark owner does not need to prove likelihood of confusion to prevent a junior from using its mark. The senior mark owner does not have to prove economic injury—it need only establish blurring or tarnishment. The senior mark owner is entitled to an injunction against another’s use of its mark if it prevails. The act protects against discordant uses, such as Du Pont shoes, Buick aspirin, and Kodak pianos. The holder of a famous mark does not have to prove likelihood of confusion in a dilution case. The act does, however, allow truthful comparative advertising and a “fair use” defense for parodying a famous mark.¹³ **For Example,** a court held that the manufacturer of a plush doggie chew toy

⁹ *Maker’s Mark Distillery, Inc. v. Jose Cuervo International*, 679 F.3d 410 (6th Cir. 2012).

¹⁰ *Wal-Mart Stores, Inc. v. Samara Bros, Inc.*, 529 U.S. 205 (2000).

¹¹ See *Gucci America Inc. v. Tyrell-Miller*, 678 F. Supp. 2d 117 (S.D.N.Y. 2008), where the court assessed Ms. Miller damages of \$200,000 for each of the 15 trademark violations incurred for selling counterfeit Gucci handbags on her Web site.

¹² 15 U.S.C. §1125(c)(1).

¹³ Trademark Dilution Revision Act (2005).

shaped like a Louis Vuitton handbag and imitating the LV logo was not trademark dilution. The court found that the parody of the famous mark qualified as a fair use to the dilution claim.¹⁴

Trademark holders vigorously protect their trademarks. Holders of famous marks are sometimes accused of being “trademark bullies” when they assert their rights against small businesses. A determined small business owner, however, may use social media to gain public support for its cause. **For Example**, when Bo Muller-Moore, a Vermont silk screen artist, sought to register “Eat More Kale,” Chick-Fil-A, owner of the mark “Eat Mor Chickin,” opposed the registration claiming it would confuse consumers and dilute the distinctiveness of its famous mark. Muller-Moore engaged in a fierce public relations battle, using Facebook and Change.org to make his case for registering “Eat More Kale.” The USPTO granted the “Eat More Kale” trademark to Muller-Moore in December 2014.

9-1j Internet Domain Names and Trademark Rights

Businesses frequently use a registered trademark in an Internet domain name, such as “Amazon.com,” “Priceline.com,” and the publisher of this book, “Cengage.com.”

The Internet Corporation for Assigned Names and Numbers (ICANN) is a nonprofit corporation responsible for coordinating the use of domain names across the Internet. ICANN clears and delegates new generic top level domains (gTLDs). The list of gTLDs is expanding rapidly. The ubiquitous “.com” or “.org” has expanded to include “.hotel,” “.apple,” and many others. Trademark owners need to check the list of new gTLDs frequently for potentially infringing marks. ICANN grants a sunrise period of one or two months priority registration to trademark owners who have filed with ICANN and who are eligible to use the gTLD. **For Example**, “.bank” became available in 2015. A 30-day sunrise period grants priority to banking institutions that have registered their trademarks with ICANN. Registration of “.bank” is limited to verified members of the banking community.

Cybersquatters

cybersquatters—term for those who register and set up domain names on the Internet for resale to the famous users of the names in question.

Cybersquatters are individuals who register and set up domain names on the Internet that are identical, or confusingly similar, to existing trademarks that belong to others or are the personal names of famous persons. The cybersquatter hopes to sell or “ransom” the domain name to the trademark owner or the famous individual. New gTLDs provide new opportunities for cybersquatters.

Because the extent of the legal remedies available to famous companies or famous individuals who have been victims of cybersquatters has not always been certain, Congress passed the Federal Anticybersquatting Consumer Protection Act (ACPA)¹⁵ in 1999 to prohibit the practice of cybersquatting and cyberpiracy and to provide clear and certain remedies. The ACPA prohibits registering, trafficking in, or using a domain name confusingly similar to, or dilutive of, a trademark. To be successful in an ACPA lawsuit, the plaintiff must prove that the name is famous and that the domain name was registered in bad faith.¹⁶ Remedies include (1) injunctive relief preventing the use of the name, (2) forfeiture of the domain name, and (3) attorney fees and costs. In addition, trademark

¹⁴ *Louis Vuitton Malletier S.A. v. Haute Diggity Dog, LLC*, 507 F.3d 252 (4th Cir. 2007).

¹⁵ Pub. L. 106, 113 Stat. 1536, 15 U.S.C. §1051.

¹⁶ A plaintiff must meet the burden of proof, however, that its mark is “famous,” in order to come within the protection of the ACPA, with the courts requiring the marks be highly distinctive and thus well known throughout the country. Among the marks courts have ruled not to be distinctive are “Blue Man Group,” the performing group; “Clue,” the board game; and “Trek,” for bicycles. In contrast, marks that have been ruled famous include “Nike,” “Pepsi,” and “Victoria’s Secret.” See *Philbrick v. eNom Inc.*, 593 F. Supp. 2d 352, 367 (D. N.H. 2009).

owners may obtain damages and the profits that cybersquatters made from the use of the name.

A safe harbor exists under the ACPA for defendants who “believed and had reasonable grounds to believe that the use of the domain name was fair use or otherwise lawful.”¹⁷ But a defendant who acts even partially in bad faith in registering a domain name is not entitled to the shelter of the safe harbor provision. **For Example**, Howard Goldberg, the president of Artco, is an operator of Web sites that sell women’s lingerie and other merchandise. He registered a domain name <http://www.victoriasecrets.net> to divert consumers to his Web sites to try to sell them his goods. The court rejected his ACPA safe harbor defense that he intended in good faith to have customers compare his company’s products with those of Victoria’s Secret. The fact that Victoria’s Secret is a distinctive or famous mark deserving of the highest degree of trademark protection, coupled with the fact that the defendant added a mere *s* to that mark and gave false contact information when he requested the domain name, indicates that he and his company acted in bad faith and intended to profit from the famous mark.¹⁸

Dispute Avoidance

To avoid the expense of trademark litigation, it is prudent to determine whether the Internet domain name selected for your new business is an existing registered trademark or an existing domain name owned by another. Commercial firms provide comprehensive trademark searches for less than \$500. Determining whether a domain name is owned by another may be done online at <http://www.internic.net/whois.html>.

The Internet Corporation for Assigned Names and Numbers (ICANN) provides fast-track arbitration procedures to protect trademark owners from conflicting online domain names under the auspices of the World Intellectual Property Organization (WIPO). **For Example**, Victoria’s Secret stores arbitrated the “victoriasecrets.net” domain name held by Howard Goldberg’s company, and the arbitration panel transferred the ownership of the name to Victoria’s Secret stores. Victoria’s Secret stores subsequently brought an action against Goldberg and Artco for damages and injunctive relief under trademark law and the ACPA.

9-2 Copyrights

The United States Constitution provides that Congress has the power to “promote the progress of science and the useful arts, by securing for limited times to authors and inventors the exclusive rights to their respective writings and discoveries.”¹⁹ The Copyright Act is a federal statute that gives an author, an artist, or a creator **copyright** protection, which consists of exclusive rights to use, reproduce, and display the work. The copyright owner also has the exclusive right to make derivative works. Under the international treaty called the *Berne Convention*, members agree to protect the copyright of the works of all member nations to the same extent as copyrighted works of their own nationals.

A copyright protects the manner in which an idea is expressed but not the idea itself.²⁰ The Copyright Act does not apply extraterritorially. However, if the infringement is completed in the United States and the copied work is then disseminated overseas, there is liability under the act for the resulting extraterritorial damages. **For Example**, the Los Angeles News Service (LANS), an independent news organization, produced

copyright—exclusive right given by federal statute to the creator of a literary or an artistic work to use, reproduce, and display the work.

¹⁷ U.S.C. §1125(d)(1)(B)(ii).

¹⁸ *Victoria’s Secret Stores v. Artco*, 194 F. Supp. 2d 204 (S.D. Ohio 2002).

¹⁹ U.S. CONST. art. I, § 8.

²⁰ *Attia v. New York Hospital*, 201 F.3d 50 (2d Cir. 2000).

two copyrighted videotapes of the beating of Reginald Denny during the Los Angeles riots of April 1992, and LANS licensed them to NBC for use on the *Today Show* in New York. Visnews taped the works and transmitted them by satellite to Reuters in London, which provided copies to its overseas subscribers. The infringement by Visnews occurred in New York, and Visnews was liable for the extraterritorial damages that resulted from the overseas dissemination of the work.²¹

It is a violation of U.S. copyright law for satellite carriers to capture signals of network stations in the United States and transmit them abroad. **For Example**, a court held that PrimeTime's satellite retransmission of copyrighted NFL football games to satellite dish owners in Canada was a violation of U.S. copyright law, notwithstanding testimony of PrimeTime's CEO that a law firm in Washington, D.C., told him that U.S. law did not pertain to the distribution of products in Canada. The NFL was awarded \$2,557,500 in statutory damages.²²

9-2a Duration of Copyright

The U.S. Constitution empowers Congress to give authors the exclusive right to their writings for "limited times."

The first U.S. copyright statute, enacted in 1790, provided protection for any "book, map or chart" for 14 years, with a privilege to renew for an additional 14 years. In 1831, the initial 14-year term was extended to 28 years, with a privilege for an additional 14 years. Under the 1909 Copyright Act, the protection period was for 28 years, with a right of renewal for an additional 28 years.

The Copyright Act of 1976 set the duration of a copyright at the life of the creator of the work plus 50 years. Under the Sonny Bono Copyright Term Extension Act of 1998, the duration has been extended to the life of the creator plus 70 years.²³ If a work is a "work made for hire"—that is, a business pays an individual to create the work—the business employing the creator registers the copyright. Under the 1998 Extension Act, such a copyright has been extended by 20 years and now runs for 120 years from creation or 95 years from publication of the work, whichever period is shorter. After a copyright has expired, the work is in the public domain and may be used by anyone without cost.²⁴

9-2b Copyright Notice

Prior to March 1, 1989, the author of an original work secured a copyright by placing a copyright notice on the work, consisting of the word *copyright* or the symbol "©," the year of first publication, and the name or pseudonym of the author. The author was also required to register the copyright with the Copyright Office. Under the Berne Convention Implementation Act of 1988,²⁵ a law that adjusts U.S. copyright law to conform to the Berne Convention, it is no longer mandatory that works published after March 1, 1989, contain a notice of copyright. However, placing a notice of copyright on published works is strongly recommended. This notice prevents an infringer from claiming innocent infringement of the work, which would reduce the amount of damages owed. To bring a copyright infringement suit for a work of U.S. origin, the owner must have submitted two copies of the work to the Copyright Office in Washington, D.C., for registration.

²¹ *Los Angeles News Service v. Reuters*, 149 F.3d 987 (9th Cir. 1998).

²² *National Football League v. PrimeTime 24 Joint Venture*, 131 F. Supp. 2d 458 (S.D.N.Y. 2001).

²³ P.L. 105-298, 112 Stat. 2827, 17 U.S.C. §302(b).

²⁴ Without the Sonny Bono Extension Act of 1998, the copyright on Mickey Mouse, created by Walt Disney Co. in 1928, was set to expire in 2003 and enter the public domain. Pluto, Goofy, and Donald Duck would have followed soon after.

²⁵ P.L. 100-568, 102 Stat. 2854, 17 U.S.C. §101 *et seq.*

9-2c What Is Copyrightable?

Copyrights protect literary, musical, dramatic, and artistic work. Protected are books and periodicals; musical and dramatic compositions; choreographic works; maps; works of art, such as paintings, sculptures, and photographs; motion pictures and other audiovisual works; sound recordings; architectural works; and computer programs.

The work must be original, independently created by the author, and possess at least some minimal degree of creativity.²⁶ **For Example,** William Darden, a Web page designer, challenged the Copyright Office's denial of a copyright registration for a series of existing maps with some changes in the nature of shading, coloring, or font. A court found that the Copyright Office acted within its discretion when it denied Darden's registration because the examiner from the Visual Arts Section concluded that the maps were "representations of the preexisting census maps in which the creative spark is utterly lacking or so trivial as to be virtually nonexistent."²⁷



9-2d Copyright Ownership and the Internet

Businesses today commonly use offsite programming services to create copyrightable software, with the delivery of code over the Internet. As set forth previously, when a business pays an employee to create a copyrightable work, it is a "work for hire" and the business employing the creator owns and may register the copyright. On the other hand, if a freelancer is employed offsite to create software for a fixed fee without a contract setting forth the ownership of the work, the freelancer owns the work product and the company utilizing the freelancer has a license to use the work product but does not have ownership of it. To avoid disputes about ownership of custom software, a written contract that addresses these ownership and license questions is necessary.

9-2e Rights of Copyright Holders

A copyright holder has the exclusive right to (1) reproduce the work; (2) prepare derivative works, such as a script from the original work; (3) distribute copies of recordings of the work; (4) publicly perform the work, in the case of plays and motion pictures; and (5) publicly display the work, in the case of paintings, sculptures, and photographs.

The copyright owner may assign or license some of the rights listed and will receive royalty payments as part of the agreement. The copyright law also ensures royalty payments, which are collected by two performing rights societies, the American Society of Composers, Authors, and Publishers (ASCAP) and Broadcast Music, Inc. (BMI), which act on behalf of the copyright holders.

Copyright infringement may be intentional or unintentional and artists may deal with alleged infringement in different ways. **For Example,** Sam Smith and his co-writers agreed to share songwriting royalties for the hit *Stay With Me* (released in 2014) with Tom Petty and Jeff Lynne, who wrote *I Won't Back Down* (released in 1989). Smith agreed that there was a coincidental likeness between the songs, although he had not been familiar with the song by Petty and Lynne. In a similar case, however, the Estate of Marvin Gaye brought a copyright infringement suit against Robin Thicke and Pharrell Williams, claiming that their 2013 hit *Blurred Lines* infringed on Gaye's 1977 success *Got to Give It Up*. A jury returned a verdict for Marvin Gaye's family in the amount of \$7.4 million.²⁸ In addition to rights

²⁶ *Feist Publications Inc. v. Rural Telephone Services Co.*, 499 U.S. 340 (1991).

²⁷ *Darden v. Peters*, 402 F. Supp. 2d 638 (E.D.N.C. 2005).

²⁸ Associated Press, *Pharrell Williams and Robin Thicke to Pay \$7.4m to Marvin Gaye's Family Over Blurred Lines*, the guardian (Mar. 11, 2015), <http://www.theguardian.com/music/2015/mar/10/blurred-lines-pharrell-robin-thicke-copied-marvin-gaye>.

under the copyright law and international treaties, federal and state laws prohibit record and tape piracy.

9-2f Limitation on Exclusive Character of Copyright

A limitation on the exclusive rights of copyright owners exists under the principle of *fair use*, which allows limited use of copyrighted material in connection with criticism, news reporting, teaching, and research. The statute lists four nonexclusive factors for courts to use in assessing whether an alleged infringer is entitled to a fair use defense:

1. The purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes²⁹
2. The nature of the copyrighted work
3. The amount and substantiality of the portion used in relation to the copyrighted work as a whole
4. The effect of the use on the potential market for or value of the copyrighted work³⁰

First Amendment privileges of freedom of speech and the press are preserved through the doctrine of *fair use*, which allows for use of portions of another's copyrighted work for matters such as comment and criticism. Parodies and caricatures are the most penetrating forms of criticism and are protected under the fair use doctrine. Moreover, while injunctive relief is appropriate in the vast majority of copyright infringement cases because the infringements are simply piracy, in the case of parodies and caricatures where there are reasonable contentions of fair use, preliminary injunctions to prevent publication are inappropriate. The copyright owner can be adequately protected by an award of damages should infringement be found. **For Example**, Suntrust Bank, the trustee of a trust that holds the copyright to Margaret Mitchell's *Gone with the Wind*, one of the all-time best-selling books in the world, obtained a preliminary injunction preventing Houghton Mifflin Co. from publishing Alice Randall's *The Wind Done Gone*. The Randall book is an irreverent parody that turns old ideas upside down. The Court of Appeals set aside the injunction of the federal district court because Houghton Mifflin had a viable fair use defense.³¹

CASE SUMMARY

Fair Use or Not Fair Use—That Is the Question

FACTS: In 2000, Patrick Cariou, a professional photographer, published a book entitled *Yes Rasta*, containing classical photographs and portraits he took while living in Jamaica

for six years. Richard Prince is a successful appropriation artist whose work has been exhibited in several prominent museums. In 2007 and 2008, Prince exhibited paintings and

²⁹ In *Princeton University Press v. Michigan Document Services, Inc.*, 99 F.3d 1381 (6th Cir. 1996), a commercial copyshop reproduced “coursepacks” and sold them to students attending the University of Michigan. The court refused to consider the “use” as one for nonprofit educational purposes because the use challenged was that of the copyshop, a for-profit corporation that had decided to duplicate copyrighted material for sale to maximize its profits and give itself a competitive edge over other copyshops by declining to pay the royalties requested by the holders of the copyrights.

³⁰ 17 U.S.C. §107. See fair use analysis in *Perfect 10 v. Amazon.com, Inc.*, 487 F.3d 701, 719–725 (9th Cir. 2007).

³¹ *Suntrust Bank v. Houghton Mifflin Co.*, 268 F.3d 1257 (11th Cir. 2001). See also *Brownmark Films, LLC. v. Comedy Partners*, 800 F. Supp. 2d 991 (E.D. Wis. 2011), where the federal district court dismissed a copyright infringement lawsuit against the South Park defendants on the basis of fair use defense in an episode lampooning viral video crazes.

Fair Use or Not Fair Use—That Is the Question continued

collages called *Canal Zone* at the Eden Rock Hotel in Saint Barth's and at the Gagosian Gallery in New York. The paintings and collages incorporate some of Cariou's copyrighted images from *Yes Rasta*. Prince used the photographs but altered them in various ways such as by painting "lozenges" over the faces or adding a guitar. In some paintings, Prince added works of other artists to Cariou's photographs. Cariou sued Prince and Gagosian, alleging copyright infringement. Prince and Gagosian raised the defense of fair use. The lower court held that Prince was not entitled to a fair use defense because "Prince did not intend to comment on Cariou, on Cariou's Photos, or on aspects of popular culture closely associated with Cariou or the Photos when he appropriated the Photos." The court ordered all of the infringing works to be delivered to Cariou for "impounding, destruction, or other disposition."

DECISION: Judgment for Prince. The court emphasized the transformative nature of Prince's work. Twenty-five of the thirty works appropriated by Prince manifest an aesthetic entirely different from Cariou's photographs. The serene classical photographs taken by Cariou printed in black-and-white were fundamentally different from the jarring, crude,

provocative and colorful works produced by Prince. Prince's work is transformative because it added something new to Cariou's photographs, resulting in a fundamentally different aesthetic. The transformative nature of the work impacted the four factor analysis. The first fair use factor, the purpose and character of the use, does not suggest that commercial uses are presumptively unfair. Even though Prince's use was commercial, the transformative nature of the work reduces the significance of this factor. The second statutory factor, the nature of the copyrighted work, weighs in Cariou's favor because the work is creative and published. But again the transformative nature of the work limits the usefulness of this factor. The third factor, the amount and substantiality of the portion used, weighs heavily in Prince's favor because the photographs were transformed into something new and different. The fourth factor, the effect of the secondary use on the potential market for the value of the copyrighted work, weighs in Prince's favor because Prince's work does not usurp the market for the original work. Prince's target audience and the nature of his work is distinct from that of the original. Twenty-five of the allegedly infringing works satisfied the fair use factors. Five of the works were remanded to the district court for further consideration. [*Cariou v. Prince*, 714 F.3d 694 (2d Cir. 2013)]

9-2g Secondary Liability for Infringement

Contributory infringement and vicarious infringement are secondary forms of infringement. Contributory infringement occurs when a defendant knew of the infringing activity and participated by inducing or furthering the direct infringement. Vicarious infringement occurs when a defendant had the ability to supervise the acts of the infringer and had a direct financial interest in the exploitation of the copyrighted materials. An entity that distributes a device with the object of promoting its use to infringe copyrights as shown by clear expression or other active steps taken to foster the resulting acts of infringement is liable for these acts of infringement by third parties, regardless of the device's lawful uses. **For Example**, *Grokster, Ltd.*, and *StreamCast Networks, Inc.*, distributed free software products that allow all computer users to share electronic files through peer-to-peer networks, so called because users' computers communicate directly with each other, not through central servers. When these firms distributed their free software, each clearly voiced the objective that the recipients use the software to download copyrighted works. These firms derived profits from selling advertising space and streaming ads to the software users. Liability for infringement was established under the secondary liability doctrines of contributory or vicarious infringement.³²

While copyright holders have historically chosen to litigate against the provider of new technologies rather than the users of the technology, the law is clear that copyright holders may sue individual infringers. **For Example**, Sony and other recording companies successfully sued Goucher College student Joel Tenenbaum for willfully downloading

³² *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.*, 545 U.S. 913 (2005).

and distributing 30 copyrighted works, and the court assessed statutory damages at \$675,000.³³

9-2h Digital Millennium Copyright Act

The Digital Millennium Copyright Act of 1998 (DMCA)³⁴ was enacted to curb the pirating of software and other copyrighted works, such as books, films, videos, and recordings, by creating civil and criminal penalties for anyone who circumvents encryption software. The law also prohibits the manufacture, import, sale, or distribution of circumvention devices.

Title II of the DMCA provides a “safe harbor” for Internet Service Providers (ISPs) from liability for direct, vicarious, and contributory infringement of copyrights provided the ISP (1) does not have actual knowledge of the infringing activity or expeditiously removed access to the problematic material upon obtaining knowledge of infringing activity, (2) does not receive financial benefit directly attributable to the infringing activity, and (3) responded expeditiously upon notification of the claimed infringement.

9-3 Patents

Under Article 1, Section 8, of the U.S. Constitution, the founding fathers of our country empowered Congress to promote the progress of science by securing for limited times to inventors the exclusive rights to their discoveries. Federal patent laws established under Article 1, Section 8, protect inventors just as authors are protected under copyright law authorized by the same section of the U.S. Constitution.

Thomas Jefferson was the first administrator of the United States’ patent system and was the author of the Patent Act of 1793. During his time of administrating the system Jefferson saw clearly the difficulty of deciding what should be patentable. Years after drafting the 1793 act, he explained that in that act “the whole was turned over to the judiciary, to be matured into a system, under which everyone might know when his actions were safe and lawful.”³⁵ In practice, Congress has left wide latitude for judicial construction of patent law, entrusting the courts to keep pace with advancing industrial and technological developments.

9-3a Types, Duration, and Notice

There are three types of patents, the rights to which may be obtained by proper filing with the United States Patent and Trademark Office (USPTO) in Washington, D.C. The types and duration of patents are as follows.

Utility Patents

Inventions classified as *utility* or *functional patents* grant inventors of any new and useful process, machine, manufacture, or composition of matter or any new and useful improvement of such devices the right to obtain a patent.³⁶ Prior to 1995, utility patents had a life of 17 years from the date of grant. Under the Uruguay Round Trade Agreement Act, effective June 8, 1995, the duration of U.S. utility patents was changed from 17 years from the date of grant to 20 years from the date of filing to be consistent with the patent law of World Trade Organization (WTO) member states.

³³ *Sony v. Tenenbaum*, 660 F.3d 487 (1st Cir. 2011).

³⁴ 17 U.S.C. §1201.

³⁵ See *Graham v. John Deere Co. of Kansas City*, 383 U.S. 1, 10 (1966).

³⁶ 35 U.S.C. §101.

Design Patents

A second kind of patent exists under U.S. patent law that protects new and nonobvious ornamental features that appear in connection with an article of manufacture.³⁷ These patents are called *design patents* and have a duration of 14 years. In order to establish design patent infringement, the patent holder has the difficult task of proving, by a preponderance of the evidence, that an ordinary observer (and not the eye of an expert) taking into account the prior art would believe the accused design to be the same as the patented design.³⁸ Design patents can be effective in combating counterfeiters. Toy manufacturers, for example, may hold design patents on game pieces, timers, and the playing board. Design patents are relatively simple in form and are issued more frequently than utility patents. The smartphone patent wars between Apple and Samsung included several design patents, including the shape of the iPhone.

Plant Patents

A third type of patent, called a *plant patent*, protects the inventors of asexually reproduced new varieties of plants. The duration is 20 years from the date of filing, the same duration applied to utility patents.

Notice

The owner of a patent is required to mark the patented item or device using the word *patent* and must list the patent number on the device to recover damages from an infringer of the patent.

The America Invents Act

Federal patent law was amended in 2011 by the America Invents Act (AIA).³⁹ Section 3 of the act defines the effective filing date of a claimed invention as the actual filing date of the patent or application for a patent, replacing the current “first to invent” system with a “first to file system.” The purpose of this change is to provide the inventor with greater certainty regarding the scope of protection and to promote international uniformity by harmonizing the U.S. patent system with systems used in Europe and other countries with which the United States conducts trade. The AIA provides the option of an expedited patent examination process, with the goal of processing applications within 12 months, as opposed to the ordinary processing period of three to four years. The USPTO fee for this service is an extra \$4,800, with a 50 percent reduction for “small entity” inventors. Under the act, the USPTO will also speed up the application process, at no additional cost, for inventions that reduce greenhouse emissions or provide energy conservation.

Challenges to patent grants can be made for up to nine months after the patent is granted. The post-grant review is made by a patent examiner.

9-3b Patentability

Section 101 of the 1952 Patent Act recognizes four categories of subject matter for patent eligibility: (1) processes, (2) machines, (3) manufactures, and (4) compositions of matter. However, even if a claim may be deemed to fit one of these categories, it may not be patent eligible. Phenomena of nature, mental processes, and abstract intellectual

³⁷ 35 U.S.C. §173.

³⁸ *Gorham v. White*, 81 U.S. 511 (1871).

³⁹ Pub. L. 112-29, H.R. 1249 enacted September 16, 2011, and effective as of March 16, 2013. Amended 35 U.S.C. §102.

concepts are not patentable because they are the basic tools of scientific and technological work.⁴⁰ **For Example**, Prometheus Laboratories Inc. patented steps for testing the proper dosage level of drug treatments for individuals with gastrointestinal diseases. When the Mayo Clinic developed a similar test to determine toxicity-risk levels, Prometheus sued Mayo for patent infringement. The Supreme Court held that the Prometheus patents were not patent eligible because they were merely instructions to apply the laws of nature.⁴¹

Once it is established that an invention is patent eligible, a patent may be obtained if the invention is something that is *new and not obvious* to a person of ordinary skill and knowledge in the art or technology to which the invention is related. Whether an invention is new and not obvious in its field may lead to highly technical proceedings before a patent examiner, the USPTO's Board of Patent Appeals, and the U.S. Court of Appeals for the Federal Circuit (CAFC). **For Example**, Thomas Deuel's application for a patent on complementary DNA (cDNA) molecules encoding proteins that stimulated cell division was rejected by a patent examiner as "obvious" and the rejection was affirmed by the USPTO's Board of Patent Appeals. However, after a full hearing before the CAFC, which focused on the state of research in the field as applied to the patent application, Deuel's patent claims were determined to be "not invalid because of obviousness."⁴²

The novelty requirement of patent eligibility addresses actions of both the patent applicant and others. Section 102 of the Patent Act provides that a patent must be denied "if the invention was patented or described in a printed publication in this or a foreign country or in public use or on sale in this country, more than one year prior to the date of application...." In other words, if an invention is in the public domain for more than a year, either through use or publication, it must remain there. An inventor may test its invention in the market before undertaking the expense of filing for a patent but must observe the one-year time limit.

Once approved by the Patent and Trademark Office, a patent is presumed valid.⁴³ However, a defendant in a patent infringement lawsuit may assert a patent's invalidity as a defense to an infringement claim by showing that the invention as a whole would have been obvious to a person of ordinary skill in the art when the invention was patented. This showing is called **prior art**. **For Example**, Ron Rogers invented and patented a tree-trimming device that is essentially a chain saw releasably mounted on the end of a telescoping pole. Rogers sued Desa International, Inc. (DIA), for patent infringement after DIA introduced the Remington Pole Saw, a chain saw releasably mounted on the end of a telescoping pole. DIA provided evidence of prior art, citing four preexisting patents dealing with "trimming tools on extension poles" that correlated with Rogers's patent. The court nullified Rogers's patent because it concluded that the DIA had met its heavy burden of proof that releasably mounting a lightweight chain saw on the end of a telescoping pole assembly to trim trees would be obvious to a person of ordinary skill in the art.⁴⁴

Patent law has expanded to include human-made microorganisms as patent-eligible subject matter, since such compositions are not nature's handiwork, but the inventor's own work.

prior art—a showing that an invention as a whole would have been obvious to a person of ordinary skill in the art when the invention was patented.

⁴⁰ *Gottschalk v. Benson*, 409 U.S. 63, 67 (1972).

⁴¹ *Mayo Collaborative Services v. Prometheus Laboratories, Inc.*, 132 S. Ct. 1289, 1301 (2012).

⁴² *In re Deuel*, 51 F.3d 1552 (Fed. Cir. 1995).

⁴³ See *Microsoft Corp. v. i4i Limited Partnership*, 131 S. Ct. 2238 (2011), where the Supreme Court determined that defenses to patent infringement claims must be proven by clear and convincing evidence.

⁴⁴ See *KRS International Co. v. Teleflex, Inc.*, 500 U.S. 398 (2007) for the Supreme Court's "obviousness" patent decision, where the Court held that mounting an available sensor on a fixed pivot point of the prior art pedal was a design step well within the grasp of a person of ordinary skill in the relevant art and that the benefit of doing so would be obvious.

CASE SUMMARY

Crude Life Forms Can Be Patented

FACTS: Chakrabarty was a microbiologist. He found a way of creating a bacterium that would break down crude oil. This could not be done by any bacteria that exist naturally. His discovery had a great potential for cleaning up oil spills. When he applied for a patent for this process, the commissioner of patents refused to grant it because what he had done was not a “manufacture” or “composition of matter” within the meaning of the federal statute and because a patent could not be obtained on something that was living. Chakrabarty appealed.

DECISION: Judgment for Chakrabarty. Discovering a way to produce a living organism that is not found in nature is within the protection of the patent laws. The fact that this kind of invention was not known when the patent laws were first adopted has no effect on the decision. The patent laws are to be interpreted according to the facts existing when an application for a patent is made. [*Diamond v. Chakrabarty*, 447 U.S. 303 (1980)]



ETHICS & THE LAW

Patenting Genes?

In *Diamond v. Chakrabarty*, the Supreme Court held that a microbiologist could patent a bacterium that breaks down crude oil. This decision spurred researchers to patent new discoveries in nature. Myriad Genetics discovered the precise location and sequence of two human genes, known as the BRCA1 and BRCA2 genes. Mutations in these genes substantially increase the risks of breast and ovarian cancer. Myriad obtained several patents based on its discovery, which, if valid, would give it the exclusive right to isolate an individual’s BRCA1 and BRCA2 genes. Isolation is necessary to conduct testing. When Myriad learned that other laboratories were providing genetic testing services to women using the isolated genes, it sent letters to them stating that the genetic testing infringed its patents.

Various groups including patients, advocacy groups, and doctors filed a lawsuit claiming that Myriad’s patents were invalid because they attempted to patent something that occurs in nature. The Supreme Court held that a naturally occurring DNA segment is a product of nature and not patent eligible merely because it has been isolated.* The Court

distinguished the facts in the *Myriad* case from those in *Chakrabarty*. In *Chakrabarty*, the Court stated, the bacterium was new “with markedly different characteristics from any found in nature,” due to the additional plasmids and resultant “capacity for degrading oil.” In *Myriad*, by contrast, the Court stated “that Myriad did not create or alter any of the genetic information encoded in the BRCA1 and BRCA2 genes.”

The Court recognized that patent protection strikes a delicate balance between creating “incentives that lead to creation, invention, and discovery” and “impeding the flow of information that might permit, indeed spur, invention.” The Court noted that, “Groundbreaking, innovative, or even brilliant discovery does not by itself satisfy the section 101 [novelty] inquiry.”

Consider how the Court’s decision impacted the cost of testing for breast cancer and ovarian cancer. Biotech companies hold patents on many genes. Do you think that the Court’s decision impacts the incentive to research?

**Association of Molecular Pathology v. Myriad Genetics, Inc.*, 133 S. Ct. 2107 (2013).

9-3c Patentable Business Methods

A 1998 Court of Appeals for the Federal Circuit (CAFC) decision recognized “business methods” as a patent-eligible “process” under Section 101 of the Patent Act.⁴⁵ A burgeoning number of business-method patents followed, with the U.S. Supreme Court referencing in

⁴⁵ *State Street Bank v. Signature Financial Group*, 149 F.3d 1368 (Fed. Cir. 1998).

its *eBay v. MercExchange* decision the “potential vagueness and suspect validity of some of these patents.”⁴⁶ A pure business-method patent consists of a series of steps related to performing a business process. **For Example**, Patent No. 6,846,131 sets forth a method of doing business with steps for Producing Revenue from Gypsum-Based Refuse Sites. So-called junk patents have also been issued as business-method patents. **For Example**, Patent No. 4,022,227, Method of Concealing Baldness, contains a series of steps for combing one’s hair that amount to what is best known as a *comb-over*. Business methods are often in the form of software programs and encompass e-commerce applications.

Such ideas are patentable only if there is some additional “inventive concept.”⁴⁷ In the wake of the Supreme Court’s decision in *Alice v. CLS Bank*, obtaining and enforcing software and business-method patents will be more difficult. Lower courts are increasingly invalidating such patents. Patents that recite fundamental economic principles or methods of organizing human activity will most likely be patent ineligible, even if they are trying to claim that these principles or activities are innovative because they are implemented through a computer.⁴⁸

CASE SUMMARY

Abstract Ideas Cannot Be Monopolized

FACTS: Alice Corporation held a patent that uses a computer as a third-party intermediary to minimize the risk associated with the exchange of financial obligations. The intermediary creates and updates “shadow” records to reflect the value of each party’s actual accounts held at “exchange institutions,” thereby permitting only those transactions for which the parties have sufficient resources. At the end of each day, the intermediary issues irrevocable instructions to the exchange institutions to carry out the permitted transactions.

CLS Bank International operates a global network that facilitates currency transactions. It sought a declaratory judgment that Alice’s patent was invalid. Section 101 of the Patent Act provides: “Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor....”

DECISION: The Court employed a two-step inquiry: 1. Whether the patent involves an abstract idea that is not patent eligible; 2. Is there anything else in the claim that transforms the abstract idea into a patent-eligible claim. A patent must be more than an abstract claim; it must include an “inventive concept.” The concept of using a third-party intermediary to mitigate settlement risk is an abstract idea that is patent-ineligible. In *Bilski v. Kappos*, 561 U.S. 593 (2010), the Court held that an algorithm for a method for hedging against the financial risk of price fluctuations was not patentable because it is an abstract idea. Like the risk hedging in *Bilski*, the concept of intermediated settlement is “a fundamental economic practice long prevalent in our system of commerce.” Moving to the second step, the Court concluded that requiring a generic computer implementation does not transform the idea into a patent-eligible invention. [*Alice Corporation Pty. Ltd. v. CLS Bank International*, 134 S. Ct. 2347 (2014)]

9-3d Infringement

The patent owner has the exclusive right to make, use, or sell the invention. The owner may bring suit for patent infringement for unauthorized use of a patent and obtain

⁴⁶ 547 U.S. 388 (2006).

⁴⁷ *Mayo Collaborative Services v. Prometheus Laboratories, Inc.*, 132 S. Ct. 1289 (2012).

⁴⁸ After *Alice v. CLS Bank*, the USPTO issued subject matter eligibility guidelines, including eight fact patterns to demonstrate the abstract idea analysis. USPTO, http://www.uspto.gov/patents/law/exam/abstract_idea_examples.pdf.

appropriate monetary damages and injunctive relief.⁴⁹ The Patent Act provides for the enhancement of damages upon proof of willful infringement and the award of reasonable attorney's fees in "exceptional cases."⁵⁰

Under the act, the owner has "the right to exclude others from making, using, offering for sale or selling the invention."⁵¹ In *eBay, Inc. v. MercExchange, LLC*, the U.S. Supreme Court dealt with the question of whether the patent holder had the right to obtain the permanent injunctive relief of stopping a business entity from "using" the patented technology in addition to obtaining damages for the patent violation. The threat of a court order may be used to seek high and often unreasonable licensing fees. Major technology companies contended that trial courts should consider multiple factors in deciding whether to issue a permanent injunction.

CASE SUMMARY

"Squeeze Play" Averted

FACTS: eBay and its subsidiary half.com operate popular Internet Web sites that allow private sellers to list goods they wish to sell at either an auction or a fixed price (its "Buy It Now" feature). MercExchange, LLC, sought to license its business-method patent to eBay, but no agreement was reached. In MercExchange's subsequent patent infringement suit, a jury found that its patent was valid, eBay had infringed the patent, and \$29.5 million in damages were appropriate. However, the District Court denied MercExchange's motion for permanent injunctions against patent infringement absent exceptional circumstances. MercExchange appealed. The Federal Circuit Court of Appeals reversed, and the U.S. Supreme Court granted *certiorari*.

DECISION: Judgment against MercExchange's position. The traditional four-factor test of equity applied by courts when considering whether to award permanent injunctive relief to a prevailing plaintiff applies to disputes arising under the Patent Act. That test requires a plaintiff to demonstrate that (1) it has suffered an irreparable injury, (2) remedies

available at law are inadequate to compensate for that injury, (3) considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted, and (4) the public interest would not be disserved by a permanent injunction. The decision to grant or deny such relief is an act of equitable discretion by the district court, reviewable on appeal for abuse of discretion. The Federal Circuit's ruling was vacated and remanded to the district court to apply the four-factor test. [A concurring opinion written by Justice Kennedy and joined by Justices Stevens, Souter, and Breyer stated that "an industry has developed in which firms use patents not as a basis for producing and selling goods but, instead, primarily for obtaining licensing fees. For these firms, an injunction, and the potentially serious sanctions arising from its violation, can be employed as a bargaining tool to charge exorbitant fees to companies that seek to buy licenses to practice the patent." Such may be considered under the four-factor test.] [*eBay, Inc. v. MercExchange, LLC*, 547 U.S. 388 (2006)]

Under the Supreme Court's "doctrine of equivalents," infringers may not avoid liability for patent infringement by substituting insubstantial differences for some of the elements of the patented product or process. The test for infringement requires an essential inquiry: Does the accused product or process contain elements identical or equivalent to each claimed element of the patented invention?⁵²

⁴⁹ See *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060 (2011), where the Court found that induced infringement of a patent is also actionable. Global-Tech Appliances, Inc., located in Hong Kong, developed a cool-touch deep fryer for Sunbeam Products by copying the "T-Fal" fryer in violation of SEB's U.S. patent. The Supreme Court agreed that the evidence was sufficient for a jury to find that Global-Tech willfully blinded itself to the infringing nature of the sales it encouraged Sunbeam to make.

⁵⁰ See *In re Seagate Technology, LLC*, 497 F.3d 1360 (Fed. Cir. 2007), where the CAFC set a higher "willfulness" standard, requiring at least a showing of objective recklessness on the part of the infringer.

⁵¹ 35 U.S.C. §154(a)(1).

⁵² *Warner-Jenkinson v. Hilton Davis Chemical Co.*, 520 U.S. 17 (1997). But see *Festo Corp. v. Shoketsu*, 493 F.3d 1368 (Fed. Cir. 2007).

9-4 Secret Business Information

A business may have developed information that is not generally known but that cannot be protected under federal law, or a business may want to avoid the disclosure required to obtain a patent or copyright protection of computer software. As long as such information is kept secret, it will be protected under state law relating to trade secrets.⁵³

9-4a Trade Secrets

trade secret—any formula, device, or compilation of information that is used in one’s business and is of such a nature that it provides an advantage over competitors who do not have the information.

A **trade secret** may consist of any formula, device, or compilation of information that is used in one’s business and is of such a nature that it provides an advantage over competitors who do not have the information. It may be a formula for a chemical compound, a process of manufacturing, treating, or preserving materials. **For Example**, shortly before he departed employment with Siemens, salesman J. J. David e-mailed the wiring schematics for the company’s reverse osmosis water desalination units (R.O. units) to his future co-founder of Revo Water Systems, LLC, and also requested and was allowed to observe and assist in the construction of a unit. Two years later a Siemens technician discovered that a Revo unit was a copy of the Siemens R.O. units. Siemens successfully sued David and Revo for breach of the confidentiality agreement David had signed with Siemens. The measure of damages for misappropriation of a trade secret is the profit derived from the misappropriation of the trade secret, which in this case amounted to \$908,160 over a 40-month period.⁵⁴

To a limited extent, courts will protect certain confidential customer lists. However, courts will not protect customer lists if customer identities are readily ascertainable from industry or public sources or if products or services are sold to a wide group of purchasers based on their individual needs.⁵⁵

CASE SUMMARY

Some Companies Don’t “Care Enough” To Do the Right Thing

FACTS: Hallmark Cards, Inc., hired a consulting group, Monitor Company Group, to compile research on the greeting cards market. Monitor created several PowerPoint presentations containing its findings. Hallmark and Monitor signed confidentiality agreements preventing Monitor from sharing these findings with anyone else. Monitor was closely affiliated with Clipper, a private equity firm founded by two of Monitor’s original partners and headquartered in Monitor’s building. Shortly after Hallmark hired Monitor, Clipper became interested in acquiring Recycled Paper Greetings (RPG), a greeting card company that competed with Hallmark. Clipper asked Monitor for the research it had compiled for Hallmark. Clipper ultimately won the auction for

RPG. Hallmark settled its claims of trade secret misappropriation with Monitor but the case against Clipper went to trial. A jury found for Hallmark and awarded it \$21.3 million in compensatory and \$10 million in punitive damages. Clipper appealed arguing that the PowerPoint presentations were not “trade secrets” under the Missouri Uniform Trade Secrets Act (MUTSA).

DECISION: Judgment for Hallmark. The market research qualified as trade secrets because the information compiled had economic value that gave Hallmark a competitive advantage. Hallmark took reasonable steps under the circumstances to keep the information secret. Even though

⁵³ Trade secrets are protected in all states either under the Uniform Trade Secrets Act or common law and under both criminal and civil statutes. The Uniform Trade Secrets Act has been adopted in all states except New York and North Carolina.

⁵⁴ *Siemens Water Technologies Corp. v. Revo Water Systems*, 74 So. 3d 824 (La. App. 2011).

⁵⁵ *Xpert Automation Systems Corp. v. Vibromatic Co.*, 569 N.E.2d 351 (Ind. App. 1990).

Some Companies Don't "Care Enough" To Do the Right Thing continued

Hallmark published some of the information from the market research, that information provided only general conclusions, not the specifics of the information compiled for Hallmark. The market research was valuable to Clipper because there was little information available about the

greeting card industry. Punitive damages were appropriate because Clipper engaged in a massive cover up of its acquisition of the material with reckless disregard for the rights of Hallmark. [*Hallmark Cards, Inc. v. Monitor Clipper Partners*, 758 F.3d 1051 (8th Cir. 2014)]

9-4b Loss of Protection

When secret business information is made public, it loses the protection it had while secret. This loss of protection occurs when the information is made known without any restrictions. In contrast, there is no loss of protection when secret information is shared or communicated for a special purpose and the person receiving the information knows that it is not to be made known to others.

When a product or process is unprotected by a patent or a copyright and is sold in significant numbers to the public, whose members are free to resell to whomever they choose, competitors are free to reverse engineer or copy the article. **For Example**, Crosby Yacht Co., a boatbuilder on Cape Cod, developed a hull design that is not patented. Maine Boatbuilders, Inc. (MBI), purchased one of Crosby's boats and copied the hull by creating a mold from the boat it purchased. MBI is free to build and sell boats utilizing the copied hull.

9-4c Defensive Measures

Employers seek to avoid the expense of trade secret litigation by limiting disclosure of trade secrets to employees with a "need to know." Employers also have employees sign nondisclosure agreements, and they conduct exit interviews when employees with confidential information leave, reminding the employees of the employer's intent to enforce the nondisclosure agreement. In addition, employers have adopted industrial security plans to protect their unique knowledge from "outsiders," who may engage in theft, trespass, wiretapping, or other forms of commercial espionage.

9-4d Criminal Sanctions

Under the federal Industrial Espionage Act of 1996,⁵⁶ knowingly stealing, soliciting, or obtaining trade secrets by copying, downloading, or uploading via electronic means or otherwise with the intention that it will benefit a foreign government or agent is a crime. This act also applies to the stealing or purchasing of trade secrets by U.S. companies or individuals who intend to convert trade secrets to the economic benefit of anyone other than the owner. The definition of trade secret is closely modeled on the Uniform Trade Secrets Act and includes all forms and types of financial, business, scientific, technical, economic, and engineering information. The law requires the owner to have taken "reasonable and proper" measures to keep the information secret. Offenders are subject to fines of up to \$500,000 or twice the value of the proprietary information involved, whichever is greater, and imprisonment for up to 15 years.

⁵⁶P.L. 104-294, 18 U.S.C. §1831 *et seq.* (1996).

Corporations may be fined up to \$10,000,000 or twice the value of the secret involved, whichever is greater. In addition, the offender's property is subject to forfeiture to the U.S. government, and import-export sanctions may be imposed.

9-5 Protection of Computer Software and Mask Works

Computer programs, chip designs, and mask works are protected from infringement with varying degrees of success by federal statutes, restrictive licensing, and trade secrecy.

CPA 9-5a Copyright Protection of Computer Programs

Under the Computer Software Copyright Act of 1980,⁵⁷ a written program is given the same protection as any other copyrighted material regardless of whether the program is written in source code (ordinary language) or object code (machine language). **For Example,** Franklin Computer Corp. copied certain operating-system computer programs that had been copyrighted by Apple Computer, Inc. When Apple sued Franklin for copyright infringement, Franklin argued that the object code on which its programs had relied was an uncopyrightable “method of operation.” The Third Circuit held that computer programs, whether in source code or in object code embedded on ROM chips, are protected under the act.⁵⁸

In determining whether there is a copyright violation under the Computer Software Copyright Act, courts will examine the two programs in question to compare their structure, flow, sequence, and organization. Courts consider whether the most *significant* steps of the program are similar rather than whether most of the program's steps are similar. To illustrate a copyright violation, substantial similarity in the structure of two computer programs for dental laboratory record-keeping was found—even though the programs were dissimilar in a number of respects—because five particularly important subroutines within both programs performed almost identically.⁵⁹

The protection afforded software by the copyright law is not entirely satisfactory to software developers because of the distinction made by the copyright law of protecting expressions but not ideas. Also, Section 102(b) of the 1980 Computer Software Copyright Act does not provide protection for “methods of operation.” A court has allowed a competitor to copy the identical menu tree of a copyrighted spreadsheet program because it was a noncopyrightable method of operation.⁶⁰

As set forth previously, the Digital Millennium Copyright Act of 1998 was enacted to curb the pirating of a wide range of works, including software.

CPA 9-5b Patent Protection of Programs

Patents have been granted for computer programs; for example, a method of using a computer to translate from one language to another has been held patentable.

The disadvantage of patenting a program is that the program is placed in the public records and may thus be examined by anyone. This practice poses a potential danger that

⁵⁷ Act of December 12, 1980, P.L. 96–517, 94 Stat. 3015, 17 U.S.C. §§101, 117.

⁵⁸ *Apple Computer Inc. v. Franklin Computer Corp.*, 714 F.2d 1240 (3d Cir. 1983).

⁵⁹ *Whelen Associates v. Jaslow Dental Laboratory*, 797 F.2d 1222 (3d Cir. 1986).

⁶⁰ *Lotus Development Corp. v. Borland International Inc.*, 49 F.3d 807 (1st Cir. 1995), *aff'd*, 516 U.S. 233 (1996).

the program will be copied. To detect patent violators and bring legal action is difficult and costly.⁶¹

9-5c Trade Secrets

While primary protection for computer software is found in the Computer Software Copyright Act, industry also uses trade secret law to protect computer programs. When software containing trade secrets is unlawfully appropriated by a former employee, the employee is guilty of trade secret theft.

9-5d Restrictive Licensing

To retain greater control over proprietary software, it is common for the creator of the software to license its use to others rather than selling it to them. Such licensing

FIGURE 9-1 Summary Comparison of Intellectual Property Rights

TYPE OF INTELLECTUAL PROPERTY	TRADEMARKS	COPYRIGHTS	PATENTS	TRADE SECRETS
PROTECTION	WORDS, NAMES, SYMBOLS, OR DEVICES USED TO IDENTIFY A PRODUCT OR SERVICE	ORIGINAL CREATIVE WORKS OF AUTHORSHIP, SUCH AS WRITINGS, MOVIES, RECORDS, AND COMPUTER SOFTWARE	UTILITY, DESIGN, AND PLANT PATENTS	ADVANTAGEOUS FORMULAS, DEVICES, OR COMPILATION OF INFORMATION
APPLICABLE STANDARD	IDENTIFIES AND DISTINGUISHES A PRODUCT OR SERVICE	ORIGINAL CREATIVE WORKS IN WRITING OR IN ANOTHER FORMAT	NEW AND NONOBVIOUS, ADVANCED IN THE ART	NOT READILY ASCERTAINABLE, NOT DISCLOSED TO THE PUBLIC
WHERE TO APPLY	PATENT AND TRADEMARK OFFICE	REGISTER OF COPYRIGHTS	PATENT AND TRADEMARK OFFICE	NO PUBLIC REGISTRATION NECESSARY
DURATION	INDEFINITE SO LONG AS IT CONTINUES TO BE USED	LIFE OF AUTHOR PLUS 70 YEARS, OR 95 YEARS FROM PUBLICATION FOR "WORKS FOR HIRE"	UTILITY AND PLANT PATENTS, 20 YEARS FROM DATE OF APPLICATION; DESIGN PATENTS, 14 YEARS	INDEFINITE SO LONG AS SECRET IS NOT DISCLOSED TO PUBLIC

⁶¹The USPTO has adopted guidelines for the examination of computer-related inventions, 61 C.F.R. §§7478–7502.

agreements typically include restrictions on the use of the software by the licensee and give the licensor greater protection than that provided by copyright law. These restrictions commonly prohibit the licensee from providing, in any manner whatsoever, the software to third persons or subjecting the software to reverse engineering.⁶²

9-5e Semiconductor Chip Protection

The Semiconductor Chip Protection Act (SCPA) of 1984⁶³ created a new form of industrial intellectual property by protecting mask works and the semiconductor chip products in which they are embodied against chip piracy. A **mask work** refers to the specific form of expression embodied in chip design, including the stencils used in manufacturing semiconductor chip products. A **semiconductor chip product** is a product placed on a piece of semiconductor material in accordance with a predetermined pattern that is intended to perform electronic circuitry functions. These chips operate microwave ovens, televisions, computers, robots, X-ray machines, and countless other devices. This definition of semiconductor chip products includes such products as analog chips, logic function chips like microprocessors, and memory chips like RAMS and ROMs.

mask work—specific form of expression embodied in a chip design, including the stencils used in manufacturing semiconductor chip products.

semiconductor chip product—product placed on a piece of semiconductor material in accordance with a predetermined pattern that is intended to perform electronic circuitry functions.

Duration and Qualifications for Protection

The SCPA provides the owner of a mask work fixed in semiconductor chip products the exclusive right for 10 years to reproduce and distribute the products in the United States and to import them into the United States. The protection of the act applies only to those works that, when considered as a whole, are not commonplace, staple, or familiar in the semiconductor industry.

Limitation on Exclusive Rights

Under the SCPA's reverse engineering exemption, competitors may not only study mask works but may also use the results of that study to design their own semiconductor chip products embodying their own original masks even if the masks are substantially similar (but not substantially identical) so long as their products are the result of substantial study and analysis, not merely the result of plagiarism.

Innocent infringers are not liable for infringements occurring before notice of protection is given them and are liable for reasonable royalties on each unit distributed after notice has been given them. However, continued purchase of infringing semiconductors after notice has been given can result in penalties of up to \$250,000.

Remedies

The SCPA provides that an infringer will be liable for actual damages and will forfeit its profits to the owner. As an alternative, the owner may elect to receive statutory damages of up to \$250,000 as determined by a court. The court may also order destruction or other disposition of the products and equipment used to make the products. **For Example,** Altera Corporation, a manufacturer of programmable logic devices, was successful in its lawsuit against Clear Logic under the SCPA, asserting that Clear Logic had copied the layout design of its registered mask works. It was also successful in its claim that Clear Logic induced breach of software licenses with Altera customers. Damages were assessed at \$36 million.⁶⁴

⁶² See *Fonar Corp. v. Domenick*, 105 F.3d 99 (2d Cir. 1997).

⁶³ P.L. 98-620, 98 Stat. 3347, 17 U.S.C. §901.

⁶⁴ *Altera Corp. v. Clear Logic Inc.*, 424 F.3d 1079 (9th Cir. 2005).

Make the Connection

Summary

Property rights in trademarks, copyrights, and patents are protected by federal statutes. A trademark or service mark is any word, symbol, design, or combination of these used to identify a product (in the case of a trademark) or a service (in the case of a service mark). Terms are categorized as: (1) generic, (2) descriptive, (3) suggestive, or (4) arbitrary or fanciful. Generic terms are never registrable. Descriptive terms, geographic terms, and proper names may be registered and receive protection after they have acquired secondary meaning. Suggestive and arbitrary or fanciful marks are registrable immediately. If there is likelihood of confusion, a court will enjoin the second user from using a particular mark.

A copyright is the exclusive right given by federal statute to the creator of a literary or an artistic work to use, reproduce, or display the work for the life of the creator and 70 years after the creator's death.

A patent gives the inventor an exclusive right for 20 years from the date of application to make, use, and sell an invention that is new, useful, and nonobvious to those in the business to which the invention is related. Trade secrets that give an owner an advantage over competitors are protected under state law for an unlimited period so long as they are not made public.

Protection of computer programs and the design of computer chips and mask works is commonly obtained, subject to certain limitations, by complying with federal statutes, by using the law of trade secrets, and by requiring restrictive licensing agreements. Many software developers pursue all of these means to protect their proprietary interests in their programs.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

9-1 Trademarks and Service Marks

LO.1 Explain the spectrum of distinctiveness used to classify trademarks and explain why distinctiveness is important

See the Cengage example, a coined mark at the most distinctive end of the spectrum, page 155.

See the Sports Illustrated example, a descriptive mark with acquired distinctiveness, page 155.

See the *Harley Davidson* case where the term *hog* was found to be generic and not distinctive at all, page 156.

LO.2 Explain how courts determine whether there is a likelihood of confusion between trademarks

See the list of factors, page 156.

LO.3 Explain how personal names can acquire trademark protection

See the example involving David Beckham, page 155.

LO.4 List the remedies available for improper use of trademarks

See the applicable remedies of injunctive relief, lost profits, and attorney's fees, page 157.

LO.5 Explain the difference between trademark infringement and trademark dilution

Compare the eight factors used to determine likelihood of confusion with the requirements for proving trademark dilution, page 158.

See the example involving "Eat More Kale" and "Eat Mor Chickin," page 159.

9-2 Copyrights

LO.6 Explain what is and is not copyrightable; explain the fair use defense

See the discussion on what is copyrightable, page 162.

See the Darden example of a denial of a copyright because of lack of creativity, page 162.

See the *Cariou* case describing fair use analysis, pages 163–164.

See the *Wind Done Gone* example involving fair use parody, page 163.

9-3 Patents

LO.7 Explain the "new and not obvious" requirement necessary to obtain a patent

See the cDNA "not obvious" example, page 167.

See the mounted chainsaw "obvious" example, page 167.

See the *Alice* decision where a patent application was found to be an unpatentable abstract idea, page 169.

9-4 Secret Business Information

LO.8 Explain what constitutes a trade secret and what steps a company must take to ensure protection
See the *Hallmark* case, pages 171–172.

9-5 Protection of Computer Software and Mask Works

LO.9 Explain the extent of protection provided owners of software
See the Apple Computer example, page 173.

Key Terms

acquired distinctiveness
copyright
cybersquatters
distinctiveness

mask work
prior art
secondary meaning
semiconductor chip product

service mark
trade dress
trade secret
trademark

Questions and Case Problems

- China is a signatory country to the Madrid Protocol on the international registration of trademarks. Starbucks opened its first café in China in 1999 and has added outlets in numerous locations including Shanghai and at the Great Wall and the imperial palace in Beijing. Xingbake Café Corp. Ltd. has imitated the designs of Starbucks' cafés in its business coffee café locations in Shanghai. *Xing* (pronounced “Shing”) means star, and *bake*, or “bak kuh” is pronounced like “bucks.” Does the Seattle, Washington, Starbucks Corporation have standing to bring suit in China against Xingbake Café Corp. Ltd? If so, on what theory? Decide.
- Cable News Network with its principal place of business in Atlanta, Georgia, is the owner of the trademark CNN in connection with providing news and information services to people worldwide through cable and satellite television networks, Web sites, and news services. Its services are also available worldwide on the Internet at the domain name CNN.com. Maya Online Broadband Network (Maya HK) is a Chinese company. It registered the domain name CNNEWS.com with Network Solutions, Inc. The CNNNews.com Web site was designed to provide news and information to Chinese-speaking individuals worldwide, making significant use of the terms *CNNNews* and *CNNNews.com* as brand names and logos that the Atlanta company contends resembles its logos. Maya HK has admitted that CNNNews in fact stands for China Network News abbreviated as CNN. The Atlanta company had notified Maya HK of its legal right to the CNN mark before the Chinese company registered the CNNNews.com domain name. Does the federal Anticybersquatting Consumer Protection Act apply to this case? If so, does a “safe harbor” exist under the ACPA for Maya HK in that most people who access its Web site in China have never heard of CNN? Decide. [*Cable News Network v. CNNNews.com*, 177 F. Supp. 2d 506 (E.D. Va.)]
- Sara Bostwick hired Christian Oth, Inc., to be her wedding photographer. The parties' written contract granted ownership of the copyright in all images created to Oth. Oth posted the wedding photos on its Web site. Bostwick e-mailed Oth to remove the photos from the Web site. Oth failed to do so and Bostwick sued, claiming that she had the sole and exclusive right to control her own wedding photos. Is she correct? [*Bostwick v. Christian Oth, Inc.* 936 N.Y.S.2d 176 (A.D.)]
- A small brewery in New York called Empire Brewing Company manufactured a brand of beer called “Strikes Bock.” For seven years, the brewery served the beer only on tap. With the intention of bottling and selling the beer in stores, Empire Brewing sought a trademark for “Strikes Bock.” Lucasfilm opposed the trademark registration maintaining that it could cause confusion with its famous film, “The Empire Strikes Back.” Should the USPTO grant the trademark to Empire Brewing? Would Lucasfilm be likely to prevail in a trademark infringement suit or a trademark dilution suit? [Natalie O'Neill, *Lucasfilm Sues Brewery over Star Wars-inspired Beer*, N.Y. POST, (Oct. 24, 2014), <http://nypost.com/2014/10/24/lucasfilm-sues-over-brewerys-empire-strikes-bock-beer/>]
- Sullivan sold t-shirts with the name *Boston Marathon* and the year of the race imprinted on them. The Boston Athletic Association (BAA) sponsors and

- administers the Boston Marathon and has used the name *Boston Marathon* since 1917. The BAA registered the name *Boston Marathon* on the Principal Register. In 1986, the BAA entered into an exclusive license with Image, Inc., to use its service mark on shirts and other apparel. Thereafter, when Sullivan continued to sell shirts imprinted with the name *Boston Marathon*, the BAA sought an injunction. Sullivan's defense was that the general public was not being misled into thinking that his shirts were officially sponsored by the BAA. Without this confusion of source, he contended, no injunction should be issued. Decide. [*Boston Athletic Ass'n v. Sullivan*, 867 F.2d 22 (1st Cir.)]
6. The Greenwich Bank & Trust Co. (GB&T) opened in 1998 and by 2008 had expanded to a total of four branches in the Greenwich, Connecticut, community of 62,000 residents. A competitor using the name Bank of Greenwich (BOG) opened in December 2006. GB&T's parent entity sued BOG for trademark violation under the Lanham Act. BOG argued that GB&T's service mark is generic and is simply not entitled to Lanham Act protection because it combines the generic term "bank" and the geographic term "Greenwich." GB&T asserted that it had been the only bank in Greenwich using the word *Greenwich* in its name and had done so exclusively for nine years. It asserted that a geographic term is entitled to protection if it acquires secondary meaning. GB&T introduced evidence regarding its advertising expenditures, sales success, and length of exclusivity of use along with evidence of actual consumer confusion. Decide. [*Connecticut Community Bank v. The Bank of Greenwich*, 578 F. Supp. 2d 405 (D. Conn.)]
 7. The U.S. Polo Association (USPA) is a not-for-profit corporation that is the governing body of the sport of polo in the United States. It has been in existence since 1890 and derives the majority of its revenue from royalties obtained from licensing its trademarks. It owns more than 900 trademarks worldwide, including marks bearing the words "U.S. Polo Assn." with the depiction of two polo players for licensees on products sold in the apparel category. In 2009 it produced 10,000 units of a men's fragrance using packaging featuring its logo as used on apparel. Since 1978 PRL (Polo Ralph Lauren) and its licensee of PRL trademarks, L'Oreal, have used the mark known as the "Polo Player" logo on men's fragrances with its logo containing one player. The fragrance has been sold for 32 years and it was voted into the industry's Hall of Fame. PRL sued USPA. What must PRL establish to prevail in an action for trademark infringement? How would you decide this case? [*United States Polo Assn. v. PRL USA Holdings, Inc.*, 800 F. Supp. 2d 515 (S.D.N.Y.)]
 8. Diehr devised a computerized process for curing rubber that was based on a well-known mathematical formula related to the cure time, and he devised numerous other steps in his synthetic rubber-curing process. The patent examiner determined that because abstract ideas, the laws of nature, and mathematical formulas are not patentable subject matter, the process in this case (based on a known mathematical formula) was also not patentable. Diehr contended that all of the steps in his rubber-curing process were new and not obvious to the art of rubber curing. He contended also that he did not seek an exclusive patent on the mathematical formula, except for its use in the rubber-curing process. Decide. [*Diamond v. Diehr*, 450 U.S. 175]
 9. Aries Information Systems, Inc., develops and markets computer software specifically designed to meet the financial accounting and reporting requirements of such public bodies as school districts and county governments. One of Aries's principal products is the POBAS III accounting program. Pacific Management Systems Corporation was organized by Scott Dahmer, John Laugan, and Roman Rowan for marketing a financial accounting and budgeting system known as FAMIS. Dahmer, Laugan, and Rowan were Aries employees before, during, and shortly after they organized Pacific. As employees, they each gained access to Aries's software materials (including the POBAS III system) and had information about Aries's existing and prospective clients. Proprietary notices appeared on every client contract, source code list, and magnetic tape. Dahmer, Laugan, and Rowan signed an Employee Confidential Information Agreement after beginning employment with Aries. While still employees of Aries, they submitted a bid on behalf of Pacific to Rock County and were awarded the contract. Pacific's FAMIS software system is substantially identical to Aries's proprietary POBAS III system. Aries sued Pacific to recover damages for misappropriation of its trade secrets. Pacific's defense was that no "secrets" were misappropriated because many employees knew the

- information in question. Decide. [*Aries Information Systems, Inc. v. Pacific Management Systems Corp.*, 366 N.W.2d 366 (Minn. App.)]
10. The plaintiff, Herbert Rosenthal Jewelry Corporation, and the defendant, Kalpakian, manufactured jewelry. The plaintiff obtained a copyright registration of a jeweled pin in the shape of a bee. Kalpakian made a similar pin. Rosenthal sued Kalpakian for infringement of copyright registration. Kalpakian raised the defense that he was only copying the idea, not the way the idea was expressed. Was he liable for infringement of the plaintiff's copyright? [*Herbert Rosenthal Jewelry Corp. v. Kalpakian*, 446 F.2d 738 (9th Cir.)]
 11. Mineral Deposits, Ltd. (MD, Ltd.), an Australian company, manufactures the Reichert Spiral, a device used for recovering gold particles from sand and gravel. The spiral was patented in Australia, and MD, Ltd., had applied for a patent in the United States. Theodore Zigan contacted MD, Ltd., stating that he was interested in purchasing up to 200 devices for use in his gravel pit. MD, Ltd., agreed to lend Zigan a spiral for testing its efficiency. Zigan made molds of the spiral's components and proceeded to manufacture 170 copies of the device. When MD, Ltd., found out that copies were being made, it demanded the return of the spiral. MD, Ltd., also sought lost profits for the 170 spirals manufactured by Zigan. Recovery was sought on a theory of misappropriation of trade secrets. Zigan offered to pay for the spiral lent him by MD, Ltd. He argued that trade secret protection was lost by the public sale of the spiral. What ethical values are involved? Was Zigan's conduct a violation of trade secret law? [*Mineral Deposits, Ltd. v. Zigan*, 773 P.2d 609 (Colo. App.)]
 12. Michael Cram alleged that he was the sole creator of a unique talking bottle opener. His product was very successful and he licensed the product to numerous NCAA schools, Major League Baseball, the National Football League, NASCAR, and various movie and TV studios. Cram became aware that a similar talking bottle opener, featuring McFarland's movie character "Ted," was sold with DVDs of the movie. Cram sued Seth McFarland, the creator of Ted; Universal Studios, the producer of the movie; and Target, which distributed the product, for trade dress infringement. Cram maintains that the trade dress consists of the shape of the plastic handle; the C shape of the metal opener; the no-button activator technology; the use and placement of a single image on the opener; the use and placement of the eight speaker holes; the quality of the sound; and the triggering of the sound by pressure on the metal opener. Do you think that Cram will be successful in his trade dress infringement suit? [Bryanna Cappadona, *Seth MacFarlane Is Being Sued for Plagiarizing Ted Bottle Openers*, BOSTON MAGAZINE, Feb. 27, 2015, <http://www.bostonmagazine.com/arts-entertainment/blog/2015/02/27/seth-macfarlane-sued-ted-bottle-openers/>]
 13. The American Geophysical Union and 82 other publishers of scientific and technical journals brought a class-action lawsuit against Texaco, claiming that Texaco's unauthorized photocopying of articles from their journals constituted a copyright infringement. Texaco's defense was that the copying was fair use under Section 107 of the Copyright Act of 1976. To avoid extensive discovery, the parties agreed to focus on one randomly selected Texaco scientist, Dr. Donald Chickering, who had photocopies of eight articles from the *Journal of Catalysis* in his files. The trial court judge held that the copying of the eight articles did not constitute fair use, and Texaco appealed. [*American Geophysical Union v. Texaco, Inc.*, 60 F.3d 913 (2d Cir.)]
 14. *The Column* is a sculpture of 19 stainless steel statues depicting a squad of soldiers on patrol; it is a key part of the Korean War Veterans Memorial on the National Mall in Washington, D.C. *The Column* was created by sculptor and World War II veteran Frank Gaylord. In January 1996, John Alli, an amateur photographer, visited the Memorial during a heavy snowstorm and photographed *The Column*. In 2002, the United States Postal Service issued a stamp commemorating the fiftieth anniversary of the Korean War armistice. The Postal Service selected Mr. Alli's photograph for the stamp face and paid Mr. Alli a one-time fee of \$1,500 for the right to use the photo. The Postal Service did not have permission from Mr. Gaylord to feature his sculpture. Do you think that Gaylord would prevail in a copyright infringement suit? If so, how would you determine damages? [*Gaylord v. United States*, 777 F.3d 1363 (Fed. Cir.)]

CPA Questions

1. Multicomp Company wishes to protect software it has developed. It is concerned about others copying this software and taking away some of its profits. Which of the following is true concerning the current state of the law?
 - a. Computer software is generally copyrightable.
 - b. To receive protection, the software must have a conspicuous copyright notice.
 - c. Software in human readable source code is copyrightable but machine language object code is not.
 - d. Software can be copyrighted for a period not to exceed 20 years.
2. Which of the following is not correct concerning computer software purchased by Gultch Company from Softtouch Company? Softtouch originally created this software.
 - a. Gultch can make backup copies in case of machine failure.
 - b. Softtouch can typically copyright its software for at least 75 years.
 - c. If the software consists of compiled computer databases, it cannot be copyrighted.
 - d. Computer programs are generally copyrightable.
3. Using his computer, Professor Bell makes 15 copies (to distribute to his accounting class) of a database in some software he has purchased for his personal research. The creator of this software is claiming copyright. Which of the following is correct?
 - a. This is an infringement of copyright, since he bought the software for personal use.
 - b. This is not an infringement of copyright, since databases cannot be copyrighted.
 - c. This is not an infringement of copyright because the copies were made using a computer.
 - d. This is not an infringement of copyright because of the fair use doctrine.
4. Intellectual property rights included in software may be protected under which of the following?
 - a. Patent law
 - b. Copyright law
 - c. Both of the above
 - d. None of the above

The Legal Environment of International Trade



10-1 Conducting Business Internationally

- 10-1a Forms of International Business
- 10-1b The International Contract

10-2 International Trade

- 10-2a Tariffs and Barriers to Trade
- 10-2b The World Trade Organization
- 10-2c Agreements Administered under the WTO
- 10-2d Protecting Trademarks Worldwide
- 10-2e Copyright Protection
- 10-2f Patent Protection
- 10-2g Trade Secrets

- 10-2h The Dispute Settlement Understanding
- 10-2i The Doha Development Agenda
- 10-2j Regional Trade Agreements
- 10-2k Antidumping, Subsidies and Safeguards

10-3 Issues Confronting Companies Engaged in International Business

- 10-3a Export Regulations
- 10-3b The Foreign Corrupt Practices Act
- 10-3c Antitrust Issues
- 10-3d Securities Fraud Regulation in an International Environment

Learning Outcomes <<<

After studying this chapter, you should be able to

- LO.1** List the methods of doing business abroad
- LO.2** Explain which country's law will govern an international contract should a dispute arise
- LO.3** Explain tariff barriers and nontariff barriers to the free movement of goods across borders
- LO.4** Identify the agreements administered by the World Trade Organization
- LO.5** Explain how to register and protect trademarks abroad
- LO.6** Explain how trade disputes are resolved
- LO.7** Explain how antidumping duties and countervailing duties operate under the WTO agreements
- LO.8** Explain U.S. law regarding payment to foreign government officials
- LO.9** Explain how U.S. securities laws might apply to foreign transactions

10-1 Conducting Business Internationally

10-1a Forms of International Business

The decision to participate in international business transactions and the extent of that participation depend on the financial position of the individual firm, production and marketing factors, and tax and legal considerations. There are a number of methods of conducting business abroad.

Export Sales

export sale—direct sale to customers in a foreign country.

A direct sale to customers in a foreign country is an **export sale**. A U.S. firm engaged in export selling is not present in the foreign country in such an arrangement. The export is subject to a tariff by the foreign country, but the exporting firm is not subject to local taxation by the importing country.

Agency Requirements

agent—person or firm who is authorized by the principal or by operation of law to make contracts with third persons on behalf of the principal.

A U.S. manufacturer may decide to make a limited entry into international business by appointing an agent to represent it in a foreign market. An **agent** is a person or firm with authority to make contracts on behalf of another—the **principal**. The agent will receive commission income for sales made on behalf of the U.S. principal. The appointment of a foreign agent commonly constitutes “doing business” in that country and subjects the U.S. firm to local taxation.

principal—person or firm who employs an agent; the person who, with respect to a surety, is primarily liable to the third person or creditor.

Foreign Distributorships

A **distributor** takes title to goods and bears the financial and commercial risks for the subsequent sale. To avoid making a major financial investment, a U.S. firm may decide to appoint a foreign distributor. A U.S. firm may also appoint a foreign distributor to avoid managing a foreign operation with its complicated local business, legal, and labor conditions.

distributor—entity that takes title to goods and bears the financial and commercial risks for the subsequent sale of the goods.

Licensing

licensing—transfer of technology rights to a product so that it may be produced by a different business organization in a foreign country in exchange for royalties and other payments as agreed.

U.S. firms may select licensing as a means of doing business in other countries. **Licensing** involves the transfer of technology rights in a product so that it may be produced by a different business organization in a foreign country in exchange for royalties and other payments as agreed. The technology being licensed may fall within the internationally recognized categories of patents, trademarks, and “know-how” (trade secrets and unpatented manufacturing processes outside the public domain). These intellectual property rights, which are legally protectable, may be licensed separately or incorporated into a single, comprehensive licensing contract. **Franchising**, which involves granting permission to use a trademark, trade name, or copyright under specified conditions, is a form of licensing that is now very common in international business.

franchising—granting of permission to use a trademark, trade name, or copyright under specified conditions; a form of licensing.

Wholly Owned Subsidiaries

A firm seeking to maintain control over its own operations, including the protection of its own technological expertise, may choose to do business abroad through a wholly owned subsidiary. In Europe the most common choice of foreign business organization, similar to the U.S. corporate form of business organization, is called the *société anonyme* (S.A.). In German-speaking countries, this form is called *Aktiengesellschaft* (A.G.). Small- and medium-sized companies in Europe now utilize a newly created form of business organization called the limited liability company (*Gesellschaft mit beschränkter Haftung*, or “GmbH” in Germany; *Società a responsabilità limitata*, or “S.r.l.” in Spain). A wholly

owned subsidiary is less complicated to form but is restrictive for accessing public capital markets.

A corporation doing business in more than one country poses many taxation problems for the governments in those countries where the firm does business. The United States has established tax treaties with many countries, granting corporations relief from double taxation. Credit is normally given by the United States to U.S. corporations for taxes paid to foreign governments.

There is a potential for tax evasion by U.S. corporations when they sell their goods to their overseas subsidiaries. Corporations could sell goods at less than the fair market value to avoid a U.S. tax on the full profit for such sales. By allowing the foreign subsidiaries located in countries with lower tax rates to make higher profits, a company as a whole would minimize its taxes. Section 482 of the Internal Revenue Code (IRC), however, allows the Internal Revenue Service (IRS) to reallocate the income between the parent and its foreign subsidiary. Intellectual property such as patent rights, internationally held and generating revenues outside the United States, provides a basis for U.S. multinational companies to legally minimize tax liability by shifting income internationally. **For Example**, global companies like Apple, Microsoft, Google, and Facebook may utilize tax avoidance techniques like the “Double Irish with a Dutch Sandwich,” relying on transferring profits on international patent royalties to places like Ireland, with routing through the Netherlands, back to an Irish subsidiary, then to a Caribbean tax haven.¹

10-1b The International Contract

What Law Applies

When there is a sale of goods within the United States, one law typically applies to the transaction. Some variation may be introduced when the transaction is between parties in different states, but for the most part, the law governing the transaction is the U.S. law of contracts and the Uniform Commercial Code (UCC). In contrast, when an international contract is made, it is necessary to determine whether it is the law of the seller’s country or the law of the importer’s country that will govern. The parties to an international contract often resolve that question themselves as part of their contract, setting forth which country’s law will govern should a dispute arise. Such a provision is called a **choice-of-law clause**. **For Example**, U.S. investors Irmgard and Mitchell Lipcon provided capital to underwriters at Lloyd’s of London and signed choice-of-law clauses in their investment agreements, binding them to proceed in England under English law should disputes arise. When the Lipcons realized that their investments were exposed to massive liabilities for asbestos and pollution insurance claims, they sued in U.S. district court in Florida for alleged U.S. securities acts violations. However, their complaints were dismissed based on the choice-of-law clauses in their contracts. The U.S. court of appeals stated that the Lipcons must “honor their bargains” and attempt to vindicate their claims in English courts under English law.²

choice-of-law clause—clause in an agreement that specifies which law will govern should a dispute arise.

CISG

The *United Nations Convention on Contracts for the International Sale of Goods* (CISG or convention) sets forth uniform rules to govern international sales contracts. National law, however, is sometimes required to fill gaps in areas not covered by the CISG. The CISG

¹ <http://www.nytimes.com/interactive/2012/04/28/business/Double-Irish-With-A-Dutch-Sandwich.html>. <http://www.npr.org/blogs/money/2010/10/21/130727655/google-s-tax-tricks-double-irish-and-dutch-sandwich>. See also James Barrett and Steven Hadjiligiou, “The Tax Benefits and Obstacles to U.S. Businesses in Transferring Foreign Intellectual Property to Foreign Affiliates,” 89 *Fla. B. J. No. 5*, pp. 40–45 (May 2012).

² *Lipcon v. Underwriters at Lloyd’s, London*, 148 F.2d 1285, 1299 (11th Cir. 1998).

became effective on January 1, 1988. There are currently 83 contracting states that have ratified the CISG.³ The provisions of the CISG were strongly influenced by Article 2 of the UCC. Nevertheless, several distinct differences exist between the CISG and the UCC. The CISG does not cover the sale of goods for personal, family, or household uses and the sale of watercraft, aircraft, natural gas, or electricity; letters of credit; and auctions and securities.⁴ The CISG is often viewed by foreign entities as a neutral body of law, the utilization of which can be a positive factor in successfully concluding negotiations of a contract. The parties to an international commercial contract may opt out of the CISG. However, absent an express “opt-out provision,” the CISG is controlling for its signatories and preempts all national law.

The Arbitration Alternative

Traditional litigation may be considered too time consuming, expensive, and divisive to the relationships of the parties to an international venture. The parties, therefore, may agree to arbitrate any contractual disputes that may arise according to dispute resolution procedures set forth in the contract.

Pitfalls exist for U.S. companies arbitrating disputes in foreign lands. **For Example,** were a U.S. company to agree to arbitrate a contractual dispute under Chinese law, only Chinese lawyers can present an arbitration case, even if one party is a U.S. company. Consequently, it is common for parties to international ventures to agree to arbitrate their disputes in neutral countries.

An arbitration agreement gives the parties more control over the decision-making process. The parties can require that the arbitrator have the technical, language, and legal qualifications to best understand their dispute. While procedures exist for the prearbitration exchange of documents, full “discovery” is ordinarily not allowed. The decision of the arbitrator is final and binding on the parties with very limited judicial review possible.

Financing International Trade

There is no international currency. This creates problems as to which currency to use and how to make payment in international transactions. Centuries ago, buyers used precious metals, jewels, or furs in payment. Today, the parties to an international transaction agree in their sales contract on the currency to be used to pay for the goods. They commonly require that the buyer furnish the seller a **letter of credit**, which is a commercial device used to guarantee payment to a seller in an international transaction. With a letter of credit, an issuer, typically a bank, agrees to pay the drafts drawn against the buyer for the purchase price. In trading with merchants in some countries, the foreign country itself will promise that the seller will be paid.

letter of credit—commercial device used to guarantee payment to a seller, primarily in an international business transaction.

10-2 International Trade

Today the rules of world trade are negotiated and administered by the World Trade Organization. The 160 member nations of the WTO account for 98 percent of global trade. Between World War I and World War II, world trade decreased substantially. In the 1930s, the U.S. Congress passed the Smoot-Hawley Tariff Act, a strong protectionist measure that imposed stiff tariffs on imports. Roberto Azevedo, the current Director-General of the World Trade Organization, has contrasted the trade environment during the interwar protectionist era to trade during the 2008 financial crisis. He notes that the mistakes that

³ See CISG: Table of Contracting States, <http://www.cisg.law.pace.edu/cisg/countries/cntries.html>.

⁴ C.I.S.G. art. 2(a)–(f).

were made between 1929 and 1933 were not repeated in 2008 because governments “knew that they were bound by rules and obligations that were common to all, and this gave them confidence that others were going to play by the rules as well.”⁵ He suggests that the commitments WTO members made to each other avoided economic catastrophe.

Before introducing the current world trading agreements, some terms in international trade are introduced.

10-2a Tariffs and Barriers to Trade

The most common barrier to the free movement of goods across borders is a tariff. A wide range of nontariff barriers also restricts the free movement of goods, services, and investments. Government export controls used as elements of foreign policy have proven to be a major barrier to trade with certain countries.

Tariff Barriers

tariff—(1) domestically—government-approved schedule of charges that may be made by a regulated business, such as a common carrier or warehouse; (2) internationally—tax imposed by a country on goods crossing its borders, without regard to whether the purpose is to raise revenue or to discourage the traffic in the taxed goods.

A **tariff** is an import or export duty or tax placed on goods as they move into or out of a country. It is the most common method used by countries to restrict foreign imports. The tariff raises the total cost, and thus the price, of an imported product in the domestic market. Thus, the price of a domestically produced product not subject to the tariff is more advantageous.

The U.S. Customs and Border Protection Service (Customs) imposes tariffs on imported goods at the port of entry. The merchandise is classified under a tariff schedule, which lists each type of merchandise and the corresponding duty rate (or percentage). Customs also determines the “computed value” of the imported goods under very precise statutory formulas.⁶ The total amount of the duty is calculated by applying the duty percentage to the computed value figure.⁷ Customs also has authority to investigate fraudulent schemes that seek to avoid or to underpay customs’ duties.⁸

Since the Second World War, exports have grown 35-fold largely due to the fact that the average tariff rate has been reduced from around 40 percent to 4 percent under the World Trade Organization’s multilateral trading rules.

Nontariff Barriers

Nontariff barriers consist of a wide range of restrictions that inhibit the free movement of goods between countries. An import quota, such as a limitation on the number of automobiles that can be imported into one country from another, is such a barrier. More subtle nontariff barriers exist in all countries. **For Example**, Japan’s complex customs procedures resulted in the restriction of the sale of U.S.-made aluminum baseball bats in Japan. The customs procedures required the individual uncrating and “destruction testing” of bats at the ports of entry. Government subsidies are also nontariff barriers to trade.

⁵ Roberto Azevedo, Speech, Regional initiatives cannot substitute for the multilateral trading system, Stockholm School of Economics, Riga, Latvia (March 24, 2015), available at <http://www.wto.org>.

⁶ See Tariff Act of 1930, as amended, 19 U.S.C. §1401 a(e).

⁷ It is common for importers to utilize customs brokers who research the tariff schedules to see whether a product fits unambiguously under one of the Customs Service’s classifications. A broker will also research the classifications given to similar products. It may find that a fax switch may be classified as “other telephonic switching apparatus” at a tariff rate of 8.5 percent or “other telegraphic switching apparatus” with a tariff of 4.7 percent. Obviously, the importer desires to pay the lower rate, and the broker with the assistance of counsel will make a recommendation to the Customs Service for the lower rate, and Customs will make a ruling. The decisions of the Customs Service are published in the *Customs Bulletin*, the official weekly publication of the Customs Service. See *Command Communications v. Fritz Cos.*, 36 P.3d 182 (Colo. App. 2001). See also *Estee Lauder, Inc. v. United States*, 815 F. Supp. 2d 1287 (Ct. Int’l Trade 2012), where the importer successfully challenged Custom’s classification of a cosmetic product and the court declined to adopt Custom’s position because of the flawed analysis and application of the “rule.”

⁸ *U.S. v. Inn Foods, Inc.*, 560 F.3d 1338 (Fed. Cir. 2009).

One U.S. law—the Turtle Law—prohibits the importation of shrimp from countries that allow the harvesting of shrimp with commercial fishing technology that could adversely affect endangered sea turtles. **For Example**, two U.S. importers sought an exemption, representing that their Brazilian supply of shrimp was caught in the wild by vessels using turtle excluder devices (TEDs). Because Brazil had failed to comply with the U.S. Turtle Law by requiring TEDs on its commercial shrimp fleet, even though it had seven years to do so, the exemption was not granted.⁹

10-2b The World Trade Organization

The WTO is an international organization located in Geneva, Switzerland, that sets the rules for world trade. It administers several trade agreements; provides a forum for trade negotiations; monitors adherence to trade rules; and provides a mechanism for resolving trade disputes. Russia, joining in 2012, is one of the newer members of the 160 WTO nations. More than three-fourths of WTO members are developing countries. WTO agreements make special accommodations for developing countries to integrate into the global trading system.

The principle of nondiscrimination is one of the hallmarks of the WTO. Each member agrees to treat all WTO trading partners equally. This equal treatment among all WTO members is referred to as **most-favored-nation** treatment. Similarly, the WTO requires that its members exercise **national treatment**. In other words, a country may not discriminate between its own products and foreign products or services. The WTO favors using tariffs over other types of barriers to trade. Because tariffs are negotiated, they provide a transparent mechanism for regulating world trade.

WTO agreements allow members to protect the environment, public health, and plant and animal health. In doing so, however, members must treat national and foreign businesses alike. A member cannot use the environment or public health concerns as a pretext for protectionist measures.

10-2c Agreements Administered under the WTO

The WTO is the umbrella organization that negotiates and administers several agreements.

The General Agreement on Tariffs and Trade (GATT)

The GATT existed long before the WTO. Motivated to create a more stable, peaceful world following World War II, several nations came to the Bretton Woods conference of 1944. The idea of creating an International Trade Organization was not realized at this time, but the General Agreement on Tariffs and Trade was signed in 1947. Focusing on trade in goods, the GATT seeks to liberalize world trade through multilateral negotiations. The primary goal of the GATT is to encourage trade by reducing tariffs and lowering trade barriers. Through rounds of negotiations, GATT members negotiate bound tariff rates. Thus, foreign companies, investors, and governments can be more confident in the stability and predictability of international trade.

From 1947 to 1994, GATT was the forum for trade negotiations. As a treaty GATT continues to change, as members negotiate not only tariff rates but numerous other issues including antidumping, subsidies, investment, and trade facilitation. In 1995, during the Uruguay Round of negotiations, GATT members formed the WTO to be the new administrative body to organize the rules of world trade.

⁹ *Earth Island Institute v. Christopher*, 948 F. Supp. 1062 (Ct. Int'l Trade 1996). See *Turtle Island Restoration Network v. Evans*, 284 F.3d 1282 (Fed. Cir. 2002), on the continuing litigation on this topic and the clash between statutory enforcement and political and diplomatic considerations.

most-favored-nation—clause in treaties between countries whereby any privilege granted to one member is extended to all members of the treaty.

national treatment—a WTO requirement in which a country may not discriminate between its own products and foreign products or services.

The General Agreement on Trade in Services (GATS)

The GATT pertains to trade in goods; the GATS extends the same principles of nondiscrimination to trade in services such as banks, insurance, telecommunications, and hotel chains.

Trade Related Aspects of Intellectual Property (TRIPS)

TRIPS is the WTO agreement that deals with trade rules that impact copyrights, patents, trademarks, geographical names, industrial designs, and trade secrets. As intellectual property issues became more important in trade, members were often frustrated with the variance in protection and enforcement of members' rights. TRIPS establishes minimum levels of protection that each government must provide to fellow WTO members. All members must show that their national laws are TRIPS compliant and that they have adequate standards of protection. Some exceptions to the rules are allowed to address public health problems. TRIPS also requires that governments enforce their intellectual property laws and that penalties are sufficient to deter violations.

Like all WTO agreements, TRIPS incorporates WTO principles such as national treatment and most-favored nation treatment. TRIPS also requires that intellectual property protection contribute to technical innovation and the transfer of technology. TRIPS incorporates the Paris Convention, the first international treaty addressing intellectual property. The Paris Convention covers patents, trademarks, and industrial designs.

10-2d Protecting Trademarks Worldwide

Trademarks

To protect trademarks internationally, a mark holder can either register in each country in which he seeks protection or he can use the Madrid System, which is administered by the World Intellectual Property Organization (WIPO). Members of the Paris Convention and the WTO can use the Madrid System to manage trademarks on a worldwide basis. The mark holder must register in its home country before seeking an international application. The Madrid System can also be used to manage the renewal of trademarks (usually every 10 years). Trademarks remain valid as long as they are renewed and continue to be used in commerce as a source identifier.

Trademark holders should be aware that most countries operate on a first to file basis. In the United States, although registration gives better protection, the Lanham Act recognizes the first to use the mark in commerce as the trademark owner.

If a company plans to do business in more than one country within the European Union, it can apply for a Community Trademark, which offers protection throughout the 28 countries that comprise the EU.

The Paris Convention recognizes that trademark protection is territorial. In other words, a mark registered in one country is independent of its possible registration in any other country. If a mark has been duly registered in the country of origin, members of Paris and TRIPS may not refuse to register the foreign mark unless it would infringe the rights of a third party or is otherwise objectionable as deceptive or against public morals.

Well-Known Marks

Just as U.S. law gives special protection to famous marks under the Federal Trademark Dilution Act, so international law gives special protection to **well-known marks**. The Paris Convention provides that a country may refuse to register or prohibit the use of a

well-known mark—in international law a mark that both the Paris Convention and TRIPS recognize as deserving protection even if it is not registered in the foreign country; national law determines what “well-known” means but the WIPO offers a list suggesting that the value of the mark, the extent of its use and promotion, and its recognition in the relevant sector of the public are key factors.

trademark that is well-known.¹⁰ Under the Paris Convention, such protection was limited to cases in which the infringing use involved identical or similar goods. TRIPS extends the protection of well-known marks to infringing uses involving dissimilar goods, if such use would harm the owner of the well-known mark. Under TRIPS, WTO members are obligated to recognize well-known marks even if they are unregistered in the foreign country; to allow the holder of a well-known mark to request cancellation of an infringing mark for at least five years from the date of registration; and to have no time limit for challenging marks registered or used in bad faith.

What constitutes a well-known mark is a matter of the law of each country. The World Intellectual Property Organization has issued a list of factors to consider, and countries may use these factors for guidance. Important factors to consider include how long and how extensively the mark has been used; the extent of publicity and advertising; the record of enforcement of rights in the mark by competent authorities; and the value associated with the mark.¹¹ **For Example**, the Trademark Office in China has recognized JNJ (Johnson and Johnson), Bosch, and Adidas as well-known trademarks.

CASE SUMMARY

Trademarks Up in Smoke!

FACTS: Both Cubatabaco and General Cigar manufacture and distribute cigars using the COHIBA mark. General Cigar is a Delaware corporation. It owns two trademark registrations for the COHIBA mark for use in connection with cigars. Cubatabaco is a Cuban entity that owns the COHIBA mark in Cuba and supplies cigars bearing the mark throughout the world. Cubatabaco does not distribute its cigars in the United States due to import restrictions imposed by the Cuban Assets Control Regulations (CACR). An exception to the CACR allows Cuban entities to engage in transactions related to the registration and renewal of trademarks before the USPTO. Cubatabaco sought to register COHIBA for cigars and related goods. Cubatabaco also sought to cancel General Cigar's registrations. General Cigar opposed the cancellation.

DECISION: Judgment for Cubatabaco. The Lanham Act allows "any person who believes that he is or will be damaged by the registration of a mark" to petition the USPTO to cancel the mark. Cubatabaco has a legitimate commercial interest in the COHIBA mark. Because the USPTO refused Cubatabaco's registration based on a likelihood of confusion with General Cigar's Registrations, Cubatabaco has a real interest in cancelling the Registrations, a reasonable belief that the Registrations blocking its application are causing it damage. Cubatabaco must have a bona fide intent to use the mark in commerce but does not have to actually use the mark before registering it. [*Empresa Cubana del Tabaco v. General Cigar Co., Inc.*, 753 F.3d 1270 (Fed. Cir. 2014), *cert. denied.*]

Geographical Indications

Some regions are rightfully proud of goods produced in their region. A product's geographic origin has much to do with its special characteristics. Consequently, producers of goods from a certain region seek to prohibit others from suggesting that a product comes from the famous region. **For Example**, champagne is only properly designated as champagne if it comes from Champagne, France. TRIPS requires countries to protect geographical indications. Wines and spirits receive a higher level of protection even if there is no danger of misleading the public. Negotiations continue to establish a multilateral system of notification and registration of geographical indications.

¹⁰ Paris Convention for the Protection of Industrial Property, July 4, 1967, 21 U.S.T. 1583, T.I.A.S. No. 6295, 828 U.N.T.S. 305.

¹¹ World Intellectual Property Organization, Joint Recommendation Concerning Provisions on the Protection of Well-Known Marks, September 1999, <http://www.wipo.int/edocs/pubdocs/en/marks/833/pub833.pdf>.

10-2e Copyright Protection

The Berne Convention for the Protection of Literary and Artistic Works has existed since 1886 and has been amended several times.¹² The treaty is administered by the World Intellectual Property Organization. WTO members recognized that the Berne Convention provides adequate copyright protection and requires that WTO members comply with the Berne Convention. The Berne Convention requires that signatories grant protection to most copyrighted works for the life of the author plus 50 years. Note that under U.S. copyright law, authors and artists receive protection for the life of the author plus 70 years. TRIPS clarifies that the Berne Convention protects computer programs. It also covers rental rights to ensure that authors of computer programs and producers of sound recordings have the right to prohibit the commercial rental of their works to the public.

10-2f Patent Protection

TRIPS requires that WTO members provide at least 20 years of protection to patent owners and that countries recognize the rights of patent owners such as preventing unauthorized persons from using the patented process. Although the Paris Convention and TRIPS require national treatment of intellectual property, obtaining a patent in one country does not mean that another country has to grant the patent.



THINKING THINGS THROUGH

Access to Medicine versus Patent Protection

Patent protection for pharmaceutical products presents unique problems in international trade. The TRIPS agreement specifies that members may take measures to protect public health. Despite the balance that TRIPS attempts to strike between access to medicine and respect for innovators' rights, conflicts are inevitable. India's patent system raises considerable controversy. India's current patent system has been in place since 2005. Before 2005, India's patent laws allowed pharmaceutical companies to re-create another's product by making changes to the production process. This system allowed India's pharmaceutical industry to become one of the largest in the world. For example, therapy medicines for HIV/AIDS cost \$10,000 per person per year in industrialized countries. An Indian company, however, makes a generic version of the drugs that it sells to its own citizens and other developing countries for less than \$200 a year.*

As a member of the WTO, however, India had to become TRIPS compliant. Still, India views many of the pharmaceuticals manufactured in the United States as patent ineligible. In the United States, a company is entitled to a new patent for improvements to an existing patent. India's laws, however, make it more difficult to obtain a patent.

In 2013, the Indian Supreme Court rejected Novartis's application for a patent on its cancer drug Glivec. The court

stated that the drug was a newer version of a "known substance." Moreover, the court stated that a drug manufacturer must show that its product enhances "therapeutic efficacy" compared to its "closest prior art." A patent should not be granted for a reformulation of an existing compound. Similarly, in 2015, an Indian court rejected a patent for Gilead's Sovaldi, a drug used to treat hepatitis C.

Some organizations have praised these decisions because access to affordable medicine is problematic in India. A majority of India's population lives on less than \$2 a day. Very few people in India have health insurance, with 70 percent of the population paying health care expenses out of their own pocket. A drug such as Sovaldi, usually given for three or six months, costs \$84,000 for a 12-week course in the United States.**

The United States Trade Representative has demanded reform of India's patent laws to give better protection to American pharmaceutical corporations. How should the United States address such issues? Should it seek trade sanctions against India?

*David Singh Grewal and Amy Kapczynski, *Let India Make Cheap Drugs*, NYT (Dec. 11, 2014).

**Summeet Chatterjee, *India Rejects Hepatitis C Drug Patent Request*, Reuters, Jan. 14, 2015, <http://in.reuters.com/article/2015/01/14/gilead-india-patent-idINKBNOKN20V20150114>.

¹²The text of the Berne Convention is available at http://www.wipo.int/treaties/en/text.jsp?file_id=283698.

10-2g Trade Secrets

Protection of trade secrets in an increasingly global environment has become a major concern for U.S. companies. TRIPS refers to trade secrets as “undisclosed information” or “know-how.” Such information is defined similarly to the definition in the United States for trade secrets. To qualify as a “trade secret,” “undisclosed information,” or “know-how,” the information must have commercial value and the owner or organization must take reasonable steps to keep it secret. According to TRIPS, the owner of trade secret information must be able to prevent it from being disclosed to, acquired by, or used by others without his or her consent in a manner contrary to honest commercial practices. A manner contrary to honest commercial practices includes breach of contract, breach of confidence and inducement to breach, as well as the acquisition of undisclosed information by third parties who knew, or were grossly negligent in failing to know, that such practices were involved in the acquisition.

CASE SUMMARY

*I hear the train a comin’
It’s rollin’ round the bend...**
And it ain’t rollin’ on cheatin’ TianRui wheels!
**Johnny Cash: Folsom Prison Blues*

FACTS: Amsted Industries Inc. is a domestic manufacturer of cast steel railway wheels. It owns two secret processes for manufacturing such wheels, the “ABC process” and the “Griffin process.” Amsted previously practiced the ABC process at its foundry in Calera, Alabama, but it no longer uses that process in the United States. Instead, Amsted uses the Griffin process at three of its domestic foundries. Amsted licensed the “ABC process” to several firms with foundries in China. TianRui Group Company Limited, a manufacturer of cast steel railway wheels in China, hired nine employees away from one of Amsted’s Chinese licensees, Datong ABC Castings Company, Limited. Datong had previously notified those employees through a written employee code of conduct that information pertaining to the ABC process was proprietary and confidential. Each employee had been advised that he had a duty not to disclose confidential information. In the proceedings brought by Amsted before the International Trade Commission (ITC), Amsted alleged that the former Datong employees disclosed information and documents to TianRui that revealed the details of the ABC process and thereby misappropriated Amsted’s trade secrets. TianRui partnered with Standard Car Truck Company, Inc., to form the joint venture Barber TianRui Railway Supply, LLC, and has marketed TianRui wheels to United States customers. Other than Amsted, they are the

only companies selling or attempting to sell cast steel railway wheels in the United States. The ITC determined that the importation of the articles violated the Tariff Act and issued a limited exclusion order. TianRui appealed to the United States Court of Appeals for the Federal Circuit.

DECISION: The ITC found that the wheels were manufactured using a process that was developed in the United States, protected under domestic trade secret law, and misappropriated abroad. The appeals court was asked to decide whether the ITC’s statutory authority over “[u]nfair methods of competition and unfair acts in the importation of articles ... into the United States,” as provided by section 337(a)(1)(A), allows it to look to conduct occurring in China in the course of a trade secret misappropriation investigation. The ITC has authority to investigate and grant relief based in part on extraterritorial conduct insofar as it is necessary to protect domestic industries from injuries arising out of unfair competition in the domestic marketplace. The imported TianRui wheels would directly compete with wheels domestically produced by the trade secret owner. Such competition constituted an injury to an “industry” within the meaning of section 337(a)(1)(A) of the Tariff Act. [*TianRui Group Co. Ltd. v. I.T.C.*, 661 F.3d 1322 (Fed. Cir. 2011)]

Dispute Settlement Body (DSB)—means provided by the World Trade Organization for member nations to resolve trade disputes rather than engage in unilateral trade sanctions or a trade war.

10-2h The Dispute Settlement Understanding

When the WTO was formed in 1995, one of the substantial improvements it made to world trade was the creation of the **Dispute Settlement Body (DSB)** to enforce the rules of WTO agreements. Countries, not individuals or business organizations, bring disputes before panels of experts if they think their rights are infringed under a WTO agreement. Independent experts resolve the disputes by interpreting the rules of the agreements. The system encourages resolution of disputes through consultation. But dispute panels are convened if necessary and there is an appeals process.

10-2i The Doha Development Agenda

The current round of WTO trade negotiations began in Doha in 2001. For years this round of negotiations stalled as agricultural issues, including market access, subsidies, and food security, caused deadlock in negotiations. One of the critical issues that continues to be negotiated is “Implementation,” which refers to how developing countries can implement the current WTO agreements. Negotiations are also addressing how WTO rules apply to members that are parties to environmental agreements. The Doha Round insists on the centrality of developing countries and ensuring that they secure a share in world trade.

One of the successes of the Doha Development Agenda (DDA) is the Trade Facilitation Agreement, which was agreed to during the Bali Conference in December 2013. By cutting red tape and streamlining customs procedures in all WTO member countries, the agreement is expected to save trillions of dollars.

10-2j Regional Trade Agreements

The slow pace and numerous complex issues involved in multilateral negotiations often lead countries to seek regional or bilateral agreements. These initiatives co-exist with the multilateral system.

EU

The *European Economic Community* (EEC) was established in 1958 by the Treaty of Rome to remove trade and economic barriers between member countries and to unify their economic policies. It changed its name and became the *European Union* (EU) after the Treaty of Maastricht was ratified on November 1, 1993. The Treaty of Rome, containing the governing principles of this regional trading group, was signed by the original six nations of Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands. Membership expanded with the entry of Denmark, Ireland, and Great Britain in 1973; Greece in 1981; Spain and Portugal in 1986; and Austria, Sweden, and Finland in 1995. Ten countries joined the EU in 2004: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. Bulgaria and Romania joined in 2007 and Croatia in 2013.

The Single European Act eliminated internal barriers to the free movement of goods, persons, services, and capital between EU countries. The Treaty on European Union, signed in Maastricht, Netherlands (the Maastricht Treaty), amended the Treaty of Rome with a focus on monetary and political union. It set goals for the EU of (1) single monetary and fiscal policies, (2) common foreign and security policies, and (3) cooperation in justice and home affairs. The EU acts as a single body for purposes of WTO negotiations.

NAFTA

The *North American Free Trade Agreement* (NAFTA) is an agreement between Mexico, Canada, and the United States, effective January 1, 1994, that included Mexico in the arrangements previously initiated under the United States–Canada Free Trade Agreement of 1989. NAFTA eliminated all tariffs among the three countries over a 15-year period. Side agreements exist to prevent the exploitation of Mexico's lower environmental and labor standards. Products are qualified for NAFTA tariff preferences only if they originate in one or more of the three member countries. Unlike the EU members, which function as one body for WTO purposes, each NAFTA member negotiates on its own behalf.

Other Regional Trade Agreements

In addition to the EU and NAFTA, there are numerous multilateral and bilateral trade agreements. The United States has free trade agreements with 20 countries.¹³ It is currently negotiating the Trans-Pacific Partnership Agreement, which involves a regional Asia-Pacific trade agreement as well as the Transatlantic Trade and Investment Partnership with the European Union.

10-2k Antidumping, Subsidies and Safeguards

WTO agreements seek to ensure the free flow of goods and services through the principles of binding tariffs and most-favored-nation treatment among all trading partners. Nevertheless, countries inevitably run afoul of the rules. The WTO recognizes three circumstances in which the WTO rules must allow exceptions.

Antidumping Actions

dumping—selling goods in another country at less than fair value.

Selling goods in a foreign market at a price lower than normally charged in the home market is referred to as **dumping**. Many governments view dumping as a form of unfair competition and have laws that prohibit and punish dumping. The WTO's Anti-Dumping Agreement does not require but allows governments to take action against dumping. The agreement requires the government to show that the dumping is causing harm to a domestic industry. If there is in fact a dumping violation, the WTO allows the injured country to deviate from its bound tariff requirements and retaliate by charging extra import duties on the product that is being dumped.

In the United States, dumping of foreign goods is prohibited under the Tariff Act of 1930. Two federal agencies examine distinct components of dumping. The International Trade Administration (ITA) of the Department of Commerce investigates whether specified foreign goods are being sold in the United States at less than fair value (LTFV). The International Trade Commission (ITC) conducts proceedings to determine if there is an injury to a domestic industry as a result of such sales. There must be both LTFV sales and injury to a domestic industry before remedial action can be taken. Remedial action might include the addition of duties to reflect the difference between the fair value of the goods and the price being charged in the United States. Decisions of the ITA and ITC may be appealed to the Court of International Trade and, if necessary, to the U.S. Court of Appeals for the Federal Circuit and then to the U.S. Supreme Court.

¹³According to the United States Trade Representative, the United States has free trade agreements with the following countries: Australia, Bahrain, Canada, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Israel, Jordan, Korea, Mexico, Morocco, Nicaragua, Oman, Panama, Peru, and Singapore. <https://ustr.gov/trade-agreements/free-trade-agreements>.

Subsidies and Countervailing Duties

Government subsidies for specific products or industries may also raise concerns about unfair competition. A subsidy may take various forms. A government may require the recipient of a subsidy to meet certain export targets or to use domestic goods instead of imported goods. These types of subsidies are prohibited by the WTO because they distort trade. WTO agreements allow a country to bring claims involving subsidies before the Dispute Settlement Body. If a prohibited subsidy is found, the country impacted may impose countervailing duties. **For Example**, the United States and the European Union imposed substantial tariffs on solar panels made in China because the products were subsidized by the government and may have violated antidumping laws as well.

Safeguards

A WTO member is allowed to temporarily restrict the import of a product that is injuring or threatening to cause “serious injury” to a domestic industry. The WTO has requirements for safeguard investigations to encourage transparency and avoid arbitrary methods.

In the United States, Title II of the Trade Act of 1974¹⁴ provides for relief for U.S. industries, communities, firms, and workers when they are substantially adversely affected by import competition. The Department of Commerce, the Secretary of Labor, and the president have roles in determining eligibility. The relief provided may be temporary import relief through the imposition of a duty or quota on the foreign goods. Workers, if eligible, may obtain readjustment allowances, job training, job search allowances, or unemployment compensation.

Section 301 and Special 301

Although the United States is likely to settle most international trade disputes through the WTO, the Omnibus Trade and Competitiveness Act of 1988 gives the United States broad authority to retaliate against “unreasonable,” “unjustifiable,” or “discriminatory” acts by a foreign country.¹⁵ The authority to retaliate is commonly referred to as “Section 301 authority.” The fear or actuality of the economic sting of Section 301 retaliation often leads offending foreign countries to open their markets to imports. Thus, indirect relief is provided to domestic producers and exporters adversely affected by foreign unfair trade practices.

Enforcement of the act is entrusted to the U.S. Trade Representative (USTR), who is appointed by the president. Under the 1988 act, mandatory retaliatory action is required if the USTR determines that (1) rights of the United States under a trade agreement are being denied or (2) actions or policies of a foreign country are unjustifiable and burden or restrict U.S. commerce. The overall thrust of the trade provisions of the 1988 act is to open markets and liberalize trade.

Special 301 is a provision that pertains specifically to intellectual property rights. Each year the USTR prepares an annual report assessing how U.S. trading partners have protected the intellectual property rights of U.S. rights holders. Countries that have most seriously infringed the rights of U.S. rights holders may be listed on the Priority Watch List or the Watch List.

¹⁴P.L. 93-618, 88 Stat. 1978, 19 U.S.C. §§2251, 2298.

¹⁵P.L. 100-418, 102 Stat. 1346, 15 U.S.C. §4727.

10-3 Issues Confronting Companies Engaged in International Business

10-3a Export Regulations

For reasons of national security, foreign policy, or short supply of domestic products, the United States controls the export of goods and technology. The Export Administration Act imposes export controls on goods and technical data from the United States. The Bureau of Industry and Security (BIS) of the Department of Commerce issues Export Administration Regulations to enforce export controls.

The BIS may impose criminal penalties and administrative sanctions for violations of Export Administration Regulations. When an exported item could be used to threaten national security, the BIS will take action. **For Example**, in 2013, Blue Coat Systems of Sunnyvale, California, supplied Internet control devices to Computerlinks. Computerlinks resold the devices to Syria, an embargoed country. Computerlinks paid a fine of \$2.8 million. Blue Coat escaped liability because its contract with Computerlinks required Computerlinks to comply with all U.S. export laws in its Middle East resales.

10-3b The Foreign Corrupt Practices Act

Congress passed the Foreign Corrupt Practices Act (FCPA) in 1977.¹⁶ U.S. companies, including Lockheed, Northrop, Raytheon, GTE, and Exxon, testified before the Senate Foreign Relations Committee that bribery of foreign officials was rampant. The legislation, which prohibits U.S. companies from bribing foreign officials to obtain or retain business, raised concern that U.S. companies would lose business to countries that did not punish bribery of foreign officials. In 1999, the Organization for Economic Cooperation and Development, an intergovernmental organization, passed a convention that made bribery of a foreign public official illegal. To date, 41 countries have signed the convention.¹⁷ Today, an increasing number of countries are bringing cases for bribery committed within their borders.

What the FCPA Prohibits and Requires

The FCPA prohibits bribing a foreign official to obtain or retain business with a foreign government. It covers issuers of U.S. securities; companies organized under U.S. laws; companies with U.S. headquarters; individuals who are citizens, nationals, or residents of the United States; and non-U.S. companies if they cause a bribe to take place in the United States. Foreign issuers who are listed on a U.S. exchange are issuers for purposes of the FCPA. The FCPA prohibits paying or offering a bribe or authorizing a bribe to a foreign government official, political party, party officials, and candidates for foreign political office. Under the FCPA, the definition of foreign official includes an “instrumentality” of a foreign government. Bribes to an instrumentality of a foreign government are illegal under the FCPA. **For Example**, a court recently held that a company may be an “instrumentality” of a foreign government if the government controls an entity. The court

¹⁶ 15 U.S.C. §§78dd-1, *et seq.*

¹⁷ The current members of the Anti-Bribery Convention are Argentina, Australia, Austria, Belgium, Brazil, Bulgaria, Canada, Chile, Colombia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Russia, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States.

found that Haiti Teleco was an instrumentality of the Haitian government because Haiti's national bank owns 97 percent of Haiti Teleco and the company's director and board members are appointed by the president of Haiti. Thus, bribes to Haiti Teleco employees violated the FCPA.¹⁸

The FCPA also requires that companies maintain accurate books, records, and accounts and have internal controls aimed at preventing and detecting FCPA violations.

There are some exceptions to the bribery provisions. The FCPA does not cover bribes that are legal pursuant to the written law of the foreign official's home state. Most countries, however, have laws prohibiting bribery. The FCPA exempts "facilitating payments" to government officials for routine or clerical governmental actions.

Enforcement

The FCPA is enforced jointly by the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC). Although enforcement was slow initially, it has increased steadily over the last years. Fines have increased dramatically, with Siemens AG paying a fine of \$800 million in 2008. In settlements, the government may require the company to hire a compliance monitor or to submit periodic assessment reports to demonstrate FCPA compliance. In recent years the SEC has increased its role in FCPA enforcement through administrative procedures.

If a company promptly reports violations of the FCPA and cooperates fully with the investigation, it may be treated with leniency. **For Example**, Ralph Lauren Corporation reported that its Argentine subsidiary bribed foreign officials in Argentina to avoid inspection of its products by customs officials. The SEC and DOJ required disgorgement of profits made in connection with the bribes as well as fines. Both the SEC and DOJ entered into nonprosecution agreements with Ralph Lauren Corporation because of its prompt reporting and extensive cooperation in the investigation.

The FCPA provides no private right of action. But shareholder derivative suits and civil RICO suits may be based on harm caused by foreign corruption.

10-3c Antitrust Issues

Increased International Criminalization and Cooperation

Antitrust laws are an important regulatory area for multinational companies. For many years, most countries did not criminalize antitrust conduct. In the last 20 years, countries have increasingly passed laws prohibiting cartel-like behavior. Cartel conduct is now criminal in more than 30 countries.¹⁹ While the United States relies heavily on criminal laws, many countries impose only administrative or civil penalties. Nevertheless, as with international bribery cases, international cooperation had grown in curbing antitrust violations. Because many foreign countries did not have laws criminalizing antitrust action, the Department of Justice could not extradite foreign executives implicated in international bribery schemes. Recently, however, as foreign countries increasingly punish antitrust activity, they have been more willing to help with foreign prosecution or extradition. **For Example**, Romano Piscioti was the oil and gas business manager for Parker ITR srl, an Italian manufacturer of marine hoses. The company, Parker ITR, pled guilty to

¹⁸ *United States v. Esquenazi*, 752 F.3d 912 (11th Cir. 2014).

¹⁹ Mayer-Brown, The Cartel Report, Commentary on Antitrust Enforcement from Around the World (Dec. 18, 2014), available at http://www.mayerbrown.com/files/Publication/9660c732-514e-4287-9bfb-d6e48b7fdc25/Presentation/PublicationAttachment/7c8826b6-55d8-46d5-9cb8-3c1441b04d32/UPDATE-Antitrust_Cartel_Report_1214.pdf.



ETHICS & THE LAW

Combating Bribery of Foreign Public Officials in International Business Transactions

Prior to 1999, German law prohibited bribery of domestic public officials but did not prohibit bribery of foreign officials. Siemens AG, headquartered in Germany, is Europe's largest engineering conglomerate; it conducts business throughout the world. Employees were allowed to withdraw up to €1 million for bribes from three "cash desks" set up at Siemens's offices to facilitate the obtaining of government contracts throughout the world. Until 1999, Siemens claimed tax deductions for these bribes, many of which were listed as "useful expenditures."

The Organization for Economic Cooperation and Development (OECD) works on global issues, endeavoring to help member countries sustain economic growth and employment. The OECD adopted its Anti-Bribery Convention in 1997 and its regulations came into effect in 1999. The Anti-Bribery Convention has legally binding standards criminalizing the bribery of foreign public officials in international business transactions. Germany joined the convention in 1999. Nevertheless, between 2001 and 2004 some \$67 million was withdrawn from the Siemens "cash desks." The bribery had continued! Mark Pieth, chairman of the working group on bribery at the OECD, said, "People felt confident that they were doing nothing wrong."** With some 470,000 employee jobs at Siemens depending on the ability to obtain engineering and high-tech contracts throughout the world, were Siemens contracting agents justified in continuing to make "useful expenditures" to save jobs and their company from ruin? How could these expenditures be a bad thing?

Siemens AG was subject to the FCPA because it was listed on the New York Stock Exchange in 2001. The bribery was first discovered by Munich law enforcement. After the Munich raid, Siemens cooperated with law enforcement agencies in both Germany and the United States. Subsidiaries of Siemens engaged in systematic bribery in countries throughout the world. The DOJ characterized the bribery as "unprecedented in scale and geographic reach," involving more than \$1.4 billion in bribes to government officials in Asia, Africa, Europe, the Middle East, and the Americas.** On December 11, 2008, Siemens AG, pleaded guilty to criminal violations of the United States Foreign Corrupt Practices Act

and received a criminal fine of \$450 million. It also reached a settlement with the U.S. Securities and Exchange Commission for violation of the FCPA's antibribery, books and records, and internal control provisions and agreed to pay \$350 million in disgorgement of profits. Moreover, it agreed to fines and disgorgement of profits of \$569 million to settle an investigation by the Munich Public Prosecutor's Office. Siemens's bribery involved criminal acts that allowed the corporation to have an inherently unfair competitive advantage over other contract bidders. Antibribery laws such as the OECD Convention and the FCPA strive to ensure that public works projects are awarded on the basis of sound economic judgment rather than on the basis of who offers the biggest bribe. The notoriety of the Siemens prosecutions should send a strong and clear message to all trading partners that parties to the convention must not engage in bribery to obtain business deals.** Siemens's board member Peter Solmsen believes that it is a myth that firms have to pay bribes to do business in developing countries and believes that Siemens can increase sales without paying bribes.

In 2011, the SEC brought charges against seven former Siemens AG representatives. Two of the defendants settled with the SEC in 2013 and charges against two were dismissed. In 2014, the SEC resolved charges against the former CFO of Siemens Argentina, Andres Truppel. Truppel agreed to a civil penalty of \$80,000. Default judgments were entered against two defendants who were heads of major projects for Siemens. Neither defendant appeared in the case. The court ordered disgorgement and penalties of nearly \$1,000,000 and \$500,000 against the defendants. The SEC stated that the penalties, the largest civil penalties assessed against individual defendants under the FCPA, reflected the "extensive and egregious nature of the violations and ... their utter refusal to accept any responsibility for their actions."***

**"The Siemens Scandal: Bavarian Baksheesh," *The Economist*, http://www.economist.com/business/displaystory.cfm?story_id=12814642.

**DOJ Press Release, *Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations* (Dec. 15, 2008), <http://www.usdoj.gov>.

****SEC v. Sharef*, C.A. No 11-CIV-09073 (S.D.N.Y. 2014).

charges of participating in a global price-fixing conspiracy in 2010. Piscioti, who resided in Italy, could not be extradited to the United States because his conduct was not criminal under Italian law. But he was arrested by German authorities in Frankfurt while waiting for a connecting flight from Nigeria to Italy. In 2014, Piscioti entered into a plea

effects doctrine—doctrine stating that U.S. courts will assume jurisdiction and will apply antitrust laws to conduct outside of the United States when the activity of business firms has a direct and substantial effect on U.S. commerce; the rule has been modified to require that the effect on U.S. commerce also be direct and foreseeable.

Foreign Trade Antitrust Improvements Act—the act that requires that the defendant’s conduct have a “direct, substantial, and reasonably foreseeable effect” on domestic commerce.

jurisdictional rule of reason—rule that balances the vital interests, including laws and policies, of the United States with those of a foreign country.

comity—principle of international and national law that the laws of all nations and states deserve the respect legitimately demanded by equal participants.

act-of-state doctrine—doctrine whereby every sovereign state is bound to respect the independence of every other sovereign state, and the courts of one country will not sit in judgment of another government’s acts done within its own territory.

agreement with the U.S. Department of Justice, agreeing to serve two years in prison and to pay a \$50,000 fine.²⁰

Jurisdiction

The U.S. antitrust laws have a broad extraterritorial reach. Our antitrust laws must be reconciled with the rights of other interested countries as embodied in international law.

The Effects Doctrine and the FTAIA. Judge Learned Hand’s decision in *United States v. Alcoa* established the **effects doctrine**.²¹ Under this doctrine, U.S. courts assume jurisdiction and apply the antitrust laws to conduct outside of the United States where the activity of the business firms has a direct and substantial effect on U.S. commerce. In 1982, Congress passed the **Foreign Trade Antitrust Improvements Act (FTAIA)**,²² to provide clarity on the extraterritorial reach of the Sherman Act. The FTAIA requires that the defendant’s conduct have a “direct, substantial, and reasonably foreseeable effect” on domestic commerce. **For Example**, in a trial to determine whether the Sherman Act reached a price-fixing scheme between Taiwanese and Korean manufacturers of LCD panels, the defendants conceded that the conduct was substantial and had a reasonably foreseeable effect on United States commerce but maintained that the overseas conduct was not sufficiently “direct” under the FTAIA. In concluding that there was a direct effect, the court noted that the LCD panels were a substantial cost component of the finished product; that some panels were sold directly into the United States; that some were sold to subsidiaries of American companies and then incorporated into finished products; that the finished products were destined for the United States; and that the practical upshot of the conspiracy was increased prices to customers in the United States. The Department of Justice obtained a \$500 million fine against the company and three-year sentences for its former president and vice president.²³

The Jurisdictional Rule of Reason. The jurisdictional rule of reason applies when conduct taking place outside the United States affects U.S. commerce but a foreign state also has a significant interest in regulating the conduct in question. The **jurisdictional rule of reason** balances the vital interests, including laws and policies, of the United States with those of the foreign country involved. This rule of reason is based on **comity**, a principle of international law, that means that the laws of all nations deserve the respect legitimately demanded by equal participants in international affairs.

Defenses

Three defenses are commonly raised to the extraterritorial application of U.S. antitrust laws. These defenses are also commonly raised to attack jurisdiction in other legal actions involving international law.

Act-of-State Doctrine. By the **act-of-state doctrine**, every sovereign state is bound to respect the independence of every other sovereign state, and the courts of one country will not sit in judgment of another government’s acts done within its own territory.²⁴ The act-of-state doctrine is based on the judiciary’s concern over its possible interference with the conduct of foreign relations. Such matters are considered to be political, not judicial, questions.

²⁰ See *United States v. Piscioti, Plea Agreement*, available at <http://www.justice.gov/atr/cases/f305500/305542.pdf>.

²¹ 148 F.2d 416 (2d Cir. 1945).

²² 15 U.S.C. 6a.

²³ See *United States v. Hui Hsiung*, 778 F.3d 738 (9th Cir. 2015).

²⁴ *Underhill v. Hernandez*, 108 U.S. 250, 252 (1897).

sovereign compliance doctrine—doctrine that allows a defendant to raise as an affirmative defense to an antitrust action the fact that the defendant's actions were compelled by a foreign state.

sovereign immunity doctrine—a doctrine that states that a foreign sovereign generally cannot be sued without its consent.

The Sovereign Compliance Doctrine. The **sovereign compliance doctrine** allows a defendant to raise as an affirmative defense to an antitrust action the fact that the defendant's actions were compelled by a foreign state. To establish this defense, compulsion by the foreign government is required. The Japanese government uses informal and formal contacts within an industry to establish a consensus on a desired course of action. Such governmental action is not a defense for a U.S. firm, however, because the activity in question is not compulsory.

The Sovereign Immunity Doctrine. The **sovereign immunity doctrine** states that a foreign sovereign generally cannot be sued unless an exception to the Foreign Sovereign Immunities Act of 1976 applies.²⁵ The most important exception covers the commercial conduct of a foreign state.²⁶

10-3d Securities Fraud Regulation in an International Environment

Illegal conduct in the U.S. securities markets, whether initiated in the United States or abroad, threatens the vital economic interests of the United States. Investigation and litigation concerning possible violations of the U.S. securities laws often have an extraterritorial effect. Conflicts with the laws of foreign countries may occur.

Jurisdiction

U.S. district courts have jurisdiction over violations of the antifraud provisions of the Securities Exchange Act of 1934 when losses occur from sales to Americans living in the United States.²⁷ U.S. district courts also have jurisdiction when losses occur to Americans living abroad if the acts occurred in the United States. The antifraud provisions do not apply, however, to losses from sales of securities to foreigners outside the United States unless acts within the United States caused the losses.²⁸

CASE SUMMARY

Extraterritorial Effect of United States Securities Law

FACTS: A federal jury convicted George Georgiou of conspiracy, securities fraud, and wire fraud for his participation in planned manipulation of the markets of four publicly traded stocks, resulting in more than \$55,000,000 in actual losses. The district court sentenced him to 300 months' imprisonment, ordered him to pay restitution of \$55,823,398 and also subjected him to forfeiture of \$26,000,000. The four target stocks were quoted on the OTC Bulletin Board (OTCBB) or the Pink OTC Markets Inc. (Pink Sheets), which are not considered national securities exchanges. Georgiou and his

co-conspirators opened brokerage accounts in Canada, the Bahamas, and Turks and Caicos. They artificially inflated the stock prices and created the false impression that there was an active market in the target stocks. In June 2006, one of Georgiou's co-conspirators began cooperating in an FBI sting. The FBI found that at least some of the manipulated trades were transacted through market makers in the United States. Georgiou maintained that his convictions were improperly based on the extraterritorial application of United States law.

²⁵ See *Verlinden B.V. v. Central Bank of Nigeria*, 461 U.S. 574 (1983).

²⁶ See *Dole Food Co. v. Patrickson*, 538 U.S. 468 (2003) for a limited discussion of when a foreign state can assert a defense of sovereign immunity under the Foreign Sovereign Immunities Act of 1976 (FSIA). The FSIA allows certain foreign-state commercial entities not entitled to sovereign immunity to have the merits of a case heard in federal court. The U.S. Supreme Court held in the *Dole Food* case that a foreign state must itself own a majority of the shares of a corporation if the corporation is to be deemed an instrumentality of the state under the FSIA, and the instrumentality status is determined at the time of the filing of the complaint.

²⁷ *Kauthar Sdn. Bhd. v. Sternberg*, 149 F.3d 659 (7th Cir. 1998).

²⁸ *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010).

Extraterritorial Effect of United States Securities Law continued

DECISION: Judgment of Conviction Affirmed. Several of the purchases were executed by market makers operating within the United States and the stocks involved were stocks in U.S. companies. The transactions were domestic

transactions because it is the place where the purchase and sale of securities occurred, not the place where the deception originated that matters. [*United States v. Georgiou*, 777 F.3d 125 (3rd Cir. 2015)]

secrecy laws—confidentiality laws applied to home-country banks.

blocking laws—laws that prohibit the disclosure, copying, inspection, or removal of documents located in the enacting country in compliance with orders from foreign authorities.

Impact of Foreign Secrecy Laws in SEC Enforcement

Secrecy laws are confidentiality laws applied to home-country banks. These laws prohibit the disclosure of business records or the identity of bank customers. **Blocking laws** prohibit the disclosure, copying, inspection, or removal of documents located in the enacting country in compliance with orders from foreign authorities. These laws impede, and sometimes foreclose, the SEC's ability to police its securities markets properly.

Make the Connection

Summary

U.S. firms choose to do business abroad by making export sales or contracting with a foreign distributor to take title to their goods and sell them abroad. U.S. firms may also license their technology or trademarks for foreign use. An agency arrangement or the organization of a foreign subsidiary may be required to participate effectively in foreign markets. This choice results in subjecting the U.S. firm to taxation in the host country. However, tax treaties commonly eliminate double taxation.

When contracting internationally, firms should select where they want any disputes to be resolved and which law should apply. The CISG is an international treaty that may be used instead of national law.

The World Trade Organization administers several international treaties involving trade in goods, services, and intellectual property. All WTO agreements require the 160 member nations to abide by the principles of non-discrimination and national treatment. Through rounds of negotiations, WTO members aim to reduce tariffs to liberalize world trade. The WTO also seeks to resolve

issues involving dumping and government subsidies through consultation or through its Dispute Settlement Body.

Multinational corporations face numerous issues including export restrictions, antitrust laws, bribery laws, and securities laws. In some cases, U.S. law will protect or restrict the behavior of a foreign corporation. The extraterritorial reach of U.S. laws has been controversial. If Congress does not specify otherwise, the presumption is that U.S. laws do not have an extraterritorial reach. The Foreign Corrupt Practices Act prohibits the bribing of a foreign official by U.S. companies or their agents to obtain or retain business. Increasingly, other countries are criminalizing cartel activity and cooperating with U.S. authorities. U.S. securities laws do not have extraterritorial effect but courts may find that the laws do apply if the parties committed to the fraudulent activity in the United States. Antitrust laws may also have extraterritorial reach if the activity had a direct, substantial, and reasonably foreseeable effect on commerce in the United States.

Learning Outcomes

After studying this chapter, you should be able to clearly explain:

10-1 Conducting Business Internationally

- LO.1** List the methods of doing business abroad
See the discussion of export sales, appointing of an agent, foreign distributorships, licensing, and subsidiaries, pages 182–183.
- LO.2** Explain which country’s law will govern an international contract should a dispute arise
See the discussion regarding national law, the CISG, and arbitration, pages 183–184.
See the choice of law example where the U.S. courts required the Lipcons to “honor their bargains” and vindicate their claims in an English court, page 183.

10-2 International Trade

- LO.3** Explain tariff barriers and nontariff barriers to the free movement of goods across borders
See the example involving the U.S. embargo on all Brazilian shrimp because of Brazil’s failure to require turtle excluder devices on its shrimp boats, page 186.
- LO.4** Identify the agreements administered by the World Trade Organization
See the discussion involving the GATT, GATS, and TRIPS, pages 186–187.

- LO.5** Explain how to register and protect trademarks abroad

See the discussion on the Madrid System, the European Community Trademark, and the importance of first to file regulations, page 187.
See the *Cubatabaco* case, page 188.

- LO.6** Explain how trade disputes are resolved

See the discussion on the Dispute Settlement Body, page 191.

- LO.7** Explain how antidumping duties and countervailing duties operate under the WTO agreements

See the discussion under the section titled “Anti-dumping, Subsidies and Safeguards,” pages 192–193.

10-3 Issues Confronting Companies Engaged in International Business

- LO.8** Explain U.S. law regarding payment to foreign government officials

See the Ethics & Law discussion regarding Siemens AG, page 196.

- LO.9** Explain how U.S. securities laws might apply to foreign transactions

See the *Georgiou* case, pages 200–201.

Key Terms

act-of-state doctrine
agent
blocking laws
choice-of-law clause
comity
Dispute Settlement Body (DSB)
distributor
dumping

effects doctrine
export sale
Foreign Trade Antitrust
Improvements Act
franchising
jurisdictional rule of reason
letter of credit
licensing

most-favored-nation
national treatment
principal
secrecy laws
sovereign compliance doctrine
sovereign immunity doctrine
tariff
well-known mark

Questions and Case Problems

- How does the selling of subsidized foreign goods in the United States adversely affect free trade?
- Able Time Inc. imported a shipment of watches into the United States. The watches bore the mark “TOMMY,” which is a registered trademark owned by Tommy Hilfiger. U.S. Customs seized the watches pursuant to the Tariff Act, which authorizes seizure of any “merchandise bearing a counterfeit

mark.” Tommy Hilfiger did not make or sell watches at the time of the seizure. Able argued that because Tommy Hilfiger did not make watches at the time of the seizure, the watches it imported were not counterfeit, and the civil penalty imposed by Customs was unlawful. The government argued that the mark was counterfeit and that the Tariff Act does not require the owner of the registered mark to make the

- same type of goods as those bearing the offending mark. Decide. [*U.S. v. Able Time, Inc.*, 545 F.3d 824 (9th Cir.)]
3. Ronald Sadler, a California resident, owned a helicopter distribution company in West Germany, Delta Avia. This company distributed U.S.-made Hughes civilian helicopters in western Europe. Sadler's German firm purchased 85 helicopters from Hughes Aircraft Co. After export licenses were obtained in reliance on the purchaser's written assurance that the goods would not be disposed of contrary to the export license, the helicopters were exported to Germany for resale in western Europe. Thereafter, Delta Avia exported them to North Korea, which was a country subject to a trade embargo by the United States. The helicopters were converted to military use. Sadler was charged with violating the Export Administration Regulations. In Sadler's defense, it was contended that the U.S. regulations have no effect on what occurs in the resale of civilian helicopters in another sovereign country. Decide.
 4. Mirage Investments Corp. (MIC) planned a tender offer for the shares of Gulf States International Corp. (GSIC). Archer, an officer of MIC, placed purchase orders for GSIC stock through the New York office of the Bahamian Bank (BB) prior to the announcement of the tender offer, making a \$300,000 profit when the tender offer was made public. The Bahamas is a secrecy jurisdiction. The bank informed the SEC that under its law, it could not disclose the name of the person for whom it purchased the stock. What, if anything, may the SEC do to discover whether the federal securities laws have been violated?
 5. United Overseas, Ltd. (UOL), is a U.K. firm that purchases and sells manufacturers' closeouts in Europe and the Middle East. UOL's representative, Jay Knox, used stationery listing a UOL office in New York to solicit business from Revlon, Inc., in New York. On April 1, 1992, UOL faxed a purchase order from its headquarters in England to Revlon's New York offices for the purchase of \$4 million worth of shampoo. The purchase order on its face listed six conditions, none of which referred to a forum selection clause. When Revlon was not paid for the shampoo it shipped, it sued UOL in New York for breach of contract. UOL moved to dismiss the complaint because of a forum selection clause, which it stated was on the reverse side of the purchase order and provided that "the parties hereby agree to submit to the jurisdiction of the English Courts disputes arising out of the contract." The evidence did not show that the reverse side of the purchase order had been faxed with the April 1992 order. Should the court dismiss the complaint based on the "forum selection clause"? Read Chapter 31 on letters of credit and advise Revlon how to avoid similar litigation in the future. [*Revlon, Inc. v. United Overseas, Ltd.*, 1994 WL 9657 (S.D.N.Y.)]
 6. Reebok manufactures and sells fashionable athletic shoes in the United States and abroad. It owns the federally registered Reebok trademark and has registered this trademark in Mexico as well. Nathan Betch is a Mexican citizen residing in San Diego, California, with business offices there. Reebok believed that Betch was in the business of selling counterfeit Reebok shoes in Mexican border towns, such as Tijuana, Mexico. It sought an injunction in a federal district court in California ordering Betch to cease his counterfeiting activity and to refrain from destroying certain documents. It also asked the court to freeze Betch's assets pending the outcome of a Lanham Act lawsuit. Betch contended that a U.S. district court has no jurisdiction or authority to enter the injunction for the activities allegedly occurring in Mexico. Decide. [*Reebok Int'l, Ltd. v. Marnatech Enterprises, Inc.*, 970 F.2d 552 (9th Cir.)]
 7. A complaint was filed with the U.S. Commerce Department's ITA by U.S. telephone manufacturers AT&T, Comidial Corp., and Eagle Telephones, Inc., alleging that 12 Asian manufacturers of small business telephones, including the Japanese firms Hitachi, NEC, and Toshiba and the Taiwanese firm Sun Moon Star Corp. were dumping their small business phones in the U.S. market at prices that were from 6 percent to 283 percent less than those in their home markets. The U.S. manufacturers showed that the domestic industry's market share had dropped from 54 percent in 1985 to 33 percent in 1989. They asserted that it was doubtful if the domestic industry could survive the dumping. Later, in a hearing before the ITC, the Japanese and Taiwanese respondents contended that their domestic industry was basically sound and that the U.S. firms simply had to become more efficient to meet worldwide competition. They contended that the United States was using the procedures before the ITA and ITC as a nontariff barrier to imports. How should the ITC decide the case? [*American Telephone and Telegraph Co. v. Hitachi*, 6 I.T.C. 1511]

8. Roland Staempfli was employed as the chief financial officer of Honeywell Bull, S.A. (HB), a Swiss computer company operating exclusively in Switzerland. Staempfli purportedly arranged financing for HB in Switzerland through the issuance of promissory notes. He had the assistance of Fidenas, a Bahamian company dealing in commercial paper. Unknown to Fidenas, the HB notes were fraudulent. The notes were prepared and forged by Staempfli, who lost all of the proceeds in a speculative investment and was convicted of criminal fraud. HB denied responsibility for the fraudulently issued notes when they came due. Fidenas's business deteriorated because of its involvement with the HB notes. It sued HB and others in the United States for violations of U.S. securities laws. HB defended, arguing that the U.S. court did not have jurisdiction over the transactions in question. Decide. [*Fidenas v. Honeywell Bull, S.A.*, 606 F.2d 5 (2d Cir.)]
9. Marc Rich & Co., A.G., a Swiss commodities trading corporation, refused to comply with a grand jury subpoena requesting certain business records maintained in Switzerland and relating to crude oil transactions and possible violations of U.S. income tax laws. Marc Rich contended that a U.S. court has no authority to require a foreign corporation to deliver to a U.S. court documents located abroad. The court disagreed and imposed fines, froze assets, and threatened to close a Marc Rich wholly owned subsidiary that did business in the state of New York. The fines amounted to \$50,000 for each day the company failed to comply with the court's order. Marc Rich appealed. Decide. [*Marc Rich v. United States*, 707 U.S. 633 (2d Cir.)]
10. U.S. Steel Corp. formed Orinoco Mining Co., a wholly owned corporation, to mine large deposits of iron ore that U.S. Steel had discovered in Venezuela. Orinoco, which was incorporated in Delaware, was subject to Venezuela's maximum tax of 50 percent on net income. Orinoco was also subject to U.S. income tax, but the U.S. foreign tax credit offset this amount. U.S. Steel purchased the ore from Orinoco in Venezuela. U.S. Steel formed Navios, Inc., a wholly owned subsidiary, to transport the ore. Navios, a Liberian corporation, was subject to a 2.5 percent Venezuelan excise tax and was exempt from U.S. income tax. Although U.S. Steel was Navios's primary customer, it charged other customers the same price it charged U.S. Steel. U.S. Steel's investment in Navios was \$50,000. In seven years, Navios accumulated nearly \$80 million in cash but had not paid any dividends to U.S. Steel. The IRS used IRC §482 to allocate \$52 million of Navios's income to U.S. Steel. U.S. Steel challenged this action, contending that Navios's charges to U.S. Steel were at arm's length and the same it charged other customers. Decide. [*United States Steel Corp. v. Commissioner*, 617 F.2d 942 (2d Cir.)]
11. National Computers, Inc., a U.S. firm, entered into a joint venture with a Chinese computer manufacturing organization, TEC. A dispute arose over payments due the U.S. firm under the joint venture agreement with TEC. The agreement called for disputes to be arbitrated in China, with the arbitrator being chosen from a panel of arbitrators maintained by the Beijing arbitration institution, Cietac. What advantages and disadvantages exist for the U.S. firm under this arbitration arrangement? Advise the U.S. firm on negotiating future arbitration agreements with Chinese businesses.
12. Sensor, a Netherlands business organization wholly owned by Geosource, Inc., of Houston, Texas, made a contract with C.E.P. to deliver 2,400 strings of geophones to Rotterdam by September 20, 1982. The ultimate destination was identified as the USSR. Thereafter, in June 1982, the president of the United States prohibited shipment to the USSR of equipment manufactured in foreign countries under license from U.S. firms. The president had a foreign policy objective of retaliating for the imposition of martial law in Poland, and he was acting under regulations issued under the Export Administration Act of 1979. Sensor, in July and August 1982, notified C.E.P. that as a subsidiary of a U.S. corporation, it had to respect the president's embargo. C.E.P. filed suit in a district court of the Netherlands asking that Sensor be ordered to deliver the geophones. Decide. [*Compagnie Européenne des Pétroles v. Sensor Nederland*, 22 I.L.M. 66]